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Trade, Direct Investment,
and Future Strategy

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Trade, Direct Investment,
and Future Strategy

Shuichi Ono

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Foreword

The World Bank's economic and sector work program on China is a very active one ranging over a wide spectrum of topics from macroeconomics to health and education. Each year we publish a handful of our formal studies, but thus far most of the background papers and informal reports, many of them containing valuable analysis and information, have remained outside the public domain. Through the China and Mongolia Department Working Paper Series, we hope to make available to a broad readership among the China watchers and development communities a few of the papers which can contribute to a better understanding of China's modernization.

This study by Mr. Ono examines the pattern of Sino-Japanese trade during the nineteen eighties and identifies the factors responsible for it. It provides the Japanese perspective on direct foreign investment in China with emphasis on geographical and subsectoral distribution. Finally, the paper explores the likely future trends in both trade as well as investment flows between the two countries.

Shahid Javed Burki
Director
China and Mongolia Department
Asia Region

CURRENCY EQUIVALENTS

(As of November 1990)

Currency unit = Yuan (Y) = 100 Fen
Y 1.00 = \$0.19
\$1.00 = Y 5.22

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS

ASEAN	-	The Association of Southeast Asian Nations
DFI	-	Direct Foreign Investment
JETRO	-	Japan External Trade Organization
kd	-	knock-down
MOF	-	Ministry of Finance
NIC	-	Newly Industrialized Country
OECD	-	Organization for Economic Cooperation and Development

SUMMARY

Trade

i. China's shift towards greater openness resulted in a rapid expansion in Japan's international trade with China with Japanese exports peaking in 1985. Thereafter, the appreciation of the yen eroded the competitiveness of Japanese goods and discouraged Japanese producers from attempting to make further inroads into Chinese markets. In addition, China's own efforts at restraining investment and curbing imports further constrained purchases from Japan.

ii. Three concerns have shaped Japan's economic relations with China since the late 1970s: political stability under conditions of outward-oriented growth, the development of business opportunities for Japanese firms, and the strengthening of trends in China's energy sector that would facilitate Japan's efforts at diversifying its sources of fuels.

iii. By 1990, Japan's exports had shrunk to almost half of the peak of 1985 and trade between the two countries had been altered in two respects. One was the drastic change in the composition of traded goods. Iron and steel, which accounted for more than half of Japan's exports to China in 1977, now represent only 17 percent of exports. Oil's share of Japan's imports from China dropped from 45 percent to 14 percent during the decade. Currently, nearly half of Japan's exports to China consists of machinery, and various manufactured goods such as apparel and machinery comprise over half of Japan's imports from China.

iv. The second fundamental change was Japan's losing its title to Hong Kong of being China's "No. 1" trade partner. It now accounts for only one sixth of China's external trade, a little over a half of Hong Kong's share.

v. However, Japanese business is cautiously optimistic regarding future trends in trade. Exporters are encouraged by the improved prospects for the Chinese economy, resumption of the disbursement of the Yen Credit and talks about the Ex-Im Bank's third natural resources loan. The importers are counting on such factors as: the depreciation of the Yuan last November, last year's record crop of agricultural products, stabilization in China's domestic economy and development of joint-venture manufacturing.

vi. For these expectations to be realized, Chinese exporters will have to deal with a number of problems: specifically, belated delivery, poor quality, cancellation of contracts and alteration of contracts. Some Japanese importers were reported to have abandoned China and shifted their supply sources to other Asian countries which they think are more reliable. Frequent change in China's economic policy have also tended to discourage some exporters.

vii. In order to expand exports to Japan, China needs to improve the quality and design of export goods. At the same time, it needs to streamline and upgrade the marketing operations of enterprises and foreign trade corporations engaged in trade.

Direct Investment

viii. Japanese direct foreign investment (DFI) to China has been motivated by the immense potential of China. But, so far, the realized investment falls short of expectations on both sides. Japanese DFI in China accounts for only 1 percent of Japan's total DFI, or 6 percent of such investment in Asia.

ix. The service industry dominated Japan's investment in China until 1987. In those years, the amount invested in the service sector alone accounted for two to five times the size of DFI in all the manufacturing sub-sectors. Leasing and the hotel industry were the areas most favored because of short payback periods, high returns and ease of repatriating profits from foreign exchange earnings.

x. As for the manufacturing industry, large-scale firms were slow to invest. Unstable economic policy and the lack of legal transparency were major problems. Chinese restrictions on foreign exchange was also identified as a major obstacle. In this period, manufacturing investment in China was mostly conducted by smaller Japanese businesses, at least in terms of numbers of projects. These companies almost monopolized textile industry investment. They also enjoyed a dominant role in many of the sectors of manufacturing.

xi. It was only in 1988 that Japan's big business started large-scale investment in China, when Japan committed a massive Yen Credit and an investment protection treaty was concluded between the two countries. Such moves seem to have given the kind of assurance capital-intensive investment awaited.

xii. Compared with other investing countries, Japan's DFI in China has a few distinct features. They are: (i) paucity of manufacturing DFI, (ii) the tendency to invest in small lots; (iii) preference of three major cities and coastal provinces; and (iv) preponderance of small or medium enterprises in terms of number of investment.

xiii. In recent years, however, the share of smaller firms' investment has been declining, while such a ratio is increasing in the rest of Asia. This is because larger Japanese investors are not pulling in as many small firms as they do in other Asian countries, and because small firms which lack political clout are inhibited by bureaucratic obstacles.

xiv. DFI's effects on trade are mixed. It seems to have played a decisive role in the recent upsurge in Japan's electronic machinery imports from China. However, the effects of DFI on apparel imports to Japan have been marginal.

xv. In the future, Japanese businesses will increasingly consider Asia as an important part of their globalization strategy. Within Asia, an intra-firm division of labor is being established. As a result of automation, production of lower-end products is not always drawn to low-wage countries anymore. Cheap labor is not sufficient for manufacturers to decide locations of their offshore production. Infrastructure, skills, ease of doing business and other factors rank higher in importance.

xvi. In order to successfully compete with the other Asian countries, China needs to: make full use of its advantages such as a potentially huge

domestic market, abundant labor, and proximity to Japan, by pursuing a stable economic policy, improving the infrastructure and increasing the transparent legal systems. Furthermore, it needs to pay more attention to the important role of small- and medium-size firms in transfer of their unique technology and know-how, and in complementing production linkages.

xvii. China may well have a chance to attract a larger portion of Japan's DFI in Asia in the near future because traditional locations of Japan's DFI are now being saturated.

China's Economic Future

xviii. Japan's business community tends to have a pragmatic view on China's future. They believe that China will keep its open-door policy and economic reforms, and that the Chinese economy will grow at least 6 percent a year. China is expected to play a much more important role than now as an integral part of the Asian production network. Liaoning, Shandong and the region around Shanghai are drawing special attention because of the geographical proximity to Japan. Among these three, Liaoning, in particular Dalian, is attracting increasing numbers of Japan's DFI.

xix. In the coming years, China is likely to have more economic rivals in addition to already very tough competitors in Southeast Asia. They are North Korea, the Soviet Union (its far-eastern region), Vietnam and other socialist countries in Indo-China.

xx. As the Chinese economy becomes more trade-oriented, changes in its production or demand of commodities will have a much larger impact on the external world. In particular, Japan, as a country that is dependent upon trade, especially the import of basic materials, such as mineral fuels and food, would benefit from the steady growth of China's economy.

xxi. The possibility that China may become a net importer of oil later in this decade and possibly more dependent on foreign supplies of grain is viewed with some apprehension. These concerns explain why a large portion of Japan's financial assistance to China is allocated towards energy- and food- (or fertilizer)-related projects. Another worry, increasingly recognized by the Japanese, is the environmental problems China's economic expansion will create. In the near future, Japan's technical assistance as well as financial support will be directed more and more toward environmental issues.

Conclusion

xxii. Being one of the closest neighbors to China with strong cultural and historical ties, Japan has always been attracted by China. It is, therefore, somewhat surprising that Japan has failed to strengthen its economic relationship with China to the due extent it should have over the past decade or so, but future trends are increasingly positive.

xxiii. Being the key economic powers in Asia where the most dynamic economic development is expected into the next century, China and Japan would be able to acquire enormous benefit through expansion of a mutual economic relationship. Failure to fulfill its potential would not only deny benefits to the two countries, but also hamper the development of the whole region.

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I. TRADE

1.1 China's spectacular development through the 1980s has transformed Sino-Japanese trade to a great extent. One of the most striking changes can be found in the composition of the traded goods. For example, iron and steel which accounted for 53 percent of Japan's total exports to China in 1977 now represents only 17 percent. And the share of oil in Japan's imports from China dropped from 45 percent to 14 percent during the decade. Nearly half of Japan's exports to China now consists of machinery. Various manufactured goods including machines, rather than raw materials or agricultural products comprise over a half of China's exports to Japan. At the same time, Japan has lost its title to Hong Kong of being China's "No. 1" trade partner (Table 1.1). It now accounts for only one-sixth of China's external trade, a little over one-half of Hong Kong's share.

Table 1.1: CHINA'S TRADE WITH MAJOR PARTNERS (TOTAL OF EXPORTS AND IMPORTS)
(%)

	Total	Hong Kong	Japan	United States	Germany	Others
1978	100.0	-	23.4	4.8	6.6	65.3
1980	100.0	-	24.3	12.7	5.4	57.5
1981	100.0	15.1	25.3	14.3	5.0	40.2
1982	100.0	15.9	21.4	14.8	4.3	43.6
1983	100.0	17.3	23.1	10.3	4.8	44.5
1984	100.0	18.4	26.0	12.1	4.0	39.5
1985	100.0	17.2	30.4	10.7	4.5	37.2
1986	100.0	20.8	23.3	10.0	6.2	39.7
1987	100.0	26.9	19.9	9.5	5.3	38.4
1988	100.0	29.4	18.5	9.7	4.8	37.6
1989	100.0	30.9	16.9	11.0	4.5	36.8

Note: Figures for 1978-80 based on FTD, for 1981-89 on GAC.

Source: Before 1983, IDE (1987); after 1984, OECF (1990).

1.2 For China, Japan has been an important source of equipment, material, technology and capital for its economic development, as well as an outlet for its manufactured products and natural resources. However, China has always wanted to alleviate its excessively large dependence on Japan, particularly in imports. In this sense, the recent decline in Japan's share can be viewed in a positive light. The same can be said for the diversification of composition of the trade between the two countries. But what is the reason behind this? Will this last or go further? This chapter reviews the development of the Sino-Japanese trade since the late 1980s with a special focus on the latter half of the decade, attempts to give answers to the above questions, and tries to shed some light on the future prospects.

A. Japan's Strategy in the First Half of the Eighties

1.3 In February 1978, shortly before China's then-president Mr. Hua disclosed the ambitious ten-year economic development plan at the People's Congress, a long-term trade protocol was signed between Chinese and Japanese business representatives. This protocol, not being a governmental treaty and not binding to either side, concerned Japan's exports of technology, plants, construction materials and equipment to China in exchange for China's oil and coal exports to Japan. Both sides agreed that, during the eight years starting with 1978, these shipments should amount to around \$10 billion each. As for crude oil, coking coal and fuel coal, a specific annual shipment schedule was targeted for the first five years. In March 1979, this protocol was extended to cover 13 years rather than eight years and the total amount of shipments was agreed to broaden to \$20-30 billion for each side.

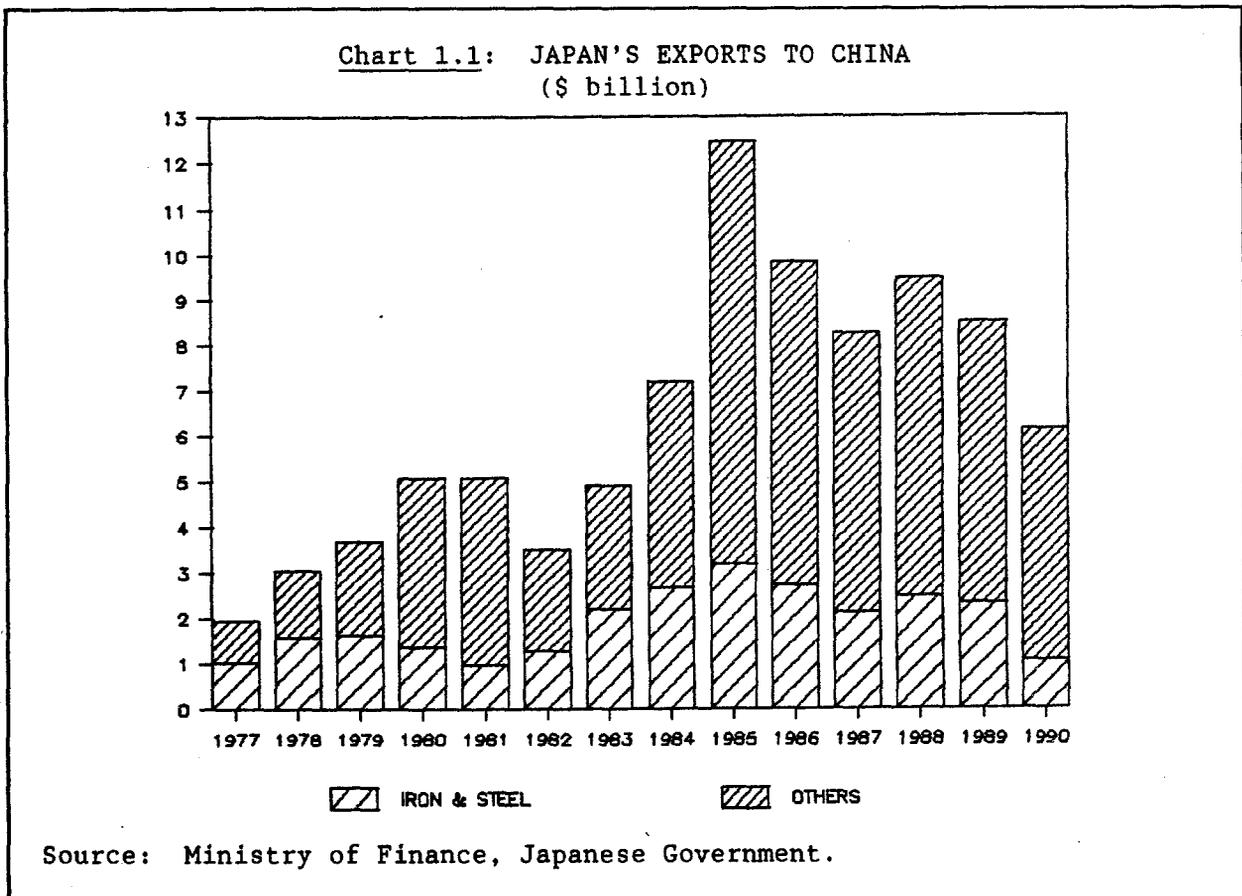
1.4 In the early 1980s, the Japanese government moved to offer financial assistance to China. It was agreed that Japan's Overseas Economic Cooperation Fund would extend Yen Credit to China for its infrastructure development projects. It was the first government loan China accepted from a foreign country since it borrowed money from the USSR during its first Five-Year Plan. The Export-Import Bank of Japan also allocated ¥ 420 billion to development of natural sources in China. Later in 1980, the Chinese and Japanese agreed to jointly explore the offshore oilfield in the Bohai Sea and to develop three coal mines.

1.5 Such moves reflect the basic standpoint of the Japanese toward China. Japan's China strategy was threefold. Firstly, it wanted China as a politically stable, more outward-oriented economy. The Japanese hoped that the extended credit would strengthen the position of newly emerged reform-oriented leadership through improvement of basic economic conditions. At the same time, it was hoped that such credit would generate opportunities to the Japanese manufacturers of plant and equipment and other basic industrial materials which were hit hard by the two oil crises. The other consideration concerned the diversification of energy sources. Japan, which is almost totally dependent on overseas supplies of oil, badly needed to lessen the importance of the Middle Eastern oil. China had oil as well as coal and was geographically much closer to Japan.

1.6 In 1978, Japanese exports to China grew by 57 percent and imports expanded by 31 percent over the previous year. Such a brisk pace of expansion was maintained for a couple of years, but in the early 1980s, both exports and imports experienced a setback. Faced with a shortfall of energy and worsened international trade deficits, the Chinese government enforced deflationary measures and controls on trade. During late 1980 and the beginning of 1981, the Chinese surprised the Japanese by informing them of massive cancellations or suspensions of awarded plant projects, which, as a total, amounted to ¥ 300 billion. This, combined with curbs on durable consumption goods imports, resulted in a decline in Sino-Japanese trade in 1982 for the first time in six years. In this year, Japanese exports to China declined by 31 percent, while its imports registered a meager 1 percent growth. The most severely affected export category was "machinery and equipment," which shrank to less than half the 1981 level (Charts 1.1 and 1.2).

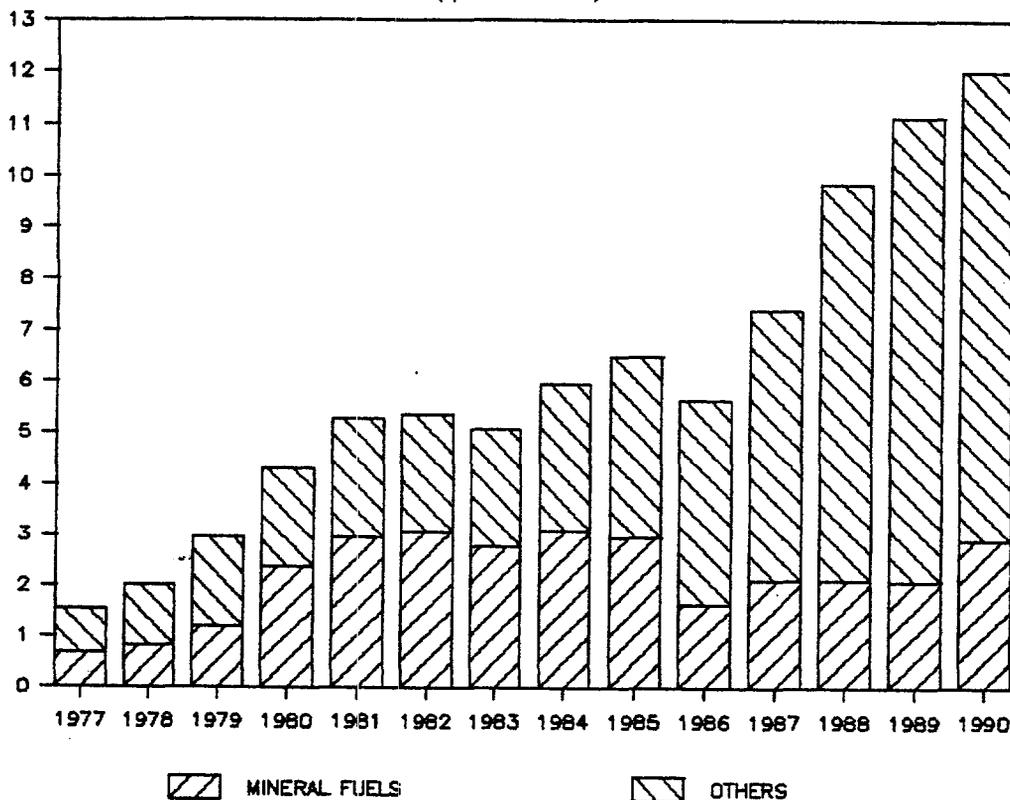
1.7 However, as the Chinese economy resumed its brisk expansion, Sino-Japanese trade also expanded rapidly. In the three years up to 1985, Japan's exports grew by 40, 47 and 73 percent, respectively, each year. In the meantime, the second round of Yen Credit was agreed between the Japanese and Chinese governments in 1984. This loan, amounting to ¥ 470 billion, was to be supplied during the six-year period starting in 1984 and to follow up the first round of such loans agreed in 1979 which amounted to ¥ 330 billion in the five years to 1983. There seemed no cloud on the horizon for the Sino-Japanese trade relationship. JETRO's (Japan External Trade Organization) annual white paper on external trade described it as a "honeymoon" in its 1984 issue.

1.8 At the end of 1984 and toward the start of 1985, a "China Boom" hit the Japanese industry. China's economic reforms, particularly the decentralization of authority to import, combined with rise in income triggered an explosion in demand for such imports as TVs and motor vehicles. During the two years to 1985, Japan's TV exports to China jumped by 15 times, and motor vehicles expanded by 12 times. Japan's exports to China in 1985, as a whole, grew 2.5 times the size of 1983 levels.



1.9 Japanese industries, which had been suffering from very slow growth in the domestic economy induced by the second oil crisis and worsening trade friction in the overseas market, saw an invaluable potential outlet for their excess goods in the burgeoning import market in China. For instance, the iron and steel industry, which was experiencing an unprecedented sharp drop in

Chart 1.2: JAPAN'S IMPORTS FROM CHINA
(\$ billion)



Source: Ministry of Finance, Japanese Government.

demand both in Japan and abroad, took to the Chinese market and shipped a quarter to one third of their total exports by cutting their prices. The "China prices," as traditionally cheaper prices of steel products for China were called, were set at nearly 40 percent less than the regular export prices in this period. In 1985, at its peak, the Japanese steel mills directed more than one-tenth of their domestic production to China. Japan's TV manufacturers found a much greater opportunity there. In 1985, the Chinese market consumed 44 percent of exported Japanese TVs, or one-third of Japan's total production of TVs that year. To cope with a sudden boom in China, they even had to expand production lines.

1.10 Alarmed by swollen trade deficits, falling oil prices and shrinking foreign reserves, the Chinese government began curbing imports in the latter half of 1985. Fixed investment in the state industry was slated to decrease in 1986. In July, the yuan was depreciated. The Chinese were particularly concerned over the huge deficits with Japan which amounted to 60 percent of its total trade deficits in 1985. To soothe the frustration of the Chinese and to avoid discriminatory controls on Japanese goods, the Japanese sent a trade mission to China and established the Japan China Trade Expansion Council, an organization to promote expansion of Sino-Japanese trade, in 1986.

B. Trade Relations, Post-1985

1.11 The Sino-Japanese trade imbalance reached its peak in 1985, but thereafter it declined much faster than was expected. Later in 1985, there was a drastic realignment of exchange rates of the major currencies which lasted a few years. The Japanese yen, which stood at 238.54 vis-à-vis the US dollar as an average in 1985, began sharp appreciation in November that year. It reached an average level of ¥ 128.15 per dollar in 1988. Such an unprecedented change in Japan's exchange rate seriously eroded the Japanese industry's international competitive edge, not only against American rivals, but against those counterparts whose currencies were more or less pegged to the US currencies, notably those in the Asian countries. Coupled with the development of their own industries, these Asian products, as well as American or European products, emerged as substitutes to Japanese imports.

1.12 Japanese business was now forced to change its export strategies toward China. The iron and steel industry was among the first to shift. The collective bargaining between the Japanese steel mills and Chinese customers after 1986 did not proceed smoothly. Faced with an overall drop in demand and worsening business performance since the yen's appreciation, Japanese steel-makers attempted to increase the dollar-denominated export price to China of their products. In the later years, as domestic demand increased rather unexpectedly, the Japanese became more reluctant to sell cheap to China. After 1986, the export prices of steel to China steadily increased to catch up with world prices.

1.13 A more fundamental change in the business strategy of Japanese industries which emerged after 1986 was a new horizontal division of labor between their factories in Japan and abroad. Instead of sticking to the old principle of exporting from Japan, they shifted the export-oriented production to either consumption markets or offshore export bases in East and Southeast Asia; and the Japanese production facilities were remodeled to produce domestic market-oriented products.^{1/} For these manufacturers, China was no longer a market for excess goods which they had to secure at any cost.

1.14 Such a change in the Japanese business strategy, coupled with China's restraint on domestic investment (1986 and 1989/90), import curbs and the development of its own industry, resulted in setbacks in Japan's exports to China after 1986. By 1990, Japan's exports had shrunk to almost half the peak of 1985. But Japanese imports from China accelerated in the second half of the decade, another reflection of the changed Japanese strategy and development of the Chinese industry.

1.15 Table 1.2 compares the annual average growth rates of major trade items in the periods preceding and after 1985. As for exports, almost all the items specified in the table faced declines in export values (in current US dollars) from 1985 to 1989. There were only a few exceptions where export values rose, but none of them exerted a marked influence on overall growth. The most significant deceleration occurred in items such as motor vehicles and TV receivers. In 1988, exports of these items picked up briefly, only to drop

^{1/} More detailed discussion on this account will be made in the next chapter.

Table 1.2: AVERAGE ANNUAL RATES OF GROWTH
(comparison before and after 1985)

Japan's Exports to China	1977/85 (%)	1985/89 (%)
Grand Total	<u>26.2</u>	<u>-9.1</u>
Foodstuff	104.9	5.9
Crude materials & fuels	28.9	-4.0
Light-industry products	17.7	3.8
Textiles	11.4	4.1
Others	33.2	3.4
Heavy-industry products	27.1	-10.5
Chemicals	9.6	2.5
Metal products	15.6	-7.9
Iron & steel	15.2	-7.6
Nonferrous metals	19.5	-16.0
Others	20.8	-5.8
Machinery equipments	54.6	-13.6
Nonelectric machinery	51.4	-6.1
Electric machinery	81.9	-7.6
TV receivers	127.4	-28.3
Transport equipment	45.4	-36.0
Motor vehicles	53.3	-42.4
Vessels	27.9	-40.6
Others	49.6	-19.5

Source: Tsusho hakusho, (White Paper on International Trade), MITI (yearly issues from 1978 to 1990).

again in 1989 with the introduction of additional import restraint measures such as a special consumption tax.

1.16 Electric machinery other than TVs, however, registered a gain between 1985 and 1989. This is partly because VCRs fared well, even after the color TV boom was dampened, and also because exports of advanced communication equipment such as electronic telephone exchanges increased due to modernization of China's communication system. Electronic components such as semiconductors also saw a sharp increase, reflecting development of China's electronics industry. As will be shown later, Japan's imports of electric machinery started to increase in this period. This simultaneous rise in electronic parts exports and electric machinery imports reflects rapid expansion of technical tie-ups, consignment processing and direct investment of the Japanese electric machinery industry in China.

1.17 The nonelectric machinery or general machinery, as a whole, has suffered a setback since 1985. But the degree of decline was much smaller than that of motor vehicles or TV receivers. This category comprises a wide range of industrial machinery. Many of the machines in this group, as well as some electric machinery, are shipped as an integral part of large-scale indus-

trial plants or utilities often under a long-term credit agreement. The shipment of equipment follows a contract and takes a few years to complete. Therefore, although the Chinese government awarded fewer contracts after 1985, actual shipments remained brisk at least for a brief period, reflecting the earlier volume of activity.^{2/}

1.18 To an extent, the exports of general machinery were buoyed by the transplanting of Japanese manufacturing industry to China and the associated purchases of Japanese-made production facilities. As is discussed in Chapter II, Japanese manufacturers' direct investment in China picked up in 1987, and amounted to about \$200 million in both 1988 and 1989. Much of the Japanese equity was spent on import of production equipment. This, as well as deferred shipment of earlier plant contracts, supported the relatively stable shipment of general machinery compared with other export items such as transport equipment, despite sharp appreciation of the yen and China's import restraints.^{3/}

1.19 Iron and steel exports also declined in part because of rising prices, but also because the construction boom in China was repeatedly checked in the second half of the 1980s, and also because China's domestic production picked up. Between 1985 and 1989, Japan's steel exports to China declined to one third in volume although, in dollar value, the drop is much smaller thanks to the rise in export prices.

1.20 The export items which scored small but positive growth during this period were chemicals, textiles and other light-industry products. These items, when combined, comprise about 20 percent of Japan's exports to China and include: synthetic fiber, yarns, chemical dyes, and plastics of a higher quality which are not easily available in China. Much of them seem to have been used for producing such fast-growing consignment processing products as garments and electronic equipment and also for offshore production of Japanese subsidiaries.

1.21 In sharp contrast to the performance of exports, many of Japan's imports saw an acceleration of growth after 1985, specifically, food, textiles and other manufactured goods (Table 1.3). Raw materials such as textile materials experienced little change, while mineral fuels, with the exception of coal, was the only category which scored negative growth between 1985 and 1989. Crude oil was the main culprit, as well as petroleum products.

1.22 Oil and coal are two import items which are dealt with in the framework of the Japan-China Long-term Trade Protocol. Within the agreed-upon target range of volume, an annual import volume is decided and prices are also set for each quarter, reflecting world market prices. Since China has established a number of petrochemical plants in recent years, it is facing shortages of oil in the domestic market and oil imports are increasing. However, China has honored its agreement and the annual import volume target, although its share of Japan's total petroleum imports is falling. The decline in

^{2/} Yokoi reported in his article in The China Quarterly (Dec. 1990) that such time lags were one to two years. (Yokoi, 1990).

^{3/} Effects of production equipment purchase of Japanese subsidiaries abroad on Japan's external trade are estimated in Sumitomo (1989).

Table 1.3: AVERAGE ANNUAL RATES OF GROWTH
(comparison before and after 1985)

Japan's Imports to China	1977-85 (%)	1985-89 (%)
Grand total	<u>19.6</u>	<u>14.5</u>
Food & food products	17.8	20.2
Raw materials	14.4	13.1
Textile materials	13.4	8.2
Metal ores & scrap	5.2	69.1
Others	15.6	14.3
Mineral fuels	20.1	-8.3
Coal	32.1	3.4
Crude & partly refined oil	16.4	-8.6
Petroleum products	66.5	-12.8
Manufactured goods	22.3	37.2
Chemicals	25.7	23.8
Machinery & equipments	n.a.	n.a.
Textile	22.9	35.8
Apparel	28.4	48.0
Yarns, fabrics, etc.	19.2	20.5
Metal products	n.a.	n.a.
Others	18.5	26.8
Nontextile manufactured goods	21.4	39.1

Source: "The White Paper on International Trade," MITI (yearly issues from 1978 to 1990).

dollar-value imports of oil, therefore, simply reflected the change in world oil prices, although there were marginal imports of spot oil.

1.23 A similar system works with fuel coal and coking coal imports from China. However, unlike crude oil which comes from only one oil well, coal production relies on a number of coal mines and is vulnerable to the dislocation introduced by economic reforms. This, together with rising domestic demand, has meant that China's coal exports to Japan tend to fall short of the target volume agreed upon.

1.24 Imports of manufactured goods, which includes such a wide range of industrial products as chemicals, machinery, textile products, metal products and sundry goods, was one of the fastest growing sectors in pre-1985 years. During the eight years up to 1985, these imports grew to five times the amount in 1977, averaging an annual growth rate of 22 percent. This was faster than the expansion rates of imports of crude oil, raw materials, or food. However, manufactured goods comprised rather a small share of Japan's imports from China. They accounted for only 21 percent in 1977 and even in 1985 they represented only a quarter of imported goods.

1.25 During the years between 1985 and 1989, manufactured goods imports further accelerated expansion to a yearly rate of 37 percent. And in 1989, the share of these products reached 51 percent of all imports. Textile products are China's most important manufactured goods for export to Japan. However, the composition within textile goods has changed tremendously over the last few years. During the period prior to 1985, apparel comprised a minor portion of these and other textile goods such as cotton and silk fabrics and yarns; in other words, less value-added items accounted for a larger part of textile exports to Japan. But between 1985 and 1989, apparel export growth accelerated to 48 percent per year, while fabrics and yarns stayed at around 20 percent growth per year. As a result, apparel now account for more than two-thirds of all textile products.

1.26 Such a spectacular success of apparel exports to Japan cannot be explained without referring to consignment processing. When Japan started importing clothing from China more than 20 years ago, the Chinese products were simply imported as produced in China. Around 1971, consignment processing was first tried but, due to a rise in synthetic fiber prices after the first oil crisis and also to complicated and time-consuming procedures to clear Chinese customs, it turned out to be not a very profitable business. However, since the Chinese government facilitated consignment processing export and compensation trade in 1979, the Japanese were increasingly engaged in this type of apparel imports; and the yen's appreciation after 1985 definitely accelerated this trend.

1.27 However, because consignment processing is still a rather complicated and risky business compared to domestic processing, low value-added clothing is not always profitable this way. To make the products more value-added, Japanese importers often bring in advanced materials which are not available in China, either from Japan or third countries. They are also selective with the Chinese manufacturers. They often have specific producers in Beijing, Shanghai, Tianjin or Jiangsu province, where the textile industry is traditionally developed, and will sometimes provide them with technical support. With an accumulation of experience in the course of development of the Chinese industry, the quality of such products is improving.

1.28 A similar arrangement is also increasingly employed in other areas of manufacturing. With sundry goods such as shoes, bags, wooden products, or simple electronic goods, Japanese buyers provide Chinese manufacturers with materials and parts, up-to-date information on Japan's market, as well as technical advice. However, when it comes to more technically advanced products typically in high-tech machinery, consignment processing is not suitable. As we will see in the next chapter, in imports of electric machinery, Japanese joint ventures play a much more important role than in apparel or other light-industry products.

1.29 The import of machinery and equipment still accounts for much less than one tenth of manufactured goods imports, but its recent yearly growth by far outpaces that of apparel. It expanded by almost nine times in the three years between 1986 and 1989. This means machinery imports more than doubled each year. Two thirds of machinery imports are now comprised of electric machinery.

C. Decline in Japan's Share

1.30 In the 12 years between 1977 and 1989,^{4/} Japan's trade with China increased 5.6 times, with exports expanding 4.4 times and imports 7.2 times. But in the same period, China's external trade as a whole registered an expansion of 7.5 times; exports grew by 6.9 times and imports by 8.2 times. It is obvious that Japan's share as China's trade partner fell over the period. Japan, which accounted for 22 percent of China's total exports in 1981, represented only 16 percent in 1989. The similar ratios concerning Chinese imports from Japan dropped from 29 percent to 18 percent in this period.

1.31 A major reason for Japan's decline as China's trade partner is Hong Kong's emergence as the most important counterpart for China's external trade. Hong Kong now accounts for 42 percent of exports and 21 percent of imports as China's customer for trade. However, Hong Kong mainly works as an intermediary and much of the merchandise Hong Kong handles are reexported to third countries.^{5/} But Japan's share in 1989 are smaller than in 1981 even if Hong Kong is excluded. The decline is more conspicuous in Japan's exports to China.

1.32 Japan's share in OECD's exports to China stood at 47 percent in 1977. But as the United States expanded its share in the early 1980s after its diplomatic normalization with China in 1979, Japan's share declined to 33 percent in 1982. In the subsequent years, Japan expanded its share, peaking out at 40 percent in 1985, and losing ground again to reach 23 percent in 1989. In imports, Japan somehow maintained its share at 45 percent or higher until 1985, despite the United States' gradual emergence as a major importer of Chinese goods. But in the following years, its share declined much further. Japan's decline took place in virtually all of the product categories. However, the decline is particularly conspicuous with respect to 1985, less so if 1978 is taken as the benchmark.^{6/}

1.33 From the above observation, we may be able to speculate as follows, although further detailed analysis is needed to say for sure:

^{4/} Although preliminary data on 1990 were recently released from Japan's Ministry of Finance, more complete information has not yet become available to make a consistent commodity-by-commodity analysis. Therefore, most of the analysis in this chapter and the following chapter deals with data only up to 1989. The 1990 figures are discussed separately later.

^{5/} In 1988, Hong Kong imported HK\$156 billion from China and reexported HK\$132 billion, of which HK\$11 billion went to Japan (OECF, 1990).

^{6/} China's customs clearance-based trade statistics are available from 1982 by country and by commodity. But 1982 figures by commodity do not add up to totals. Therefore, 1983 data are shown here instead. Data for 1978 are based on Institute of Developing Economies' (IDE) own estimates. Since this is compiled from UN and OECD data and does not include China's trade with communist countries, Japan's shares tend to be overstated. Import total is 4 percent larger than noncommodity-disaggregated data China has published. Export total by 3 percent.

- (a) Textiles and chemicals are in a long-term down trend because Japan is losing the competitive edge in these products, particularly in the lower end of such products.
- (b) In most machinery products, the decline in Japan's shares is largely in reaction to the abnormally high level reached in 1985. The share of general industrial machinery dropped from 62 percent in 1978 to 31 percent in 1989.
- (c) The falling trend in industrial machinery coincides with a drop in Japan's share in plant and technology export to China. This reflects Japan's slide in competitiveness and/or China's preference for other countries as a source of such imports.

1.34 In the case of China's exports to Japan, most of the commodities did not experience drop in shares. This is particularly so if China's exports to Hong Kong are excluded. The exception is mineral fuels. Since energy accounted for a substantial portion of Japan's imports from China, this has pulled down Japan's overall share in China's exports. If energy exports are discounted and also Hong Kong is excluded, Japan's share in China's exports have been increasing (Charts 1.3 and 1.4).

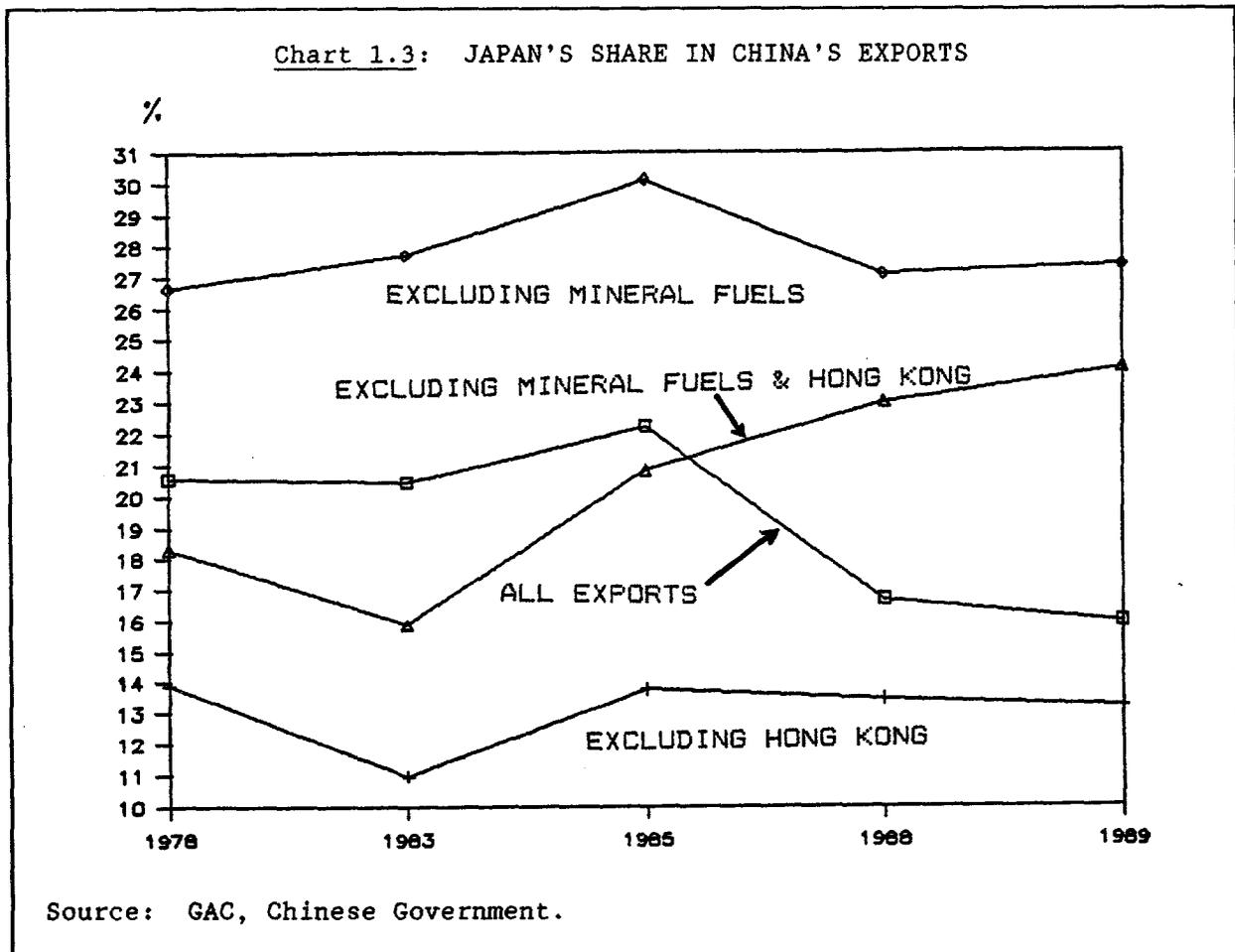
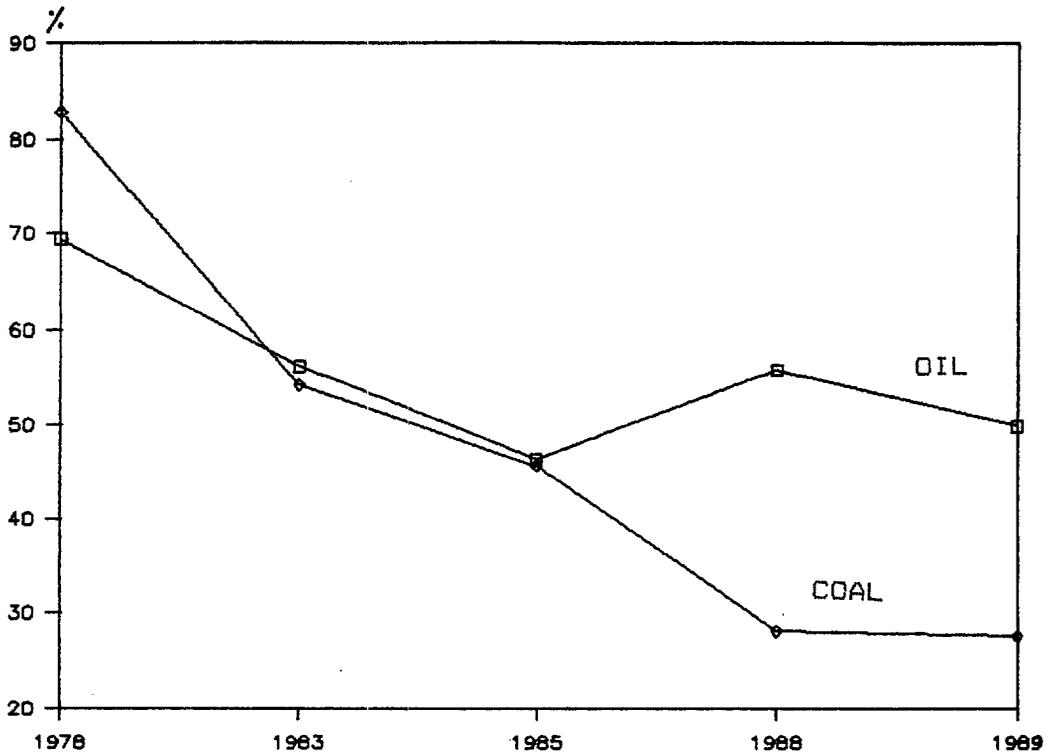


Chart 1.4: JAPAN'S SHARE IN CHINA'S ENERGY EXPORTS



Source: GAC, Chinese Government.

1.35 Political turmoil and uncertainties triggered by the incident of June 4 (1989) dampened Sino-Japanese trade, particularly until the first half of 1990. Japan's exports to China in 1990 fell by 28 percent from 1989. This was the largest drop since 1985. Almost everything decreased. But the most serious decline was in iron and steel. Because of severe financial tightening, the opening of a Letter of Credit was delayed by several months, thus blocking shipment of Japanese steel in the first few months of 1990.

1.36 In contrast to Japan's exports, its overall imports from China scored a 24 percent growth last year. Crude oil and coal imports increased both in volumes and prices. Food and raw material imports declined. In the case of cotton, due to a fear of reliability of supply and quality, importers moved to other countries. Manufactured goods slowed its pace of increase. Apparel import kept on rising, but it grew much slower. However, machinery imports increased by a hefty 51 percent. It seems that the Chinese government, threatened with the prospect of a severe shortage of foreign exchange after the June 4 incident, acted forcefully to check imports and to push exports. This lasted until the first half of 1990 and a more normal pattern had reemerged by early 1991.

D. Future Prospects

1.37 The deep disappointment and pessimism which prevailed among Japanese businesses after the June 4 incident was gradually replaced with a more sober wait-and-see attitude toward China in 1990. And more recently in 1991, even a certain reserved optimism is surfacing with resumption of the third round of Yen Credit amounting to ¥ 810 billion and talks about the Ex-Im Bank's third natural resources loan, although it is a far cry from the euphoria which prevailed before June 4. There are several factors which make Japanese businesses engaged in trade with China somewhat optimistic about the near future. They are as follows:

(a) For Japanese exporters to China:

- (i) The Chinese economy has bottomed out. And although the economic adjustment policy is going to be kept unchanged for some more time, economic restraint is being loosened.
- (ii) The Eighth Five-Year Plan is under implementation.
- (iii) The disbursement of the Yen Credit will soon be at full steam.
- (iv) Japan Ex-Im Bank's natural resource loan will shortly be finalized.
- (v) The rate for Japanese government's export insurance for China was lowered to the pre-incident levels.
- (vi) Other international or bilateral lending will be fully resumed during 1991/92.

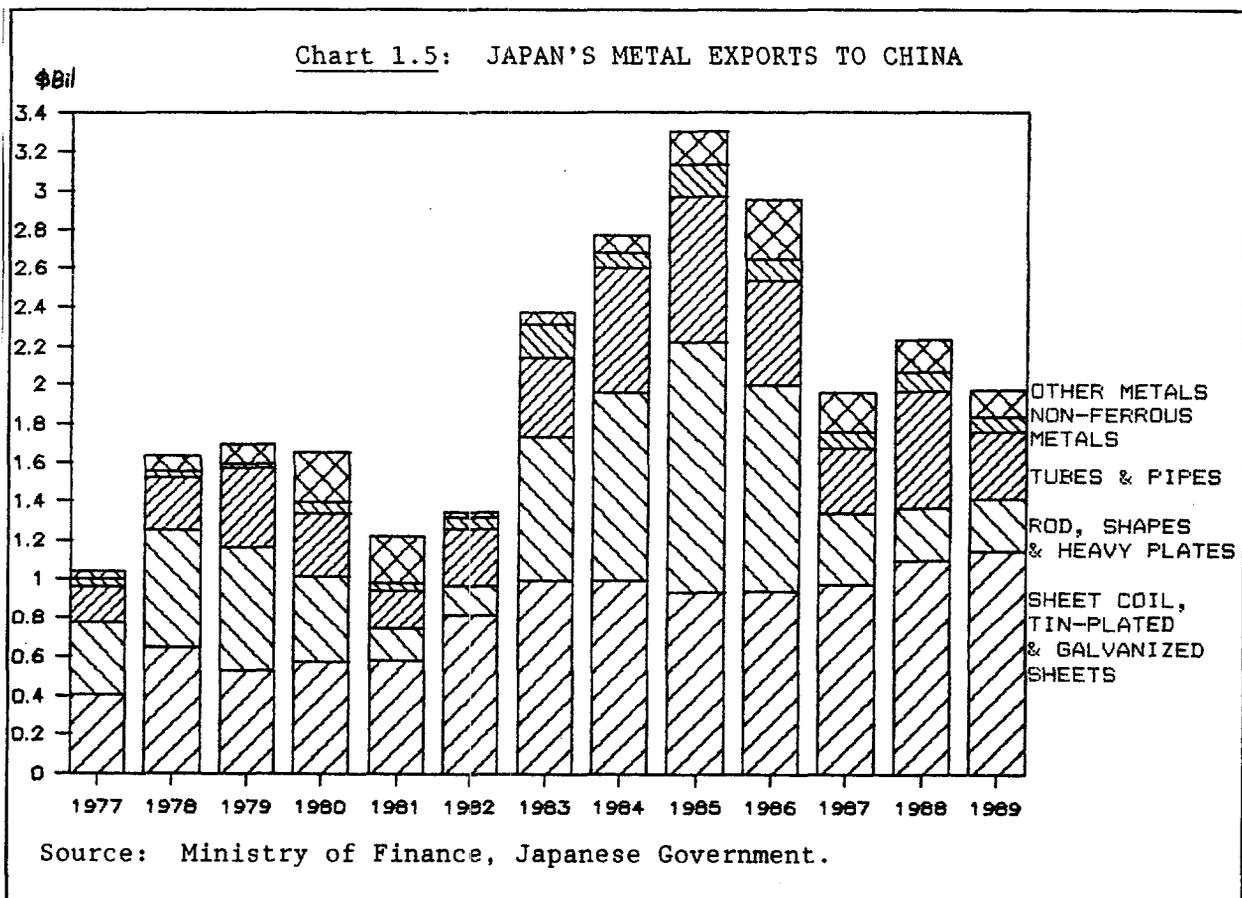
(b) For Japanese importers from China:

- (i) The depreciation of the Yuan last November and again in May will boost the price competitiveness of Chinese products.
- (ii) Agricultural production has recovered.
- (iii) Streamlining of trade companies and local authorities will reduce quality and delivery problems.
- (iv) The easing of certain resource and infrastructure bottlenecks in China's domestic economy will improve the supply of a number of products.
- (v) Through development of consignment processing and joint-venture manufacturing, the quality of Chinese products is continuing to improve.

1.38 However, at the same time, it must be noted that the rapid expansion of imports over the past five years has aggravated old problems afflicting China's exports. They are: belated delivery, poor quality, cancellation of contracts and alteration of contracts. Some Japanese importers were reported to have abandoned China and shifted their supply source to other Asian coun-

tries which they think are more reliable. Success at resolving these difficulties will have an important bearing on the growth of China's trade.

1.39 Turning to Japan's exports, Chart 1.5 shows the composition of Japan's iron and steel exports to China. It is quite obvious that a group consisting of iron rod, shapes and heavy plates fluctuates in accordance with the cyclical expansion of the Chinese economy. The products in this group are mostly used for construction and are rather easy to manufacture. On the other hand, a group which is made of thinner sheet, coil and tin-plated or galvanized sheet shows a gradual but steady increase. These products kept on growing, even in the last few years. Between 1985 and 1988, China's overall steel imports decreased by 11 million tons with steel imports from Japan declining by some 4 million tons; however, Japan's share has recovered from 46 percent to 54 percent.



1.40 At the same time, China's domestic production increased by about 10 million tons, almost offsetting the drop in imports. In China, some 40 percent of steel production comes from smaller-scale mills scattered around the country. They mainly depend on scrap iron and find it easier to adjust to the sudden surge in demand. Much of construction-related steel can be supplied by them. However, very recently, several large-scale mills are scheduled to expand operation. Therefore, in the near future, the shortage of more advanced steel products will be lessened. As the Chinese economy returns to its more normal growth, some expansion of Japanese steel exports to China can

be expected, but the mainstay will increasingly be made up of technically advanced products.

1.41 Japan's share in China's plant and technology imports dropped to its lowest level in the past couple of years. However, of late, Japanese exporters are more optimistic because they are regaining price competitiveness, and partly because the third round of Yen Credit is going to take its full effect in the coming years. In the case of the second round of Yen Credit, some 60 percent of the related equipment was estimated to have been shipped from Japan at the beginning, but in the later years, that ratio dropped to less than 30 percent as the local procurement expanded and Japan lost competitiveness. Moreover, the hopes are that the reduced burden on China's foreign reserves will stimulate the import of industrial plants.

1.42 Industrial equipment exports are also expected to grow because, after a brief pause following the Tiananmen incident, some Japanese manufacturers are considering building factories in China.^{7/} The scale of factories to be transplanted will probably become larger and more technologically advanced, thus making their dependence on Japanese machinery larger. While production equipment exports grow in relation to new investments or expansion of existing facilities, the supply of parts and materials for production increases are related to the accumulated amount of investment, hence such exports will grow much faster than the outflow of direct foreign investments. Of course, more and more low-tech parts and materials will be supplied locally. But as the more advanced products are increasingly made in China, dependence on Japanese parts and materials will grow. In short, the most promising items in Japanese exports to China are more advanced industrial equipment and materials.

1.43 Natural resources such as raw materials, food and mineral fuels still account for half of Japan's imports from China. Their prospects are largely decided by the speed of China's industrial development. With 1.1 billion people, China cannot ultimately be an exporter of natural resources. Its comparative advantage lies, after all, in processing products using human resources.^{8/}

1.44 As indicated, crude oil availability has fallen behind expectations. The current focus is on the prospects of Tarim Basin development. A big chunk of Japan Ex-Im Bank's third resource-oriented bank loan is likely to be directed to the development of the oilfield in this region. However, a lot of difficulty is anticipated. For example, the oil layer will be very deep and much will be taken out in gas. Since the Tarim Basin is located in the far west, transportation will be difficult and costly. It is considered unlikely that Japan can import oil or gas from there by the end of this century.^{9/}

^{7/} See the next chapter on direct investment.

^{8/} China is likely to become a net importer of oil later in this decade. (see Chapter III). But in the recently renewed Sino-Japanese Long-term Trade Protocol it was agreed that the target volume range for China's oil export to Japan was to be maintained without change.

^{9/} The Japan Bond Research Institute, 1991.

In the meantime, this project will rather contribute to increasing Japanese exports of steel pipe and excavation equipments.

1.45 In terms of energy resources, coal can be a more promising export product to Japan.^{10/} But the quality of Chinese coal is often a source of complaint to Japanese customers. Much more attention will have to be paid to quality control by Chinese suppliers in order to make Japan more willing to import.

1.46 Japan's imports of manufactured goods will, no doubt, grow rapidly over the foreseeable future. The most promising items are apparel and machinery. Some processed foods such as pickled vegetables also have a chance to grow. But the Japanese, as customers, are very strict about the quality of the product they purchase. Often the quality level required for the Japanese market is higher than for other markets. Although it is recognized that the quality of Chinese products has much improved lately, it is generally far from being satisfactory. This results not only from inadequate production technology, but often from poor packaging or handling during transport. Some of the Japanese buyers established service firms in Hong Kong, which are solely engaged in checking and examining the products they purchase from China and selecting only those which can be shipped onward to Japan. This naturally adds costs to imports, and erodes competitiveness of Chinese products. Improvements in China's infrastructure such as transport is also indispensable for further development of the Chinese manufacturing industry, not to mention development of manufacturing skills themselves.

^{10/} According to the renewed Sino-Japanese Long-term Trade Protocol, framework for coal export to Japan was expanded. The range for coking coal is now between 2.5 and 3.5 million metric tons instead of 2.3 to 2.5 million metric tons. But the range for fuel oil was also expanded marginally.

II. DIRECT INVESTMENT

2.1 The volume and content of Japan's direct investment has been an object of Chinese complaint throughout the last decade. The Chinese expected the Japanese to be a major investor in China to the same extent as its importance in trade. They wanted Japan's direct foreign investment (DFI) to contribute to the development of Chinese industry through transfer of high-tech and state-of-the-art equipment as well as providing foreign currencies. But for the Japanese, China was a risky market to make a large-scale, capital-intensive investment because of uncertainties regarding economic policy and an underdeveloped legal system, not to mention poor infrastructure and shortage of foreign currencies. A big chunk of Japan's DFI in China was directed towards nonmanufacturing sectors, and the average size of each investment was small. However, a sign of change seems to have surfaced very recently.

2.2 This chapter reviews the development of Japan's DFI in China and points out its characteristics. Special attention is given to the unique role of small firms. Through analysis of past trends, it attempts to delineate the future course of investment. It consists of five sections: overview; characteristics of Japan's DFI in China; impact on trade; role played by small firms; the most recent development; and future prospects. Some policy recommendations are given in the final section.

A. Overview

2.3 Japanese direct investment to China has been motivated by its immense market potential. But, so far, the realized investment falls short of expectations of both sides. According to statistics released by China, the accumulated amount of Japanese direct investment in China, on a commitment basis, stood at \$2.64 billion in 951 projects as of end-1989. This represents 8 percent of China's direct investment inflow from abroad. Japan's Ministry of Finance (MOF) also publishes figures on Japan's direct foreign investment (DFI).^{1/} These data, based on approval or notification by the Ministry, are compiled in fiscal years which run to the end of March. The accumulated amount of approval/notification of Japanese DFI in China as of end-March 1990 came to \$2.47 billion, involving 694 projects. This accounts for only 1 percent of Japan's total DFI, or 6 percent of such investment in Asia. As a matter of fact, China comprises 4 percent of Japan's total international trade, or 13 percent in its trade with Asian countries in 1989. Moreover, the Japanese manufacturing investment in China accounts for less than 4 percent of its investment in Asia so far.

2.4 In the years following the adoption of the Joint-Venture Law in 1979 by China's People's Congress, the majority of Japanese firms took a wait-and-see attitude. Most of them thought it was premature to go because relevant laws were yet to be written. But there were a few firms which went ahead. The very first joint venture between Chinese and Japanese businesses was set up in Tianjin early in 1981 by the China Medical Industry Corporation and Japan's major pharmaceutical firm, Otsuka Pharmaceutical Co., Ltd. on a 50-50

^{1/} A discussion concerning the definition of DFI in Japanese statistics is given in the annex.

partnership. Capitalized at ¥ 22 million, the firm started production of an injection solution in 1984. The initial move to this venture was taken by the Chinese side. One third of the product was exported. Three fourths of the material was supplied domestically. The operation turned out to be fairly successful.

2.5 Shortly after Otsuka, Hitachi followed suit and established a TV manufacturing venture with Fujian Industrial Investment Corporation (10 percent) and Fujian Electronics Import and Export Company (40 percent) with a registered capital of ¥ 3.6 million and 224 employees. This was also proposed by the Chinese, when Fujian Province sent a mission to Japan in 1979. After the first four years of gradual expansion of production and the following two years of difficulty because of the change in exchange rates, the firm has entered a period of growth since 1986. It gradually increased export of the products.

2.6 Another major Japanese business which started a joint venture with China in 1981 was Orient Leasing.^{2/} This is a financial leasing joint venture, headquartered in Beijing, with the Chinese taking 50 percent of the equity. In this year, several other ventures were started by smaller Japanese firms, including two cooperative ventures for hotel operations. According to Japan's MOF data on DFI, in fiscal 1980 which ended in March 1981, Japan's DFI in China numbered six with \$12 million, and in fiscal 1981 it grew to \$26 million, involving nine projects.

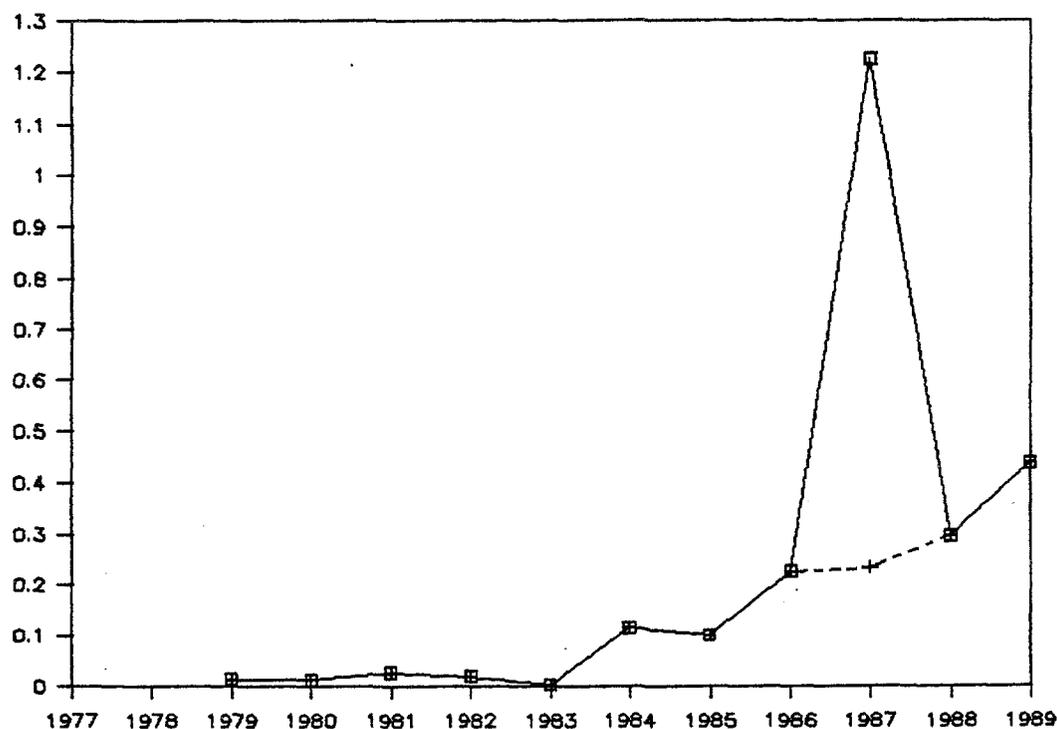
2.7 However, in the following two years of 1982 and 1983, Japan's DFI in China stagnated instead of continuing to grow. This reflects the turnaround of China's economic policy. Economic reforms saw a setback in the second half of 1980. Although in 1982 economic reform was resumed and direct investment was given official support during the Communist Party Congress in September, DFI was slow to recover because it took about a year or more to complete the negotiation and procedure and to set up a joint venture.

2.8 It is noteworthy that, in these early years of Japanese DFI in China, large-scale and powerful companies adopted a low profile. They did not initiate ventures but reacted to suggestions or persuasion by the Chinese. In some cases, overseas Chinese played an important role in the process and stayed on as a co-investor when the venture was started. Initially these joint ventures put little emphasis on exports. It was simply a measure of earning foreign currencies needed for importing materials. One exception of a joint venture aimed at exporting its product to third countries in this period was Rikiō, a small manufacturer specializing in workboots. This company had adopted a unique policy of transferring all of its production out of Japan to Korea and Taiwan. It had established its own know-how in management of overseas production and retained a powerful distribution network in Japan for its products.

^{2/} Currently, Orix Corporation.

2.9 By the middle of 1983, Japanese joint ventures numbered nine, representing 7 percent of all such ventures in China.^{3/} It was only later that year that the Japanese started seriously considering DFI in China when more detailed rules concerning implementation of foreign joint ventures were made public. According to Japan's DFI data compiled by MOF, in fiscal 1984, Japanese investment in China jumped \$114 million from the previous year's \$3 million (Chart 2.1). The number of projects registered in this year, 66, was more than twice total outlay since 1979.

Chart 2.1: JAPAN'S DIRECT INVESTMENT IN CHINA
(\$ billion)



Note: Dotted line between 1986 and 1988 represents the pattern when a giant oil project in 1987 is excluded.

Source: Ministry of Finance, the Japanese government.

2.10 In 1984, services dominated Japan's DFI in China. It accounted for 74 percent of the amount of investment and 24 percent of the number of projects. Leasing and the hotel industry were the major components of the service industry. This was a reflection of China's lack of foreign exchange and its policy toward joint ventures and domestic companies concerning foreign currencies. These leasing companies could easily find customers among Chinese firms, as well as joint ventures which had difficulty in borrowing foreign currency to finance production facilities and materials. Most of the firms,

^{3/} As quoted in JETRO's White Paper on Foreign Investment, 1984 edition, p. 136.

domestic or foreign, had to acquire foreign currencies by themselves. Safe and quick return was expected.

2.11 A similar situation can be found behind the increase of hotel ventures. While newly formed manufacturing ventures were struggling to earn hard-to-get foreign currencies, the hotel industry could largely avoid this problem because its customers, mostly foreign guests, paid in foreign currencies. These hotels usually ran a surplus in foreign currency balance and sometimes lent it to other joint ventures. They did not have difficulty in finding enough customers because the opening Chinese market attracted increasing numbers of foreign businessmen and their Chinese rivals were not fully prepared for this challenge in terms of accommodations or services. Although Japan's hotel industry was increasingly interested in overseas investment by then, it took a few more years until it started DFI in large scale in the rest of the world.

2.12 By mid-1985, according to Chinese statistics,^{4/} the Sino-Japanese joint ventures numbered 102 and Japan ranked second only to Hong Kong as the home country. But the Chinese remained unsatisfied. Their complaint was not simply based on the fact that Japan's 102 ventures accounted for only 6 percent of China's joint ventures, but rather on their argument that Japanese business was more interested in easy-to-earn service and other nonmanufacturing industry and reluctant to transfer technology through opening production factories.

2.13 The service industry dominated Japan's investment until 1987. In those years, the amount invested in the service sector alone accounted for two to five times the size of DFI in all the manufacturing sectors. Real estate business became active too. Here, again, the target was foreigners. Residential buildings, industrial sites, golf courses and tennis courts were constructed to serve them. Major players in this field were large-scale Japanese companies such as banks, leasing, securities firms, construction firms and general trading companies. In most cases, they invested jointly with other Japanese firms to share the risk because the size of the investment was relatively large. For some, this process also served as a means of gauging the prospects for manufacturing investment.

2.14 As for the manufacturing industry, large-scale firms were slow to invest. An unstable economic policy and the lack of legal transparency were major problems. Chinese restrictions on foreign exchange was also pointed out as a major obstacle. And, particularly for big businesses, the difficulty encountered in obtaining basic data and sometimes unavailability of fundamental figures for feasibility studies of projects was considered to hamper their lengthy in-firm procedures to a great extent. Such problems may have affected more negatively on Japanese big business than their foreign counterparts because Japanese decisions were made "from bottom to top" rather than "from top to bottom" processes.

2.15 However, it needs to be mentioned that the bigger Japanese manufacturing firms, which had potential to invest in China, were preoccupied with

^{4/} As quoted in JETRO's White Paper on Foreign Investment, 1985 edition, p. 145.

their most important market, the United States. In those years, trade frictions with America forced these companies to shift their export production facilities to the United States. They mobilized their full strength to this unprecedented venture. Until appreciation of the Japanese yen weakened the competitiveness of their products in 1986, production costs were not their major concern. It was only later than 1986 that Asia drew their serious attention as a destination for their transplants.

2.16 In this period, manufacturing investment in China was mostly conducted by smaller Japanese businesses, at least in terms of numbers of projects. Although accurate figures are unavailable, probably no less than 70 percent of manufacturing DFI projects were undertaken by small- and medium-sized Japanese corporations.^{5/} These companies almost monopolized textile industry investment. They also enjoyed a dominant role in many of the sectors of manufacturing, such as wood and paper products, sundry goods, and chemicals and plastics. These were all labor-intensive industries and smaller firms had suffered a severe shortage of labor force in Japan.

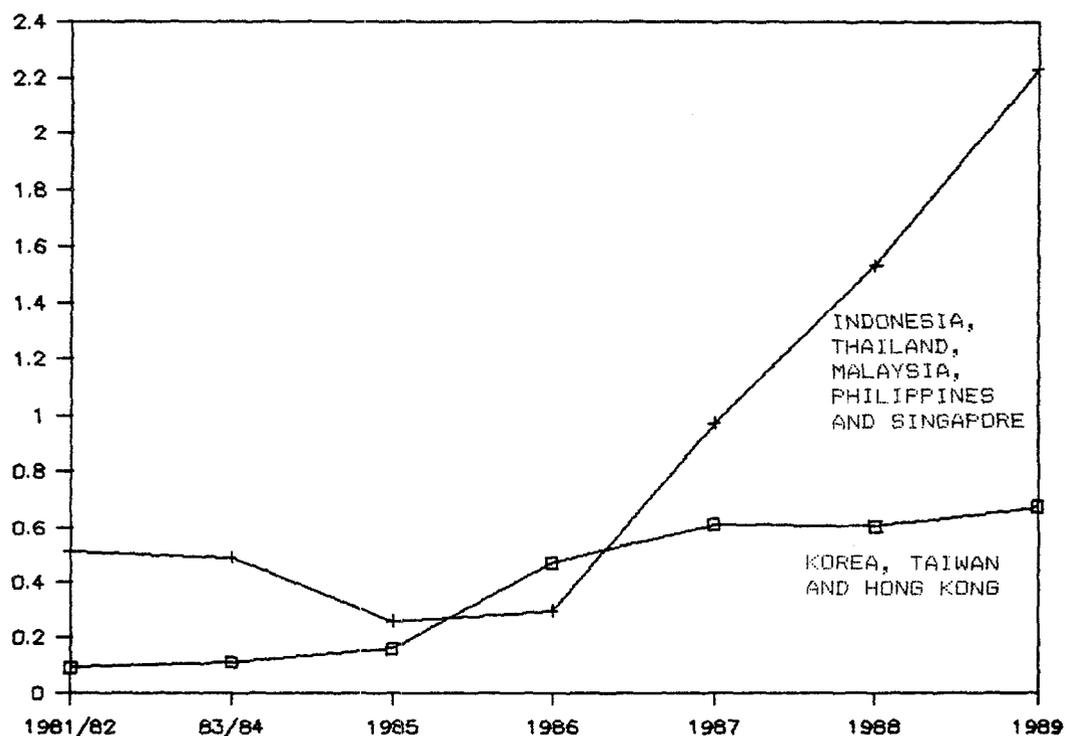
2.17 In 1986, Japanese direct investment to the rest of the world increased sharply. The Japanese data, based on MOF, registered a hefty 62 percent rise in DFI in the Asian countries in this fiscal year. But the major portion went to Hong Kong, Korea, Singapore and Taiwan. As for manufacturing investment, Taiwan and Korea enjoyed the largest part of the surge in incoming investment. These countries were the traditional locations of Japanese offshore production and were considered as the easiest and most reliable destinations in Asia. Some companies simply expanded existing facilities. But later, as these countries faced serious trade disputes with the United States and their currencies were forced to appreciate vis-à-vis the US dollar, Japanese manufacturers began exploring other Asian countries (Chart 2.2). It was only then, in 1987, Japanese DFI in manufacturing started to show a distinctive pattern of growth in China.

2.18 Japanese data show an extremely big jump in fiscal 1987 (Chart 2.1). But this was due to an extraordinarily large oil-exploring project which amounted to nearly \$1 billion. If this project was excluded, the total amount of DFI would have scored only 3 percent growth. This was mainly because the rest of the nonmanufacturing sector did not show much increase. But manufacturing DFI marked a sharp increase this year.^{6/} It grew by 53 percent in terms of numbers and tripled in amount compared with the preceding fiscal year (Chart 2.3). But it is interesting to note that China's share in Japan's total DFI in Asia saw a decline in this year in terms of number of DFI. It dropped to 7.5 percent in fiscal 1987 from the previous year's 10.4 percent.

^{5/} Estimates made for 1985 and 1986. Here, the definitions of small and medium-sized companies follow those given by Japan's Medium and Small Enterprises Agency. Full accounts will be given in Section D.

^{6/} This is also due to China's DFI policy which favors manufacturing investments. In 1986, the Provision of the State Council of the People's Republic of China for the Encouragement of Foreign Investment was enacted. This gave incentives only to productive investment, particularly to export-oriented or high-tech DFI. For more detail, see the World Bank (1990).

Chart 2.2: JAPAN'S MANUFACTURING DFI IN ASIA
(\$ billion)

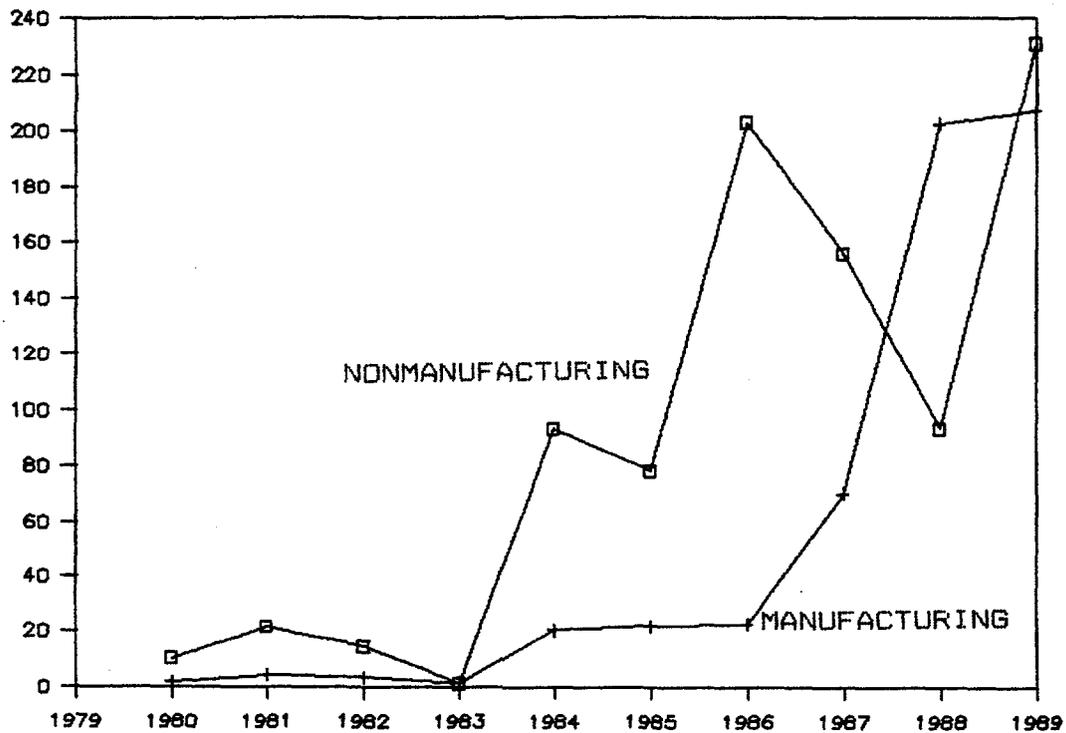


Source: Ministry of Finance, the Japanese Government.

In manufacturing DFI alone, it fell to 7.3 percent. This is less than half of its peak of 15.8 percent marked just a couple of years ago. In amount of DFI, China's share jumped sharply in this year because of the oil project. But if it was excluded, DFI to China accounted for only 6 percent of Japan's DFI to Asia.

2.19 Such a decline of China's relative importance in Japan's direct investment in Asia was a reflection of change in business strategy of Japanese industry. In 1987, Japanese companies turned their attention increasingly to Southeast Asian countries. It became evident that the drastic realignment of major currencies was to hold. The Japanese economy had overcome the initial shock of the yen's appreciation. A booming stock market and soaring land prices improved the financial position of Japanese business. They went to such countries as Thailand, Malaysia and Singapore, where stable political and labor situations were expected. And in countries other than Singapore, with a cheap and ample labor force, the labor-intensive process of production could be transferred not only from Japan but also from Korea and Hong Kong. Developing Southeast Asian countries attracted related nonmanufacturing businesses such as transport, hotel and commerce, as well as smaller manufacturers of parts and materials. China had similar appeal to such investors, too. But it did not enjoy priority because bureaucratic procedures in China were more

Chart 2.3: JAPAN'S DFI IN CHINA
(in manufacturing and nonmanufacturing)
(\$ million)



Note: Nonmanufacturing in 1987 excludes the giant oil project which amounted to \$993 million.

Source: Ministry of Finance; the Japanese Government.

time-consuming.^{7/} And for some, particularly smaller firms lacking in political clout, China's difficult investment climate was increasingly perceived as a matter of concern despite the attractiveness of an abundant labor force and the potential of China's huge domestic market.

2.20 The Chinese government enhanced the attractiveness of its DFI policy in 1988. The Secretary General, Mr. Zhao, disclosed his economic development strategy for the coastal area early in the year, and coastal economic open zones were expanded. Localization of authority regarding DFI was also extended. In August 1988, Japan's then-prime minister, Mr. Takeshita, visited China and promised the third Yen Credit. At the same time, an investment protection treaty which guaranteed an equal treatment of Japanese ventures as Chinese ventures was concluded between the two countries. Such moves seem to

^{7/} A survey conducted in late 1989 showed the majority of the firms surveyed spent more than a year for negotiation for setting up a joint venture (Japan-China Association on Economy and Trade, 1990).

have given the kind of assurance capital-intensive investment awaited. It was in 1988 that Japan's big business started large-scale investment in China, one after another. In September, Nisshin Oil Mills Ltd. signed to build a ¥ 5 billion oil mill in Dalian. In the same month, Matsushita Electric disclosed a plan for a TV tube joint venture in Beijing. In fiscal 1988, Japan's statistics reported a large gain in manufacturing DFI in China, while nonmanufacturing investment dropped even after the giant oil project of the previous year was discounted. Such a trend continued into the first half of 1989. But the June 4 incident interrupted this upsurge.^{8/}

B. Characteristics of Japan's DFI in China

2.21 Compared with other investing countries, Japan's DFI in China has a few distinct features. Table 2.1 is a sectoral breakdown of the ventures listed in MRI statistics.^{9/} The Japanese ventures differ in many ways from those of the United States and other countries.^{10/} Firstly, the Japanese invested a much smaller proportion in manufacturing. Out of 466 cases, only 337 or 66 percent were directed to production, compared with 83 percent by the United States and about 73 percent by other countries. Compared with the United States, only a few sectors of manufacturing industry attracted a larger proportion of Japanese investors; namely, textiles and garments, wood and furniture, and precision machinery. Except for precision machinery, the share of ventures in the machinery industry is much lower than that of American firms. Chemicals, cement and ceramics also drew much less Japanese investment than from the United States. On the other hand, the service industry, real estate, commerce and construction were the sectors where a larger share of Japanese investment was made compared with the United States. In terms of sectoral composition of DFI in China, Japan and the United States stand at the extremes and the other countries as a group fall in the middle.

2.22 In the Japanese government's data on DFI in China, 567 cases are reported as the total number of projects registered with the MOF as of March 1989. Of these, only 304 are classified as manufacturing investment. This represents only 54 percent of the total, an even lower share than MRI data suggested. About one third of nonmanufacturing investment went to the service sector. With the rest of Asia, manufacturing DFI accounted for 53 percent, hardly different from the case of China (Table 2.2). In nonmanufacturing, however, instead of the service sector, the commerce industry accounts for one third of nonmanufacturing. And the service industry represents only 6 percent of the total number of investments. The difference in sectoral composition of

^{8/} Analysis of DFI in 1989 and onward is given in Section E of this chapter.

^{9/} Since 1986 MRI, a Japanese private think-tank, annually publishes "Chūgoku Gōbenkigyō Ichiran" (A List of Joint Ventures in China), a list of brief descriptions of joint ventures with firms of origins other than Hong Kong. This paper is based on its 1990 edition, the most recent version. The statistics in this annual cover 1,252 firms, including wholly foreign-owned ventures. It is estimated that this list covers some 30 percent of the existing firms.

^{10/} Of 389 companies under the category "other countries", 181 are established with European firms and 149 with Asian firms other than Japanese.

Table 2.1: JOINT-VENTURES IN CHINA BY SECTOR AND BY INVESTING COUNTRIES

Sector	Japan		USA		Others		Total (excl. HK)	
	(number)	%	number	%	number	%	number	%
Food, tobacco	41	8.0	33	9.4	50	12.9	124	9.9
Textiles, garments	59	11.5	19	5.4	28	7.2	108	8.5
Wood, furniture	15	2.9	3	0.9	10	2.6	28	2.2
Pulp, paper	2	0.4	1	0.3	4	1.0	7	0.6
Publishing, printing	7	1.4	5	1.4	4	1.0	16	1.3
Chemicals	46	9.0	62	17.7	50	12.9	158	12.6
Leatherware	11	2.1	17	4.9	18	4.6	46	3.7
Cement, ceramics	14	2.7	22	6.3	8	2.1	44	3.5
Metals	25	4.9	17	4.9	16	4.1	58	4.6
General machinery	12	2.3	22	6.3	16	4.1	50	4.0
Electrical machinery	57	11.1	50	14.3	40	10.3	147	11.7
Transport equipments	8	1.6	9	2.6	19	4.9	36	2.9
Precision machinery	23	4.5	13	3.7	10	2.6	46	3.7
Firearms, others	17	3.3	16	4.6	11	2.8	44	3.5
Subtotal (manufacturing)	<u>337</u>	<u>65.7</u>	<u>289</u>	<u>82.6</u>	<u>284</u>	<u>73.0</u>	<u>910</u>	<u>72.7</u>
Agricultural/forestry	10	1.9	8	2.3	10	2.6	28	2.2
Fisheries/marine	11	2.1		0.0	6	1.5	17	1.4
Mining/gas/oil	3	0.6	12	3.4	10	2.6	25	2.0
Construction	13	2.5	6	1.7	11	2.8	30	2.4
Utilities	1	0.2		0.0	0	0.0	1	0.1
Commerce	17	3.3	4	1.1	8	2.1	29	2.3
Financial/insurance	5	1.0		0.0	4	1.0	9	0.7
Services	91	17.7	23	6.6	36	9.3	150	12.0
Leasing	20	3.9	1	0.3	5	1.3	26	2.1
Hotel	25	4.9	6	1.7	13	3.3	44	3.5
Leisure	13	2.5	1	0.3	0	0.0	14	1.1
Information	24	4.7	11	3.1	7	1.8	42	3.4
Others	9	1.8	4	1.1	11	2.8	24	1.9
Transportation, comm.	10	1.9	6	1.7	18	4.6	34	2.7
Real estate	15	2.9	2	0.6	2	0.5	19	1.5
Other nonmanufacturing		0.0	1	0.3	0	0.0	1	0.1
Subtotal (nonmanufacturing)	<u>151</u>	<u>29.4</u>	<u>54</u>	<u>15.4</u>	<u>85</u>	<u>21.9</u>	<u>290</u>	<u>23.2</u>
Total	<u>518</u>	<u>100.0</u>	<u>350</u>	<u>100.0</u>	<u>389</u>	<u>100.0</u>	<u>1,252</u>	<u>100.0</u>

Source: "Chugoku Goben Kigyo Ichiran (the list of China Joint-Ventures)", MRI, 1990.

Japan's DFI between China and the other Asian countries is also distinct within the manufacturing industry, too. While such light-industry sectors as food processing, textiles, and wood and pulp have relatively larger shares, machinery sectors account for a much smaller portion compared with other Asian countries.

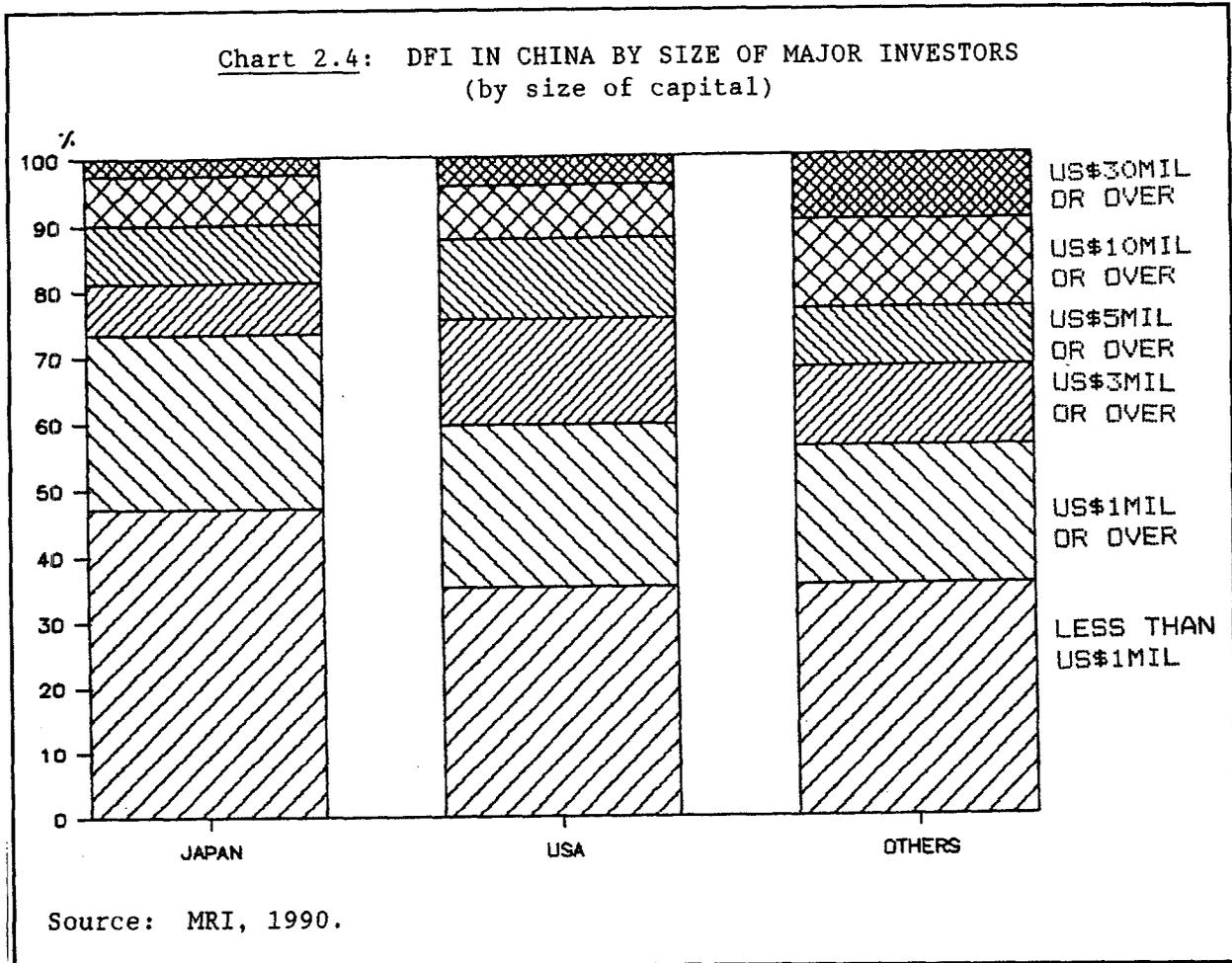
2.23 Another feature of Japanese DFI in China is the fact that a larger portion of it consists of small-size investment. Chart 2.4 compares the size of Japan's investment with that of the United States. Each layer of the bar represents the number of investments corresponding to a certain range of invested capital amount. As much as 73 percent of Japan's investment in China amounts to less than \$3 million, while 60 percent of the investment from the United States falls in this category. In the case of the other countries' investment, such small investments claim an even smaller portion of all investments.

Table 2.2: JAPAN'S DFI TO CHINA AND OTHER ASIA BY SECTOR
(Accumulated numbers of approved/notified DFI cases as of March 1989)

	<u>DFI to China</u>		<u>DFI to Other Asia</u>	
	Cases	%	Cases	%
Food processing	65	11.5	569	3.8
Textiles	45	7.9	829	5.6
Wood/pulp	17	3.0	362	2.4
Chemicals	30	5.3	961	6.5
Metals	22	3.9	789	5.3
Machinery	25	4.4	874	5.9
Electrical machinery	39	6.9	1,444	9.7
Transport equipments	5	0.9	387	2.6
Others	56	9.9	1,591	10.7
Subtotal, manufacturing	<u>304</u>	<u>53.6</u>	<u>7,806</u>	<u>52.5</u>
Agricultural/forestry	16	2.8	371	2.5
Fisheries/marine	29	5.1	230	1.5
Mining/gas/oil	3	0.5	230	1.5
Construction	11	1.9	463	3.1
Commerce	54	9.5	2,678	18.0
Financial/insurance	1	0.2	368	2.5
Services	106	18.7	915	6.2
Transportation	9	1.6	209	1.4
Real estate	21	3.7	304	2.0
Other nonmanufacturing	4	0.7	519	3.5
Subtotal, nonmanufacturing	<u>254</u>	<u>44.8</u>	<u>6,287</u>	<u>42.3</u>
Branch offices	8	1.4	606	4.1
Real estate purchases	1	0.2	161	1.1
<u>Total</u>	<u>567</u>	<u>100.0</u>	<u>14,860</u>	<u>100.0</u>

Source: The Japanese Ministry of Finance data, as reported in "Kinyu Zaisei Tokei Geppoo," MOF, December 1989, and in "Kaigai Toshi Kenkyuujo," the Ex-Im Bank of Japan, November 1990.

2.24 Even by Japanese standards, the average size of Japan's direct investment in China is small. It is smaller than in the rest of Asia in almost all sectors of the manufacturing industry. Chart 2.5 depicts the average size of manufacturing investment of Japanese firms. The lighter bars show the sectoral average in China and the darker bars that in Asia other than

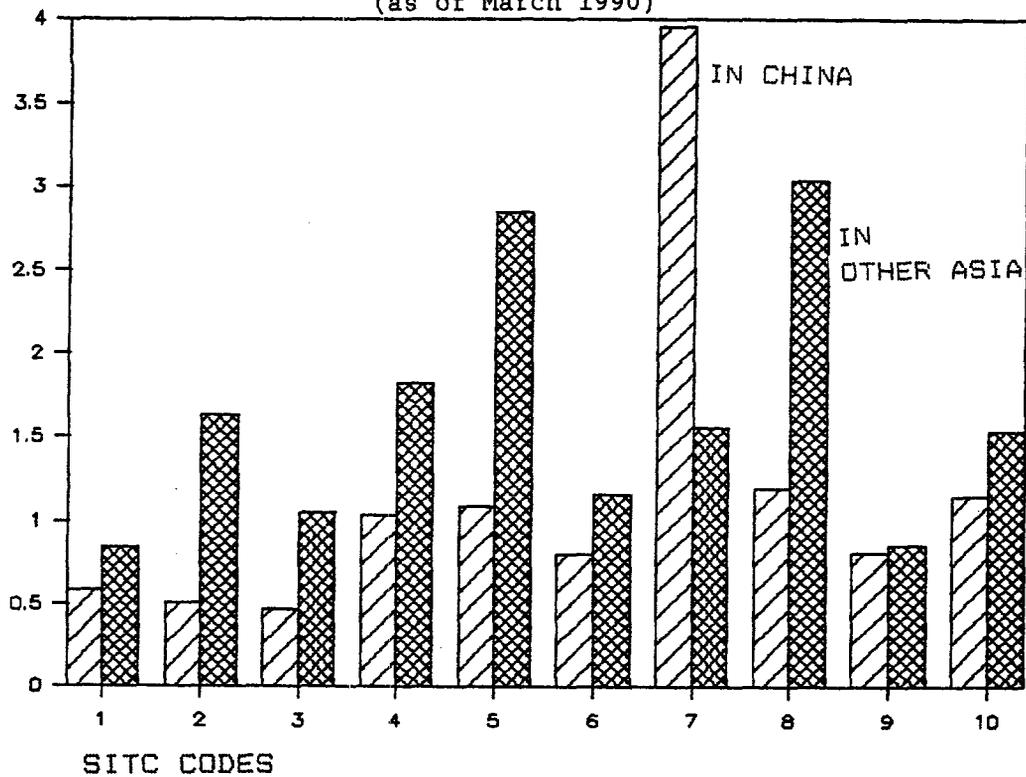


China. It is shown that Japan's manufacturing investment in China is smaller, with only one exception: electric machinery industry.^{11/}

2.25 The difference is particularly large in such industries as transport equipment, metal, chemicals and textiles. This reflects the fact that in investment in these sectors mostly are directed to the labor-intensive process of the industry and made in many instances by smaller firms, while in other Asian countries more capital-intensive parts of these sectors are also dealt with on a large scale by Japan's big businesses. Take, for example, the textile industry; Japan's major textile companies have set up upstream plants such as synthetic fiber factories, or large-scale spinning mills in Thailand or Indonesia but, in China, these firms invested in more downstream parts of the textile industry such as knitting, sewing or carpeting, where the size of the investment can be smaller. This is partly linked to perceived political risk and also to the relatively early stage of Japan's investment in China.

^{11/} It should be noted that the stock data of Japan's DFI employed here are simply accumulated values of past investments and, therefore, do not show present values of investment. Since the average vintage is quite new for China compared with the rest of Asia, the real difference should be larger than the chart implies.

Chart 2.5: AVERAGE SIZE OF MANUFACTURING DFI IN ASIA
(\$ million)
(as of March 1990)



- Note:
1. Food
 2. Textiles
 3. Wood and Pulp
 4. Chemicals
 5. Metals
 6. General Machinery
 7. Electrical Machinery
 8. Transport Equipment
 9. Other Manufacturing
 10. Manufacturing Total

Source: Ministry of Finance, the Japanese Government.

In other parts of Asia, the Japanese textile investment started from downstream and moved to upstream later on.^{12/}

2.26 Geographical distribution within China of Japan's DFI is also different from that of other countries. One of its features is a concentration in three municipalities. As much as 41 percent of Japanese ventures went to one of the three major cities, while the United States allocated only 35 per-

^{12/} See Yoshihara (1976).

cent (Table 2.3). Another geographical feature of Japanese DFI is its dependence on the coastal provinces; 51 percent of investment was directed to this area. Therefore, only a small portion was left for inland provinces. While Japan invested only 7 percent in this area, the United States directed as much as 17 percent, in other words, a larger portion than any of these three major cities. Lastly, in Liaoning Province, Japan took a disproportionately large share of such ventures (Chart 2.6).

Table 2.3: GEOGRAPHICAL DISTRIBUTION OF JOINT-VENTURES MADE BY US AND JAPAN

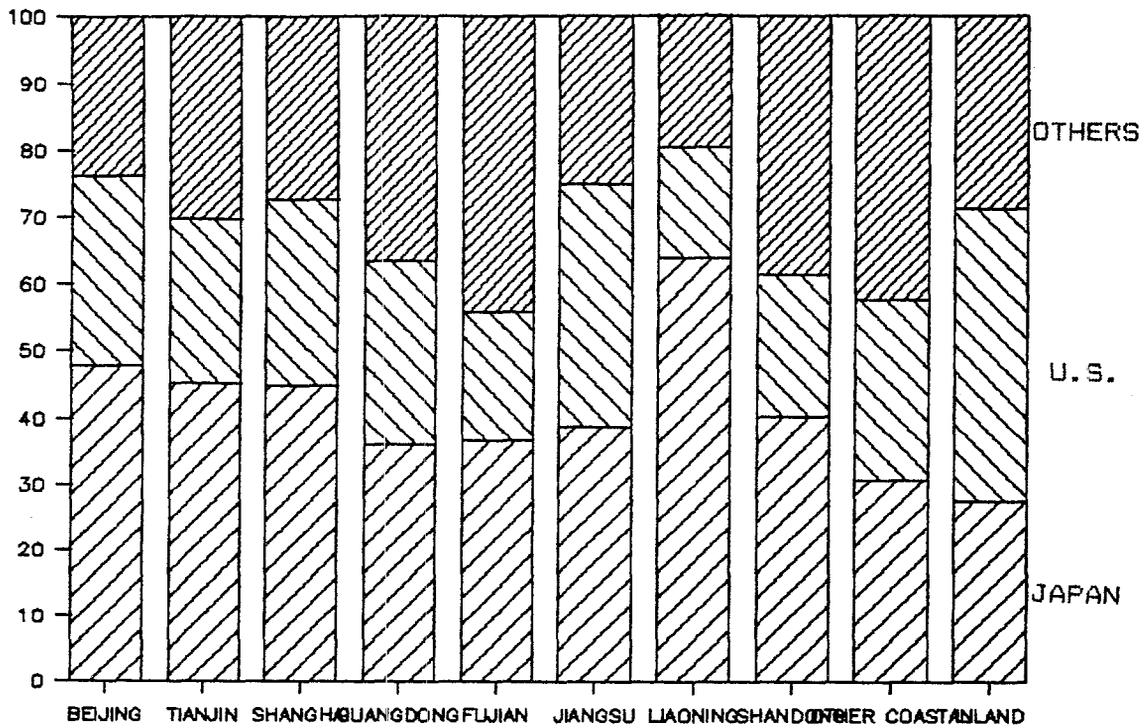
	Japan	USA	Others	Total	Japan	USA	Others	Total
	--Number of Joint Ventures--				----- % -----			
Three Municipalities	210	124	121	455	40.9	35.3	31.2	36.3
Beijing	86	51	43	180	16.8	14.5	11.1	14.4
Tianjin	48	26	32	106	9.4	7.4	8.2	8.5
Shanghai	76	47	46	169	14.8	13.4	11.9	13.5
Coastal Provinces	259	164	215	638	50.5	46.7	55.4	51.0
Guangdong	75	57	76	208	14.6	16.2	19.6	16.6
Fujian	30	16	36	82	5.8	4.6	9.3	6.5
Jiangsu	45	42	29	116	8.8	12.0	7.5	9.3
Liaoning	62	16	19	97	12.1	4.6	4.9	7.7
Shandong	23	12	22	57	4.5	3.4	5.7	4.6
Others	24	21	33	78	4.7	6.0	8.5	6.2
Inland Provinces	38	61	40	139	7.4	17.4	10.3	11.1
Not specified	6	2	12	20	1.2	0.6	3.1	1.6
Total	<u>5.13</u>	<u>351</u>	<u>388</u>	<u>1,252</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: MRI, 1990.

2.27 Table 2.4 gives sectoral details of Japan's 513 ventures in China. Although the largest number of them are located in Beijing, it is far away from being typical. Its most important industry is not manufacturing but the service industry. Nearly one third of such firms are located in Beijing. And an even heavier concentration exists in commerce, construction and real estate. In all, 56 percent of the firms are engaged in nonmanufacturing activities. Compared with Shanghai, Beijing lags behind in most of the manufacturing sectors. But the most impressive exception is electric machinery firms which number ten in Beijing.

2.28 In the electric machinery sector, however, Guangdong enjoys the honor of the most favored location by the Japanese. This is also reflected in the importance of the computer software industry. Jiangsu Province, on the other hand, is more light-industry oriented. If Shanghai is included, more or less half of the textile and leatherwork ventures are located in this region. About 90 percent of Japanese DFI is directed in either one of the coastal provinces or the three municipalities. In the inland area, which consists of

Chart 2.6: MAJOR LOCATIONS OF DFI, SHARES BY HOME COUNTRY (%)



Source: MRI, 1990.

18 provinces, there are only 10 percent ^{13/} of Japanese joint ventures or wholly-owned subsidiaries. A large part of it is invested in agriculture or related sectors such as food processing and chemicals (Chinese pharmaceuticals).

C. Impact on Trade

2.29 According to the statistics recently released from the Chinese customs, DFI firms such as joint ventures, wholly-owned foreign subsidiaries and cooperative ventures increased their exports by 59 percent in 1990. This represents 12.6 percent of China's total exports for the year. The most important export products of these firms were electric and nonelectric machines, accounting for more than one third of such products. Also important were textiles and apparels. By the origin of exports, Guangdong province accounted for as much as 70 percent of the total exports of DFI factories. As for machinery exports, a quarter of China's exports of such products were conducted by these firms. It is obvious that the very rapid transformation of China's foreign trade over the past few years, particularly the expansion in machinery trade, was largely the result of DFI in manufacturing.

^{13/} Here, those whose location is unknown are included.

Table 2.4: JAPAN'S JOINT VENTURES IN CHINA BY SECTOR AND BY LOCATION

	Total	Three Municipalities			Coastal Provinces					Others	Inland Provinces	
		Sub-total	BJ	TJ	SH	Sub-total	GD	LN	JS			FJ
Food, tobacco	41	11	6	3	2	20	3	7	2	3	5	10
Textiles, garment	59	21	5	1	15	34	6	7	11	3	7	4
Wood, furniture	15	7	2	1	4	6		3	1	1	1	2
Pulp, paper	2	1		1		1			1			0
Publishing, pri.	7	3	2	1		2	2					2
Chemicals	46	12	2	3	7	29	5	4	9	3	8	5
Leatherware	13	6			6	6	2	2	1	1		1
Cement, ceramic	12	3	1		2	8	1	1	3	2	1	1
Metals	25	5	2	1	2	17	5	5	5		2	3
General machinery	12	7	1	4	2	5	1	1	1		2	0
Electrical machinery	57	22	10	8	4	32	21	4		7		3
Transport equipment	7	2		1	1	4	1	1	1	1		1
Precision machinery	24	11	4	1	6	12	3	5	1	1	2	1
Firearms, other	17	9	3	5	1	7		3	1	1	2	1
Subtotal manufacturing	337	120	38	30	52	183	50	43	37	23	30	34
Agricultural/fores.	10	2	1	1		3	1			1	1	5
Fisheries/marine	11	1		1		10	1	3	3		3	0
Mining/gas/oil	3	2		2		1		1				0
Construction	13	9	5	1	3	3	2	1				1
Utilities	1	0				1		1				0
Commerce	17	13	8	3	2	4	1	2	1			0
Financial/insur.	5	2		1	1	2	1			1		1
Services	91	48	28	6	14	34	15	8	2	6	3	9
Leasing	20	10	6	1	3	9	4	2	1	2		1
Hotel	25	11	7	1	3	10		3	1	3	3	4
Leisure	13	9	7	1	1	3	2	1				1
Information	24	15	7	2	6	8	5	2	1			1
Others	9	3	1	1	1	4	4					2
Transportation	10	4		3	1	4	2	2				2
Real estate	15	11	6	2	3	3	2	1				1
Other nonmanufacturing												
Subtotal Non-manufacturing	176	92	48	20	24	65	25	19	6	8	7	19
Total	513	212	86	50	76	248	75	62	43	31	37	53

Note: BJ-Beijing, TJ-Tianjin, SH-Shanghai, GD-Guangdong, LN-Liaoning, JS-Jiangsu, FJ-Fujian.

Source: MRI, 1990.

2.30 Unfortunately, there is hardly any information on the role of Japanese ventures in China concerning international trade. The most recently published detailed survey on overseas operation of Japan's overseas subsidiaries, which reports on fiscal 1989, gives only aggregated data for Asia as a whole. This survey disclosed that Japan's overseas manufacturing factories shipped ¥ 1.77 trillion (\$11.2 billion) of products to Japan. This accounted for 10.4 percent of Japan's imports other than food, raw materials and mineral fuels. About a half of such shipment came from the Japanese overseas subsidiaries in Asia.^{14/}

^{14/} See Takeuchi (1990), Tran Van Tho (1987).

2.31 Goods from Japanese subsidiaries and joint ventures in other Asian countries mainly consisted of machinery, in particular electric machines. Electric machines alone accounted for 66 percent of Japan's import from such factories amounting to ¥ 535 billion for fiscal 1989. This roughly matches the total customs clearance 15/ of ¥ 556 billion worth of such goods with Asian origin for 1989, meaning that almost all the electric machines Japan imported from Asia came from Japanese subsidiaries. By comparison, textile products including apparel, which comprise a large portion of Japan's manufactured goods imports from Asia, accounted for a rather small portion of shipment of such firms to Japan. The ¥ 37 billion worth of textile products manufactured by Japanese subsidiaries in Asia and shipped to Japan in fiscal 1989 equal only 3 percent of Japan's textile imports from Asia.16/

2.32 This contrast reflects the difference in the relative position of Asian industries and also different strategies of Japanese importers. While Japanese electric machinery enjoys a far superior position both in Japan and in neighboring countries, the textile industry shares the market with its Asian rivals. But more importantly, from the fact that electric machinery such as components and low-end consumer goods is one of the fastest growing import items, we can conclude that regional division of labor in Asia is rapidly expanding with the initiatives of the Japanese electric machine makers.

2.33 As we have seen in the preceding chapter on trade, China accounts for 18 percent of Japan's manufactured imports from Asia. Although a major portion consists of textiles, machinery imports are growing very rapidly. And among machinery imports, electric machinery is expanding by far faster than other machines. The earlier observation concerning the export policy of Japanese subsidiaries in Asia suggests a strong linkage between China's fast-growing electric machinery export to Japan and the recent upsurge of Japan's electric machinery investment in China. In fact, Japan's electric machinery import from China has been widening its share in imports from Asia almost at

15/ It must be noted that the customs clearance imports are compiled according to the calendar year. Such data for fiscal 1989 are not available for this category. Since calendar years precede fiscal years by three months, data on a calendar-year basis tend to undervalue the real trend.

16/ Such a ratio for all goods excluding electric machines stands at 6.8 percent. This implies the virtual control of imports by the Japanese subsidiaries only exists in the electric machinery industry in Asia as an exceptional case rather than the standard.

the same pace as accumulated DFI in this sector with roughly a one-year lag.^{17/}

D. Role Played by Small Firms

2.34 Much attention has been paid to the role played by small- or medium-sized companies concerning Japan's DFI, particularly in Asian countries.^{18/} As the analysis in Sections A and B strongly suggests, it appears that these firms played an even more important role in China than in the rest of Asia. As we have seen, particularly in the manufacturing field, small firms took a lead when such investment took off in the mid-1980s, when larger firms generally took a more conservative stance with some exceptions. Therefore, in thinking of the future of Japanese direct investment in China, better knowledge of DFI of these firms is indispensable. However, due to lack of proper statistics, accurate analysis is fairly difficult to make. The following is a trial in this direction.

2.35 The data concerning small- and medium-size firms in this analysis is taken from various issues of the "White Paper on Small and Medium Enterprises" (henceforth referred to simply as the White Paper) issued annually by the Small and Medium Enterprise Agency of the Japanese government. Although the data are sketchy, limited only to number of projects and not quite on a com-

^{17/} It is important to note that the correlation exists between China's shares in Japan's electric machinery imports and in Japan's electric machinery DFI stock (or accumulated amount), and not annual flows.

	1987	1988	1989
<u>China's Share in Japan's Imports from Asia (%)</u>			
All manufactured goods	15.8	16.8	17.5
Machinery	2.0	3.0	5.2
Of which: Electric	1.9	3.2	6.2
<u>China's Share in Japan's DFI Stock in Asia (%)</u>			
All manufactured goods	1.5	2.8	3.6
Electric machinery	3.4	6.4	7.0
Others	1.1	2.0	2.6

Source: "Tsusho hakusho (White Paper on International Trade)", Ministry of International Trade and Industry, 1989 and 1990. "Dai-4-kai kaigai jigyo katsudo kihon chosa (The 4th Basic Survey of External Business Activities)," MITI, 1991.

^{18/} There are many who count this as one of the major features of Japan's DFI. See Kojima (1977), Ozawa (1979), the World Bank (1988) for examples. But recent studies may indicate this is not very particular to Japan. See United Nations Center on Transnational Corporations (1988). For an international comparison, see UNCTC (1991) and Fujita (1990).

parative basis with MOF's data, this is virtually the only official data on Japan's DFI in China by smaller companies.^{19/}

2.36 The White Paper started reporting such enterprises' ^{20/} DFI by sector and by broad region of destination, including a few major host countries in Asia in its 1976 edition. But separate treatment of China became available only for 1985 and onward. As we have seen in the previous sections, Japan's DFI in China first took off in 1984. In 1985, small firms' newly made DFI in China numbered 56 in total. This meant that more than one third of such firms' DFI in Asia went to China. However, in the following two years, this number declined to reach 48 in 1987. And China's share dropped to only 10 percent. In 1988, small enterprises' China investment increased fairly sharply. But China's share did not see much recovery. The other countries also attracted many of the small- and medium-size companies.

2.37 In 1985, more than a quarter of small firms' DFI in China was directed in the service industry. All combined, almost half of the total DFI was accounted for by nonmanufacturing investment, although it declined in the following years. In the case of small firms' direct investment to Asia other than China, the service sector did not account much. The largest sector in nonmanufacturing was commerce. And nonmanufacturing as a whole took a smaller share than in China.

2.38 There is a difference between DFI in China and in the rest of Asia within the small firm's manufacturing industry, too. While such firms invested heavily in such light-industry sectors as food and textiles in China, machinery investment accounted for a rather small part of their manufacturing DFI. Quite the opposite took place in the other Asian countries ^{21/} (Table 2.5).

^{19/} There are two official sources of more or less consistent data on smaller firms' DFI in Japan. The other one is MITI's "Kaigai jigyo katsudo kihon chosa" (Basic Survey of External Business Activities,) which is conducted every three years. Although these statistics give some interesting details of smaller firms' overseas business, individual country data are not published. Detailed information on the data issued by the Small and Medium Enterprise Agency is provided in the annex.

^{20/} Small and medium enterprises are defined as follows:

- (a) Manufacturing: with capital amounting to ¥ 100 million or less; or the number of employees totaling 300 or less.
- (b) Wholesaling: with capital amounting to ¥ 30 million or less; or the number of employees totaling 100 or less.
- (c) Retailing and other services: with capital amounting to ¥ 10 million or less; or the number of employees totaling 50 or less.

^{21/} This seems to reflect the difference in patterns of the linkage of small firms to large core-firms. For further discussion see page 22.

Table 2.5: SMALL FIRMS' DFI TO CHINA AND OTHER ASIA BY SECTOR
(Accumulated DFI cases between 1985 and 1989)

	DFI to China			DFI to Other Asia		
	Cases	%	%	Cases	%	%
Food processing	31	16.3		72	5.8	
Textiles	41	21.6		124	10.0	
Wood/pulp	10	5.3		30	2.4	
Chemicals	14	7.4		81	6.5	
Metals	12	6.3		132	10.6	
Machinery	35	18.4		488	39.4	
Others	47	24.7		313	25.2	
Subtotal, manufacturing	<u>190</u>	<u>100.0</u>	<u>57.8</u>	<u>1,240</u>	<u>100.0</u>	<u>67.4</u>
Agricultural/forestry	14		4.3	15		0.8
Mining/gas/oil	0		0.0	5		0.3
Construction	9		2.7	23		1.2
Commerce	58		17.6	281		15.3
Services	42		12.8	109		5.9
Subtotal, nonmanufacturing	<u>85</u>		<u>25.8</u>	<u>284</u>		<u>15.4</u>
Branch offices	16		4.9	168		9.1
Total	<u>329</u>		<u>100.0</u>	<u>1,841</u>		<u>100.0</u>

Source: Compiled from various issues of Chusho Kigyo Hakusho, the White Paper on Small and Medium Enterprise Agency, SMEA, the Japanese Government.

2.39 Despite some flaws,^{22/} the comparison of these two data gives meaningful clues to the actual importance of smaller enterprises in Japan's DFI. Table 2.6 shows the percentage of small firms' DFI to that of all firms' by sector, which is obtained by dividing the former by the latter. To narrow the gap in the time span, the neighboring two years are combined to produce a moving two-year average. But because the numerators are of a narrower definition, the figures in this table undervalue the actual shares of smaller firms.^{23/} It is obvious that small enterprises play by far the larger role in China than in other parts of Asia in almost all the sectors. The only exception is machinery in 1987/88.

2.40 In manufacturing, China's dependence on small firms in DFI from Japan is most conspicuous in labor-intensive, light-industry sectors such as textiles, sundries (others in manufacturing), and wood and paper. In nonmanufacturing sectors, in the most recent year small firms monopolized the construction and commerce sectors. But in the service sector, small enterprises

^{22/} Although the above-mentioned data on the numbers of DFI by small and medium enterprises are originated from MOF's approval/notification file of DFI, we cannot compare these with the figures which cover all firms to know the actual share of small firms' investment. There are two major problems. Firstly, there is a difference in years in which these data are presented. The Small and Medium Enterprises Agency's data are compiled in calendar years, while MOF's data on all firms are based on fiscal years. Therefore, if we compare the two series of the same year, only three quarters of each year overlap and the other quarter has a difference of one full year. This produces a fairly large gap when DFI is growing so rapidly as now. The other reason concerns the difference in the coverage of DFI. MOF's data on all firms' DFI include long-term loans with the intention of establishing lasting business relationships or between the enterprises which have entered such relationships, as well as equity acquisitions. In the past few years, some 30 percent of Japan's manufacturing DFI in Asia is made in such a form of loan. But the Small and Medium Enterprises Agency's data exclude this type of investment.

^{23/} Although small firms' DFI numbers in broader definition are not available, as for manufacturing DFI by all firms, regional aggregate of DFI numbers in the narrower definition are published. In the past few years, all firms' manufacturing DFI in Asia in this definition stayed at around 73 percent of the numbers in the broader definition. Therefore, the actual share of small enterprises in DFI in Asia in 1987/88 should be 65 percent rather than 47 percent as shown in Table 2.6. Such information is not available on particular countries but, if we can assume the same ratio to China small firms' share of 66 percent in manufacturing DFI in 1985/86, it would imply an "actual" 91 percent. But it is possibly an overvaluation because, in China where Japanese DFI has not a long history as in other parts of Asia, DFI in the form of loans can be relatively fewer, in other words, the gap in the two definitions is smaller. A safe bet would be somewhere between 70 and 90 percent.

Table 2.6: SMALL FIRMS IMPORTANCE INDEX

Sector	DFI to China			DFI to Other Asia		
	1985/86	1986/87	1987/88	1985/86	1986/87	1987/88
Food processing	48.0	48.0	51.6	28.4	33.0	40.9
Textiles	100.0	76.9	71.0	33.3	50.0	58.3
Wood/pulp	75.0	75.0	62.5	18.8	26.5	25.7
Chemicals	70.0	50.0	43.8	21.3	29.7	28.3
Metals	60.0	57.1	57.1	24.0	36.7	50.8
Machinery	66.7	45.0	23.3	32.3	41.8	47.2
Others	70.6	106.7	67.7	33.1	44.7	55.1
Subtotal, manufacturing	<u>66.3</u>	<u>62.5</u>	<u>51.1</u>	<u>30.1</u>	<u>40.0</u>	<u>46.9</u>
Agricultural/forestry	28.6	35.3	33.3	8.3	16.7	18.9
Mining/gas/oil	0.0	0.0	ERR	4.8	0.0	6.3
Construction	40.0	0.0	100.0	8.9	12.5	15.8
Commerce	42.1	76.5	105.0	18.6	26.0	28.5
Services	38.2	35.6	25.6	11.0	13.5	12.2
<u>Total</u>	<u>53.0</u>	<u>53.5</u>	<u>50.2</u>	<u>24.0</u>	<u>33.2</u>	<u>38.0</u>

Note: Explanation is given in the text.

Source: Computed by using MOF data and SMEA data.

were always limited to a relatively small role.^{24/} The change of such ratios over the years also gives an interesting insight. While in China the share of small firms in overall investment stayed rather constant during the period, such ratios of the manufacturing sector followed a distinctive downward trend. But in the rest of Asia, such figures showed a growing trend in both the manufacturing and nonmanufacturing sectors. The most conspicuous contrast can be found in the machinery sector.

2.41 Although small and medium enterprises have accounted for a relatively large portion of Japan's DFI, they have always invested mainly in neighboring Asian countries. And their shares against all firms have drawn a distinctive pattern in correlation with the change in the yen's exchange rate. This is largely a reflection of the weaker position of smaller firms. They had to rely on cultural and geographical closeness of Asia more than larger

^{24/} It must be noted that small firms' large share in the number of DFI does not mean a correspondingly large share in the amount of DFI. On the contrary, there has been a substantial difference in average size of investment between the two groups of enterprises. The average size of small firms' DFI was a quarter to one sixth of that of larger firms in 1972 to 1976 (see Annex).

companies. They were more vulnerable to the changes in the yen's exchange rate than large-scale enterprises whose competitive edge is based not only on price competitiveness. Small firms' investment abroad is also more closely linked to the general business conditions of Japan's economy than large firms. When the economy is booming, they can invest easily but, in a downturn, they have greater difficulty.

2.42 The steady rise in small firms' shares in DFI in Asia since 1985 is not unusual, but why does this pattern not hold with China? There are three factors. Firstly, the recent move to Southeast Asia by the Japanese large-scale manufacturers, accompanied by small subcontractors who supply parts and materials, or related services. Particularly for large machinery assembly makers to have their old and reliable Japanese suppliers of semi-assembled parts close to their offshore plant was considered an indispensable condition for success. These smaller suppliers were sometimes strongly urged to follow their large customers.

2.43 But in China, such a strategy cannot work. When the Japanese set up a joint venture in China, domestic suppliers of parts and materials are often designated by the Chinese government. Even if Japanese suppliers were allowed, they will have difficulty to meet foreign exchange requirements since their sales to the large firm's Chinese venture do not earn the foreign currencies they need for importing necessary materials from Japan or abroad.

2.44 There are two types of small or medium enterprises which go abroad. One is the "independent type" and the other is the "dependent type."^{25/} The former are those which have their own know-how and strategy supported by technical edge and/or merchandise planning ability. They are often manufacturers of finished products, although some are parts producers. The "dependent type" companies have strong and stable ties with specific customers of their products of a size much larger than themselves. They are typically engaged in making components or parts to be assembled by larger manufacturers of machinery. They may well have highly respected skills or technologies, but such skills are derived from joint work with their larger-size customers and not separable. They cannot move independently.

2.45 So far, most of the small- and medium-size firms which invested in China are of the first type. They are mainly engaged in light-industry types of products such as textile clothing, leatherwear and sundries, although some are producing specialized machines or equipment. The smallness of the number of "dependent type" of DFI in China, which is reflected in the relatively small share of the machinery sector, is partly due to the reluctance of Japan's large-scale assembly makers to go to China in the past and, partly due to the low multiplication effect such makers can generate in terms of the number of "dependent type" DFI in China.

2.46 The second reason is the recognition of difficulty of operation in China. Although there are some small firms which are faring rather well in China, generally speaking, smaller enterprises lack political clout to solve

^{25/} Giddy and Young have categorized the types of small firms in more detailed groups. See Giddy and Young (1982).

problems in China, unlike larger firms.^{26/} The last factor is a positive one. The large-scale Japanese makers finally started to pay more attention to China and began investing recently. Small firms' shares have been reduced proportionately to this extent. A number of large projects were announced or being planned by late 1988. But the June 4 incident led to postponements and a general slowdown which lasted well over a year.^{27/}

2.47 Japan's DFI statistics for the latter half of fiscal 1989 registered a large fall in both number and amount. For fiscal 1989 as a whole, Japanese data recorded a 26 percent decline in number of projects, although the amount of total values increased by 48 percent. The average amount per project doubled for this year, reflecting an increase in large-scale investment, particularly before the incident.

2.48 But since the middle of 1990, Japan's direct investment in China seems to have recovered. The MOF data for the first half of fiscal 1990, ending September last year, saw a pickup in the number of projects, although it still fell short of the previous year's level (Chart 2.7). The reported projects since 1990 are mainly in the manufacturing field spread over a variety of sectors such as electric machinery, apparel, medical supplies, cement and electronics. There also are projects in software development and energy- or agriculture-related businesses. Canon has launched a wholly-owned compact camera production venture, Mitsubishi a joint-venture cement mill and a joint-venture project for coal water-mixture development. Smaller firms are also becoming active.^{28/}

E. Globalization, The New Strategy for Japanese Firms

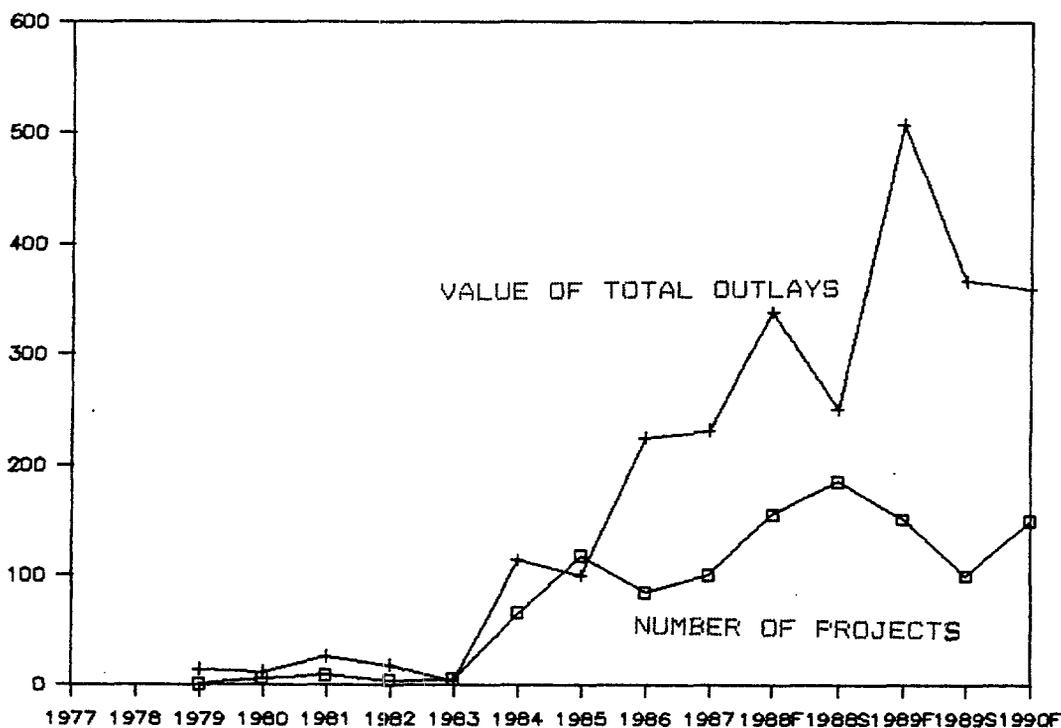
2.49 Globalization has become a buzzword for Japan's big business since 1985. In short, this means a global deployment of production sites and coordinated operation of these facilities. The basic strategy on external markets of Japanese major firms before the "globalization" was "export from Japan." In the early 1970s, when the Japanese yen was first allowed to appreciate, their main task was to streamline their production while exporting from Japan. Even when they shifted a part of their production facilities to Asia, to follow their American competitors in some cases, they kept on manufacturing components in Japan. The life employment policy was sacred, particularly for big

^{26/} Problems DFI faces in China are discussed in Section G.

^{27/} A survey conducted in November 1989 by the Japan-China Association on Economy and Trade revealed that the majority of the companies which were considering direct investment in China had been forced to change their investment policy because of the incident. Only 25.2 percent of the firms surveyed responded that the effects were negligible. Those who reported suspension of the project amounted to 30.1 percent. Alteration or cancellation of the project was reported by 10.4 percent of the surveyed companies. And 7.4 percent of the firms responded that they had already started studies of locations in countries other than China.

^{28/} JETRO (1991), p.201.

Chart 2.7: THE RECENT DEVELOPMENT
(\$ million, cases)



Source: Ministry of Finance, the Japanese Government.

corporations.^{29/} They could not afford to simply shut down domestic factories and go abroad as some of their American rivals did.^{30/}

2.50 But by the early 1980s, widening trade deficits had so aggravated trade disputes with the United States and Europe that Japan's big businesses were compelled to build factories in these countries. Color TV, VCR and car production were begun in this way. At first, most of the parts were imported from Japan. When this was also criticized, Japanese companies induced their parts suppliers, with whom they had established long-standing relationships, to join them overseas as well.

2.51 The drastic appreciation of the yen in late 1985 made building factories in foreign countries much cheaper and transplanting to the developed world was accelerated. Japanese producers also worked hard to streamline their domestic production facilities and expanded them in some of the advanced NICs, retaining only top-of-the-line items in Japan. Soon afterwards, labor

^{29/} Hara (1988).

^{30/} Sakai (1987).

problems in Korea and the appreciation of the won as well as the Taiwanese dollar prompted Japanese firms to move to the the ASEAN countries.^{31/}

2.52 Although the ASEAN countries other than Singapore had the advantage of an abundant labor force and relatively cheap wages, the export processing in these countries was not immediately profitable. Imported parts from Japan were too costly. Therefore, Japanese producers were forced to automate production to achieve higher efficiency, to cut the number of parts through compositization, and to reduce the defect ratio. They also tried to raise local content. But there were very few local suppliers which could meet the stringent requirements of Japanese producers. Thus, the Japanese started production of components by themselves or encouraged their old suppliers to invest there. Some of the parts were supplied by Japanese subsidiaries in the East Asian NICs.

2.53 Thus, a fairly large concentration of Japanese transplants emerged in some of the Southeast Asian countries. Currently there are 434 subsidiaries producing electric machines, including those in Korea and Taiwan. This is almost three times the number of those in the United States. These plants in Asia account for more than half of the total offshore production of Japan's electric machinery industry. Japanese subsidiaries in Southeast Asia can now obtain a fairly large portion of electric components in the local market including neighboring countries. Most of them are supplied by Japanese firms operating locally. For example, in the case of radio-cassette players, 97-98 percent of the needed parts are available in Singapore. But, here, the Japanese subsidiaries account for 80 percent.^{32/}

2.54 Since Asia became an important offshore production base as well as the United States and Europe, Japanese big businesses now have a global strategy of production allocation and intrafirm division of labor. In this grand design, Asia is not only an offshore production base for exports anymore. Within the Asian countries, a horizontal division of labor is being established.

2.55 As a result of automation, production of lower-end products is not always suitable in low-wage countries.^{33/} Particularly from the viewpoint of the Japanese market, even low-end goods may be produced more cheaply in the NICs than in the Philippines or Indonesia. This is not only because the former are geographically closer to Japan (which lessens transport costs), but also these countries are good at producing a large quantity of goods with stable quality. If products with a higher value added require more manual operations, these are often best located in the ASEAN countries. There are many examples, such as toys and footwear, where Japanese subsidiaries in NICs produce at lower cost.

^{31/} The member countries of ASEAN (the Association of South-East Asian Nations) included Brunei, Malaysia, Indonesia, the Philippines, Singapore and Thailand. But Brunei should be excluded in this context.

^{32/} Sakai (1987), Ex-Im Bank of Japan (1988).

^{33/} The World Bank (1991).

2.56 In the field of machinery, assembly often takes place in the ASEAN area, using components either made locally or in more developed Asian countries with only core parts imported from Japan. But even in such instances, a cheap and abundant labor force is not sufficient. To secure a consistent level of quality, often a state-of-the-art facility, often with equipment superior to what is installed in Japan, is introduced.

F. Future Prospects

2.57 The future course of Japanese DFI in China can be gleaned from two surveys (Table 2.7). One was conducted in November 1985, the other in March 1989. Although the potential of the Chinese market still attracted the largest portion of Japanese firms, its relative importance declined. Also, such "cosmetic" motives as "to establish a corporate image in China" or "to counter competitors' advance to China" lost ground. Although such passive reason as "due to solicitation from the Chinese" still retains the second highest position in the answers, more positive and active motives such as "due to cheap and rich raw materials" have seen an increase in shares of the respondents. The Japanese are attaching more and more importance to realistic reasons.^{34/}

Table 2.7: MOTIVES OF DFI IN CHINA
(Comparison of surveys conducted in 1985 and 1989)

1985 Survey (Nov. 1985)	%	1989 Survey (Mar. 1989)	%
China's potential	31.4	China's potential	27.0
Request by Chinese	18.9	Request by Chinese	20.0
Corporate image	11.3	China's labor force	16.5
China's labor force	8.4	Corporate image	10.4
Preceding rivals	7.0	China's protectionism	7.0
China's raw materials	5.5	China's raw materials	7.0
Dividend or royalty	5.2	Following rivals	3.5
Following rivals	5.2	Tax privileges	0.9
Geographical closeness	2.3	Other reasons	7.8
Other reasons	1.2		

Source: The 1985 survey is from "Kaigai-Toshi-Kenkyushoho," Export-Import Bank of Japan, June 1986. The 1989 survey is from "Chugoku-Keizai," JETRO, April 1990. Both as quoted in Imai, 1990.

2.58 The investors' concerns are, in general:

- (a) whether the workforce can absorb the needed skills and technology;

^{34/} It is noteworthy that tax incentives were paid very little attention (0.9 percent). They may be discounted by the frequent changes of basic policy and lack in relevant rules.

- (b) whether the capacity of the production equipment can be fully mobilized (power shortage, maintenance services, transport);
- (c) whether good-quality parts and materials can be easily obtained.

China needs to meet such criteria in order to compete successfully with its rivals in Southeast Asia.

2.59 As regards (a), Japanese investors generally give high marks to Chinese workers, although some of them complain about the indifference of the Chinese toward quality control and teamwork, which are factors the Japanese consider as important as technical skills to ensure high quality of production. The majority view on (b) and (c) is that China ranks behind most of the other Asian countries. Two years ago, the Japanese Association of Commerce and Industry of Shenzhen submitted a letter of complaint protesting the frequency of power outages to the city authorities. There is no shortage of such episodes.^{35/}

2.60 According to a survey conducted in 1989,^{36/} as many as 38 percent of the Japanese joint ventures surveyed reported their operation fell short of the original plan. Only 55 percent replied that they were going more or less as planned. The main problem was related to parts and raw materials. Domestically supplied parts and materials are generally considered poor in quality by the Japanese. Even when Chinese factories have the manufacturing capability, they generally are reluctant to supply the Japanese whose requirement of quality and delivery tends to be exacting. When they do enter a subcontracting relationship, they often become more expensive than the international standard. If the Japanese decide to import these parts and materials, they then face a strict requirement to balance the foreign exchange needs by themselves, or to trade on one of the foreign exchange adjustment centers. Many of the Japanese joint ventures had been requested to present an export plan. But the majority of them are falling behind.^{37/}

2.61 On top of these problems directly related to production, there are several others. They are: political uncertainty and relatively unpredictable, inconsistent economic policy; a nontransparent legal system, the enforcement of which is often conducted by the local authorities. Unstable stop-and-go policies worry high-tech industries which are attracted by China's domestic market rather than export. Other complaints include: obligation to

^{35/} The recent surge of Japanese direct investment in Dalian is partly due to the successful drive of the local authorities to assure them in this regard. In August 1990, Japanese direct investment in Dalian was reported to number 136. This outnumbers Beijing, Shanghai and Tianjin and represents 30 percent of the total foreign ventures set up in Dalian. See Chapter III.

^{36/} "Study Report II on Japan-China Joint Ventures," November 1989, published by the Japan-China Association on Economy and Trade.

^{37/} As of November 1989. Based on "Study Report II on Japan-China Joint Ventures."

balance foreign exchange, perception gap with the Chinese counterpart, intervention into management by the authorities, and high utility charges.^{38/}

2.62 However, surveys show that, despite all these complaints, Japanese joint ventures in China are generally faring well. In a most recent survey,^{39/} 71 percent of the firms surveyed reported surpluses and only 15.9 percent replied they were running a deficit.^{40/} There are many which started to become profitable earlier than the original plan.^{41/} Some are reported to have recouped the initial investment in the first few years. Some are reinvesting earnings. A small-size manufacturer of gloves has set up four fully-owned subsidiaries in five years. For those which have their own firm-specific advantage, such as production skills and marketing know-how, the above-mentioned obstacles are not insurmountable.

2.63 China may well have a chance to attract an increasingly larger portion of Japan's DFI in Asia now that the Japanese traditional locations in Asia are gradually becoming saturated in terms of labor force and land. However, China needs to make further efforts to improve the conditions surrounding foreign ventures such as infrastructure. To attract large firms which are looking for off-shore production bases in line with their globalization strategy, China should give more encouragement to export-oriented DFI. At the same time, small firms should not be ignored. They may not offer state-of-the-art facilities or highly advanced technology as large-scale firms have, but they have plenty of production know-how or marketing know-how which is nonetheless valuable to the development of Chinese industry. Small firms' skills and technologies may be easier to transfer than those of giant corporations and, therefore, more productive for development of local industry such as TVEs. It must not be forgotten that these small firms are indispensable parts of Japanese industry and an important source of its competitiveness.^{42/} Large-scale companies' DFI is not good enough to make Chinese industry competitive enough against the Asian rivals. And coordination in planning, designing, production and delivery that exists between large and small Japanese firms is something China needs to adopt to improve its industry.

^{38/} Based on Imai, 1990, p.102.

^{39/} "Study Report II," Japan-China Association on Economy and Trade.

^{40/} When interviewed, even those reporting surplus often stress hardship. Some consider reported profits conceals some expenses the Japanese investing firms unilaterally bears.

^{41/} Because of worries about the uncertainty of China's politics, some firms may be forced to plan in shorter terms than elsewhere.

^{42/} In this connection, nonmanufacturing investments should not be neglected. They often play vital parts of a linkage-chain. And also, it is known that smaller firms often start with nonmanufacturing investment such as commerce when they make overseas DFI, and later on, move to manufacturing investment (see UNCTC, 1991).

III. CHINA'S ECONOMIC FUTURE

A. Japanese Perception

3.1 Before the June 4 incident in 1989 dented their optimism about China's future as a much more democratic and outward-oriented economy, the Japanese think-tanks used to publish a rosy long-term prospect on Asia with special attention on China. But at least temporarily many of the Japanese research institutions seems to have stopped disclosing a long-term forecast on China. For example, the Research Institute on the National Economy, a Tokyo-based, well-established think-tank, failed to give specific numbers for China in its most recent 1990 issue of the "Annual Report," a ten-year forecast revised each year. There are exceptions, three of them, at least (Table 3.1).^{1/}

Table 3.1: LONG-TERM FORECAST ON CHINA BY JAPANESE THINK-TANKS AFTER 1989

Forecaster	Average GNP growth (%)	Forecast period
JCER ^{/a}	6.6	1989-94
NRI ^{/b}	7.6	1990-2000
YRI ^{/c}	8.3	1989-2000

^{/a} Japan Center for Economic Research, March 1990.

^{/b} Nomura Research Institute, March 1990.

^{/c} Yamaichi Research Institute, April 1990.

3.2 Compared with these institutional forecasts, individual researchers tend to be more conservative although there are also those with very optimistic views. Those who have a pessimistic view about China's economic future are concerned about the postponement of reforms after 1989; they worry that economic opening will be sacrificed for political discipline; and that economic growth will be hampered to this extent. Some foresee political turmoil after the death of Deng Xiaoping.

3.3 But Japan's business circle generally has a more pragmatic view on China's future. This stems from their perception of the Tiananmen incident which is very different from that of many Japanese intellectuals as well as many Westerners. They see it as a regrettable incident and wish it could have been avoided. But they think it wrong to judge China by the standards of fully developed democratic countries in the West. In their view, an

^{1/} These forecasts are almost one year old and will be updated shortly. It seems likely that these institutions will revise their forecast a little downward because it has become clear that the Chinese government's own ten-year plan is aimed at much slower growth.

authoritarian regime is not always avoidable for a developing country undergoing rapid change.

3.4 Such a view partly reflects their concern over the possibility of serious social disturbances in China and its spill-over to the neighboring countries in Asia, including Japan, if political reforms are too hastily implemented. Even if a fraction of 1.1 billion people become refugees, its impact would be immense.

3.5 This worry seems to be basically similar to that of the current leadership in China and conservative economic policymakers. They would like a rapid expansion of the economy to catch up with the rest of the world. But they believe economic development cannot be accomplished without political stability. To assure political stability, excessive growth which leads to inflation needs to be avoided and hasty reforms are also undesirable because they tend to lead to disorder. But the target of quadrupling China's economy by the year 2000 needs to be accomplished to satisfy the aspirations of the Chinese people. Failure would damage the credibility of the leadership, hence, political stability.

3.6 Japanese business leaders are generally optimistic about the future of China's open economy policy, because they believe that without it a growth rate of 6 percent per annum might not be attainable. China has to import technology, DFI, as well as advanced production equipment to improve the efficiency of its economy. Economic reforms are also necessary to attract foreign investment as well as to make its own economy more efficient.

B. China's Economic Impact on Japan

3.7 With a GDP of \$393 billion in 1989, the size of China's economy was less than one-seventh (13 percent) of Japan's.^{2/} If 6 percent growth is maintained during the period, China's GNP will double to reach close to \$750 billion by the year 2000. But, assuming 4 percent annual growth for Japan, China will still remain less than one-sixth (17 percent) of the size of Japan in terms of GNP in the year 2000. China's relative size to Japan, then, would roughly match that of Canada in 1988. But, once put in the Asian perspectives, China's importance comes out clearly. At present, China's GDP roughly matches the combined GDP of the all four NICs in Asia. And if compared with ASEAN economies, China's economy surpasses the total GDP of the five countries ^{3/} by more than 50 percent. China's exports and imports nearly equal those of Asia's most successful NICs. By the year 2000, China's relative political and economic importance in the Asian economy will grow larger than it is now. If China's huge population and geographical proximity is factored in, China will become an increasingly more important economic partner for Japan.

^{2/} The World Bank Atlas, 1990. But it must be noted that international comparison of size of economy is not easy with centrally planned economy whose GNP/GDP does not properly represent the service sector which could have a substantial portion.

^{3/} Indonesia, Philippines, Thailand, Malaysia, and Singapore.

3.8 As economic development in the Southeast Asian countries continues to the year 2000, economic interdependence between them will grow. From the viewpoint of Japanese business, this means that Asia will become a more independent economic entity within which economies of different level of development complement each other, rather than the collection of export-hungry economies which heavily depend on outside markets such as the United States. Here Japan is considered to serve not simply as a supplier of equipment, material, or capital but also as the import market of products made in the region. And Japanese multinational firms are deemed to work as leading players together with the area's indigenous companies.4/

3.9 In the future Asian market, China is expected to play a much more important role than now as an integral part of the Asian production network. It has two advantages: (i) abundant labor force and locations fit for production, with further improvement in infrastructure; and (ii) geographical closeness to Japan, in particular Liaoning, Shandong, and also the region around Shanghai.

3.10 Since Thailand and Malaysia are almost saturated, the Japanese DFI has begun to move to Indonesia. However, if the finished products are to be shipped to Japan or the materials need to be sent from Japan, Indonesia may be too remote for certain products. Indonesia may better serve for those which will use materials or components produced in nearby countries such as Singapore or Malaysia, or for those which export the products to the neighboring countries or the United States rather than to Japan, where China has the advantage.

3.11 Among the three regions of China mentioned above, Liaoning Province, or more precisely Dalian is gaining the largest attention of the Japanese business right now. Its transportation link with Japan is considered to be relatively well developed with a direct passenger flight service regularly operated between Tokyo. Labor, electricity, and land are much cheaper than Shanghai. Water supply is abundant. It has already attracted 136 Japanese ventures as of August 1990. This represents 30 percent of Dalian's total ventures with foreign capital, an exceptionally high concentration of Japanese investment. Currently, a group of Japanese major companies are planning to develop a collective industrial site which will accommodate more than 100 factories in Dalian's economic development zone. If this project is materialized, it will surely introduce many more Japanese ventures.5/

4/ Such a move has already started. According to a MITI survey on Japan's multinational corporations, Japan's manufacturing subsidiaries in Asia shipped only 11 percent of the products to outside of the region in 1989. In 1986, they exported 17 percent of their products to such countries (MITI, 1991).

5/ Historical or cultural ties are also a very important factor in this instance. Before and during the last War, the Japanese military had established a puppet regime and ruled this region. And in Dalian, there was a very large colony of Japanese. A mixed feeling of nostalgia and remorse still prevails among elder Japanese, including many business leaders. Yoshihara (1976) pointed out the importance of cultural and historical ties in Japan's early investment in Asia.

3.12 Shanghai and its Pudong development project is gaining attention among the Japanese, too. Shanghai, despite its geographical proximity to Japan, has been viewed as more inclined to the West by the Japanese. But with the strong support given by the central government to Pudong projects and already well-developed industry in the region, Shanghai has irresistible charm to some Japanese industries such as machinery and textiles, among others.

3.13 Shandong province is also close to Japan, but closer to Korea. Since the governments of Korea and China agreed to open trade representative offices in both capitals last year, the Koreans are showing increasing interest in this region. Already a ferry boat service links Weihai and the Korean port of Inchon, off Seoul. Korean firms have started DFI in Qingdao. The Korean government began constructing industrial parks in the area around Inchon last year. As the rapprochement of the two countries deepens, this whole region surrounding the Yellow Sea is expected to work as a core exemplifying the economic interdependence of China, Korea, and Japan.

3.14 Among the Japanese, there is a view that the Chinese coastal development centers will strengthen their special economic ties with particular partners. It anticipates, for example, Guangdong will consolidate the relationship with Southeast Asian Chinese businesses; Fujian with the Taiwanese; and Shanghai with the West. But it is more likely that these regions will be more dependent upon each other rather than act as autonomous industrial centers as the economic integration of all of East and Southeast Asia will develop into the year 2000. This is already witnessed by the growing numbers of interregional multinational joint ventures in Hong Kong, Shanghai, or Fujian province involving more than three different countries.

3.15 In the coming years, China is likely to have more economic rivals in addition to already very tough competitors in Southeast Asia. In April 1991, the Soviet president visited Japan for the first time in history. This may well lead to closer economic relationship between the two countries in the near future. Among the Japanese business circles, a notion of "the Japanese Sea Rim Economic Zone" is gaining interest these days. This embraces the far eastern coastal region of USSR, the northeastern provinces of China, the Korean nations, and relatively, less-developed northwestern coastal regions of Japan. Interchange of technology, capital, national resources, and labor is expected to lead to the revitalization of the whole area. Another frontier in Asia also drawing the Japanese attention lately is Indo-China centering on Vietnam.

C. Japan's Other Concerns

3.16 But this does not mean that China, which will have doubled its size by the year 2000, will be treated simply as one of many trade partners of Japan. China already surpasses Japan in some of the most important fields of economic activities. For example, its cement consumption amounts to 2.3 times what Japan consumes 6/ and its energy intake exceeded Japan by 86 per-

6/ Watanabe and Zheng, 1990, p. 197.

cent in 1988.^{7/} Its steel consumption already amounts to 83 percent of that of Japan in 1988.^{8/} With more than nine times the size of Japan's population and 25 times the amount of land, China overwhelmingly outweighs Japan in food and other agricultural products. In 1988, China imported 14 million tons of wheat. This, alone, amounted to 2.4 times total national consumption of the Japanese.^{9/}

3.17 Since the Chinese economy will be more open as the turn of the century draws near, change in China's production or demand in these commodities will submit a much large impact on the external world. Japan, as a country heavily dependent upon external supply for basic materials, particularly mineral fuels and food, will be increasingly vulnerable to disruptive changes in supply or demand in China, if such happens. It is, therefore, Japan's critical interest to secure the steady growth of China's economy.

3.18 The energy problem is even more important to the Japanese. It is understood that China could become a net importer of oil before the turn of the century because of the development of the petrochemical industry, enhancement of consumption of plastic consumer goods and advancement of road transport. Currently, China supplies 7 percent of Japan's oil imports. However, China is by no means a marginal supplier of oil to Japan. On the contrary, China is an invaluable source to Japan, which imports 99.7 percent of its oil consumption from abroad and relies more than 70 percent upon the Middle East. The idea that Japan and China may someday have to compete for oil in Asia causes apprehension in Japan.

3.19 China, which comprises more than 10 percent of Japan's total ODA, is one of the largest recipient countries and has been directed to the energy-related and food production-related projects. Out of 42 projects deemed for the latest round of yen credit, as many as six are for construction of chemical fertilizer plants and three are for hydroelectric power generating plants. There are also four coal-fueled power plant projects.

3.20 But as increase in coal consumption is expected another concern has surfaced--the environment. Traditionally, China is heavily dependent on coal as energy sources. Coal represents more than 70 percent of China's primary energy sources and also as a source for generating electricity. Since demand for electricity is estimated to double by the year 2000, coal-fired power plants will be expanded almost by twice.^{10/}

3.21 With consumption of almost 1 billion tons of coal each year, China is already a major source of sulfur oxide (SO_x) and nitrogen oxide (NO_x), not to mention carbon dioxide (CO₂) which accounts for 10 percent of the world's total emissions. By the year 2000, 77 million kWh equivalent of thermal power

^{7/} "Japan 1991, An International Comparison," Japan Institute for Social and Economic Affairs, 1990.

^{8/} Ibid.

^{9/} Ibid.

^{10/} OECF, 1990, p. 74.

plants need to be added. But due to heavy additional expenses, preventive facilities such as Flue Gas Desulfurization (FGD) are hard to implement.^{11/}

3.22 As Japan is affected by pollutants originating in China, this is a subject frequently noted by Japanese business ^{12/} leaders. As a result, there seems a growing recognition of the need of extending technical assistance as well as financial support to China in this regard.

^{11/} OECF, 1990, p. 77.

^{12/} Environmental problems was one of the topics Japanese business leaders raised during their meeting with China's prime minister, Li Peng, in September 1990 (Nicchū Keizai Kyōkai Kaihō, October 1990, p. 23).

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JAPANESE STATISTICS ON DFI

A. BOJ-Based Data and MOF-Based Data

1. In Japan there are two official statistical sources on annual flows of DFI. One is the balance of payment statistics compiled by the Bank of Japan (BOJ). Here, direct investment flows are recorded in both ways (outward and inward) and by nature (Japan's asset and debt). This data set is based on transactions reported from foreign exchange banks, and published each month. Since this is compiled more or less in accordance with the IMF's guideline,^{1/} international comparison of DFI is often based on it.

2. However, the BOJ-based DFI data are not very useful for detailed analysis because it lacks sectoral information and provides very limited details on geographical distribution.

3. The other data source is the approval (until 1980) or notification (after 1981) required under the Foreign Exchange Law, and recorded and published by the Ministry of Finance (MOF). Although monthly information is available only in an aggregated total, detailed information with industry and country breakdowns is issued for each fiscal year which ends in March in the following year. Therefore, the foregoing analysis of Japan's DFI in Chapter II is based on MOF statistics.

4. But it must be noted that MOF-based DFI tend to overstate the flows of DFI compared with BOJ data. There are three reasons. Firstly, the MOF data are based on a broader definition of DFI. While the BOJ data count only those investments made by investors who hold at least 10 percent of the equity of a foreign enterprise, the MOF data include even those made by investors who control less than 10 percent or none of a foreign firm, as long as a close relationship exists between the investor and the invested firm. A certain type of long-term credit with a product-sharing arrangement without equity participation, which is classified as an indirect investment in BOJ statistics, is included as DFI in MOF data.

5. Secondly, the MOF data register only gross flows, and negative flows such as withdrawals of equity investment or repayment of loans are disregarded. This problem is particularly disturbing because, due to lack of stock data, accumulated annual flows are used as a substitute for DFI stock position.

^{1/} The IMF's guideline is shown in its Balance of Payments Manual. But it is not very strict and allows fairly large differences in practice. One of the most important features of Japan's BOJ-based DFI data is the exclusion of reinvestment.

6. Thirdly, being only plans for investment, approval- or notification-based data may well overstate the actual DFI flows to the extent that firms may cancel, postpone,^{2/} or scale down the plan.

B. Small Firms' DFI Statistics

7. Small firms' DFI data reported in the "White Paper on Small and Medium Enterprises" are recompiled from MOF's approval-/notification-based data by the Small and Medium Enterprise Agency (SMEA). But this data set has some flaws which make complete comparative analysis with larger firms' DFI impossible. Firstly, small firms' data are reported only in numbers of outlays and the information on the amount of such DFI is extremely limited.^{3/}

8. Another problem comes from the fact that small firms' data cover only "newly acquired entities" and exclude loans and other forms of DFI, and also additional purchases of equities are omitted. Although MOF's DFI data on all firms do not provide detailed information in such a narrow definition, geographical aggregates for manufacturing total are disclosed in the publication of the Ex-Im Bank of Japan.^{4/} Comparing these data we can know the gap between the MOF's regular, or broader, definition and SMEA's narrower definition amounts to some 37 percent for Japan's manufacturing DFI by all firms in Asia in recent years.

9. Lastly, there is one more important difference between the DFI data for small firms and all firms: the difference in reporting years. While MOF's data on all firms' DFI are reported in fiscal years, which start in April of the corresponding calendar year and end in March of the following year, SMEA's data are compiled in regular calendar years.

^{2/} Although Komiya (1987, p. 243) states that "the time of actual investment is generally later--sometimes much later than the time of the approval or notification, ..." it is unlikely that the delay takes more than a couple of months. According to the Foreign Exchange Law, the notification is to be made within a period of more than 20 days but less than two months prior to the planned investment.

^{3/} In the "White Paper on Small and Medium Enterprises," sectoral and geographical breakdown of such investment is provided only in number of outlays and the information concerning value is unavailable in most years. Only sporadically is the aggregate total amount of small firms' DFI mentioned. The data in Annex Table 2, obtained by UNCTC directly from MITI, the Japanese government in charge of SMEA, disclosed the average size of small firms' DFI was much smaller than that of all firms' DFI.

^{4/} Ex-Im Bank's research monthly, "Kaigai Tōshi Kenkyūjohō," issued from its Research Institute of Overseas Investment, reviews the preceding year's DFI in detail in one of its fall issues.

Annex Table 1: JAPAN'S DIRECT FOREIGN INVESTMENT

To:	China	China's share (%) in Asia Total		Asia	North America	Europe	Total
<u>Number of Projects</u>							
<u>Fiscal Years</u>							
1977				511	693	162	1,761
1978				669	1,055	251	2,393
1979	1	0.1	0.0	759	1,228	301	2,694
1980	6	0.9	0.2	646	1,006	364	2,442
1981	9	1.3	0.4	712	961	229	2,563
1982	4	0.6	0.2	669	907	272	2,549
1983	5	0.6	0.2	825	888	316	2,754
1984	66	9.8	2.6	674	799	269	2,499
1985	118	17.2	4.5	685	962	313	2,613
1986	85	10.4	2.7	819	1,284	404	3,196
1987	101	7.5	2.2	1,342	1,885	537	4,584
1988	171	9.8	2.8	1,737	2,543	692	6,077
1989	126	7.4	1.9	1,707	2,848	916	6,589
<u>Fiscal Half Years</u>							
1988F	78	10.2	2.8	768	1,179	312	2,760
1988S	93	9.6	2.8	969	1,364	380	3,317
1989F	76	8.5	2.3	898	1,371	434	3,280
1989S	50	6.2	1.5	809	1,477	482	3,309
1990F	75	9.6	2.4	779	1,351	491	3,083
<u>Values (\$ million)</u>							
<u>Fiscal Years</u>							
1977				865	735	220	2,806
1978				1,340	1,364	323	4,598
1979	14	1.4	0.3	976	1,438	495	4,995
1980	12	1.0	0.3	1,186	1,596	578	4,693
1981	26	0.8	0.3	3,339	2,522	876	8,932
1982	18	1.3	0.2	1,384	2,905	876	7,703
1983	3	0.2	0.0	1,847	2,701	990	8,145
1984	114	7.0	1.1	1,628	3,544	1,937	10,155
1985	100	7.0	0.8	1,435	5,495	1,930	12,217
1986	226	9.7	1.0	2,327	10,441	3,469	22,320
1987	1,226	25.2	3.7	4,868	15,357	6,576	33,364
1988	296	5.3	0.6	5,569	22,328	9,116	47,022
1989	438	5.3	0.6	8,238	33,902	14,808	67,540
<u>Fiscal Half Years</u>							
1988F	170	6.4	0.7	2,659	11,770	4,046	22,857
1988S	126	4.3	0.5	2,910	10,558	5,070	24,165
1989F	254	6.5	0.8	3,906	13,782	7,690	30,824
1989S	184	4.2	0.5	4,332	20,120	7,118	36,716
1990F	180	5.1	0.7	3,553	13,322	6,622	27,678

Source: Ministry of Finance, the Japanese Government.

Annex Table 2: JAPAN'S FLOWS OF FOREIGN DIRECT INVESTMENT BY SMEs, 1974-86

Year/ <u>a</u>	DFI by SMEs		DFI by all firms		Share (%) of investments by SMEs	
	No. of investments	Value (\$ mln)	No. of investments	Value (\$ mln)	No. of investments	Value
1974	615	129	1,912	2,396	32.2	5.4
1976	542	99	1,652	3,462	32.8	2.9
1978	1,219	381	2,395	4,599	50.9	8.3
1980	1,100	806	2,442	4,693	45.0	17.2
1982	927	1,033	2,604	7,808	35.6	13.2
1983	943	839	2,546	7,074	37.0	11.9
1984	1,028	1,645	2,656	10,276	38.7	16.0
1985	967	1,707	2,513	11,190	38.5	15.3
1986	1,239	2,899	3,053	19,840	40.6	14.6

/a Fiscal year before 1980 and calendar year after 1982.

Source: Ministry of International Trade and Industry, as quoted in UNCTC (1991).

Table A.1: CHINA'S TRADE PARTNERS
(\$ million)

	Total	Hong Kong	Japan	United States	Germany	Others
<u>Exports</u>						
1978	9,745	-	1,719	271	326	7,430
1980	18,272	-	4,032	983	711	12,547
1981	21,614	5,288	4,781	1,515	839	9,191
1982	21,948	5,192	4,822	1,767	775	9,392
1983	22,242	5,837	4,548	1,724	865	9,269
1984	26,140	6,910	5,420	2,430	810	10,570
1985	27,350	7,200	6,110	2,340	730	10,970
1986	30,940	9,780	4,780	2,630	1,000	12,750
1987	39,440	13,780	6,400	3,040	1,220	15,000
1988	47,540	18,270	7,920	3,380	1,480	16,490
1989	52,490	21,920	8,360	4,390	1,600	16,220
<u>Imports</u>						
1978	10,893	-	3,105	721	1,030	6,037
1980	19,550	-	5,169	3,830	1,333	9,218
1981	21,513	1,239	6,149	4,649	1,335	8,142
1982	18,853	1,308	3,893	4,274	963	8,415
1983	21,298	1,713	5,506	2,758	1,210	10,110
1984	27,410	2,950	8,500	4,040	1,330	10,590
1985	42,250	4,800	15,040	5,090	2,410	14,910
1986	42,900	5,610	12,440	4,720	3,560	16,570
1987	43,220	8,440	10,070	4,830	3,130	16,750
1988	55,250	11,970	11,060	6,630	3,430	22,160
1989	59,140	12,540	10,530	7,860	3,380	24,830

Note: Figures for 1978 and 1980 based on FTD, others on GAC.

Source: Before 1984, IDE (1987); after 1984, OECF (1990).

Table A.2: OECD COUNTRIES' TRADE WITH CHINA

	Exports to China				Imports from China			
	Total (1)	USA (2)	Japan (3)	(4)	Total (5)	USA (6)	Japan (7)	(8)
<u>\$ Million</u>								
1977	4,121	172	1,939		3,128	203	1,547	
1980	13,260	3,755	5,032		8,784	1,058	4,313	
1981	12,660	3,602	5,054		10,680	1,895	5,305	
1982	10,536	2,912	3,500		10,812	2,284	5,327	
1983	11,736	2,173	4,915		10,500	2,244	5,090	
1984	15,456	3,005	7,244		12,492	3,065	5,941	
1985	24,552	3,856	12,590		14,340	3,862	6,557	
1986	22,416	3,107	9,936		15,840	4,771	5,726	
1987	21,528	3,497	8,336		21,660	6,294	7,478	
1988	25,488	5,039	9,486		28,596	8,513	9,860	
1989		5,807	8,516*			11,988	11,146*	
<u>Shares (%)</u>								
1977	100.0	4.2	47.1	49.1	100.0	6.5	49.5	52.9
1980	100.0	28.3	37.9	52.9	100.0	12.0	49.1	55.8
1981	100.0	28.5	39.9	55.8	100.0	17.7	49.7	60.4
1982	100.0	27.6	33.2	45.9	100.0	21.1	49.3	62.5
1983	100.0	18.5	41.9	51.4	100.0	21.4	48.5	61.7
1984	100.0	19.4	46.9	58.2	100.0	24.5	47.6	63.0
1985	100.0	15.7	51.3	60.8	100.0	26.9	45.7	62.6
1986	100.0	13.9	44.3	51.5	100.0	30.1	36.1	51.7
1987	100.0	16.2	38.7	46.2	100.0	29.1	34.5	48.7
1988	100.0	19.8	37.2	46.4	100.0	29.8	34.5	49.1

Source: OECD Trade Statistics, as quoted in Tsushohakusho (the White Paper on International Trade), MITI, various issues. The figures with an asterisk are from Japanese MOF statistics.

Table A.3: JAPAN'S MANUFACTURED GOODS IMPORTS FROM CHINA
((\$'000))

Exports	1985	1986	1987	1988	1989
MANUFACTURED GOODS	1,599,445	1,830,285	2,767,098	4,564,130	5,659,971
CHEMICALS	301,899	326,478	444,259	619,414	708,865
MACHINERY & EQUIPMENTS	-	37,920	63,136	149,567	340,762
ELECTRICAL MACHINERY	-	-	34,907	97,159	248,257
Electric power machinery	-	-	-	12,024	39,182
Radio, tape recorders	-	-	13,356	40,391	94,459
PRECISION MACHINERY	-	-	-	20,319	41,362
Wrist watches	-	-	1,305	9,710	20,105
TEXTILE	956,806	1,132,537	1,615,848	2,437,824	3,253,985
Apparel	459,960	555,466	833,118	1,447,863	2,206,655
Yarns, fabrics, etc.	496,846	577,071	782,730	989,961	1,047,330
METAL PRODUCTS	-	-	264,336	711,159	475,491
Iron and steel	-	25,410	128,354	446,317	304,643
Nonferrous metals	84,817	39,681	115,267	235,398	131,893
OTHERS	340,740	333,350	379,519	646,166	880,868

Source: The White Paper on International Trade, MITI, corresponding issues.

Table A.4: JAPAN'S CRUDE OIL IMPORT FROM CHINA WITHIN THE
SINO-JAPANESE LONG-TERM TRADE AGREEMENT
(1,000 metric tons)

	Agreed framework	Annual volume	Actual import
1978	7,000	7,100	7,110
1979	7,600	7,640	7,637
1980	8,000	8,000	8,010
1981	8,300	8,300	8,320
1982	8,300	8,300	8,300
1983	8,000 - 8,600	8,000	8,001
1984	8,000 - 8,600	8,000	8,000
1985	8,000 - 8,600	8,000	7,973
1986	8,800 - 9,300	8,800	9,267
1987	8,800 - 9,300	9,300	9,318
1988	8,800 - 9,300	9,100	9,141
1989	8,800 - 9,300	9,100	9,099

Source: Japan-China Long-Term Trade Consultation Committee, as quoted in JCAET, March 1990.

STATISTICAL APPENDIX

**Table A.5: JAPAN'S TRADE WITH CHINA
(8'000)**

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Exports														
GRAND TOTAL	1,938,643	3,048,748	3,698,670	5,078,335	5,095,452	3,510,825	4,912,334	7,216,712	12,477,446	9,856,178	8,249,794	9,475,987	8,515,888	6,127,624
FOODSTUFF	64	35	461	1,306	5,286	5,985	16,258	20,547	19,903	21,733	34,403	25,333	25,016	25,485
CRUDE MATERIALS & FUELS	11,654	14,537	19,020	24,540	23,890	34,703	23,957	52,090	88,795	100,637	68,349	66,534	75,310	
LIGHT-INDUSTRY PRODUCTS	239,607	271,000	306,711	618,532	787,547	516,816	500,424	664,535	882,021	892,097	961,527	1,066,515	1,024,702	
TEXTILES	196,240	197,613	164,339	403,880	599,425	367,913	286,372	382,609	471,403	447,918	475,541	586,726	554,542	609,348
OTHERS	41,367	73,387	142,372	214,652	188,122	148,903	214,052	281,926	410,618	444,179	485,986	479,789	470,160	
HEAVY-INDUSTRY PRODUCTS	1,665,956	2,745,359	382,179	4,373,056	4,206,387	2,891,276	4,315,788	6,414,454	11,348,978	8,750,704	7,123,665	8,242,037	7,285,505	
CHEMICALS	342,952	419,597	459,614	543,090	523,150	469,837	509,735	610,214	713,010	677,525	750,484	941,441	788,161	750,968
METAL PRODUCTS	1,105,660	1,688,842	1,747,972	1,683,300	1,249,845	1,354,332	2,427,908	2,842,849	3,529,859	3,130,453	2,404,268	2,736,134	2,540,951	1,193,197
IRON & STEEL	1,028,174	1,579,461	1,630,102	1,370,047	967,091	1,271,763	2,202,877	2,668,092	3,192,582	2,715,766	2,115,810	2,471,468	2,323,256	1,058,691
NONFERROUS METALS	39,445	27,760	16,412	56,946	43,325	55,862	165,968	80,257	164,515	109,372	88,451	97,908	81,734	55,474
OTHERS	38,041	81,621	101,458	256,307	239,429	26,707	59,063	94,500	172,762	305,315	200,007	166,758	135,961	
MACHINERY EQUIPMENTS	217,344	636,921	1,124,593	2,146,665	2,433,392	1,067,107	1,378,146	2,961,392	7,106,109	4,942,727	3,968,913	4,564,462	3,956,393	
NONELECTRIC MACHINERY	74,639	259,323	425,240	1,172,781	1,454,501	400,501	545,337	870,418	2,055,404	2,295,623	1,647,067	1,753,638	1,596,331	1,031,612
ELECTRIC MACHINERY	21,464	80,983	224,070	484,295	657,307	304,636	437,619	1,064,267	2,576,436	1,569,924	1,673,259	2,154,615	1,876,145	1,391,504
T.V. Receivers	1,499	4,025	70,122	115,377	134,845	56,642	68,896	363,866	1,073,555	358,418	283,294	358,418	283,294	241,256
TRANSPORT EQUIPMENT	110,457	274,909	418,737	414,800	209,053	302,827	305,115	871,854	2,200,756	911,795	490,295	524,925	368,845	313,708
Motor vehicles	49,237	201,875	175,129	130,557	155,374	104,026	120,665	471,201	1,501,605	608,038	186,104	260,762	165,507	145,294
Vessels	51,775	52,758	215,597	268,702	18,397	147,221	138,343	256,874	369,713	118,081	89,376	66,683	45,920	53,634
OTHERS	10,884	22,306	56,546	74,789	112,531	59,143	90,075	154,853	273,513	165,385	158,292	131,284	115,072	95,191
RE-EXPORTS, Etc.	21,362	17,817	3,040,299	60,901	72,342	62,045	55,907	65,086	137,749	91,007	61,850	75,568	105,355	
Imports														
GRAND TOTAL	1,547,344	2,030,292	2,954,781	4,323,374	5,291,809	5,352,417	5,087,357	5,957,607	6,482,686	5,652,351	7,401,429	9,858,823	11,145,762	12,017,613
FOOD & FOOD PRODUCTS	252,461	361,525	432,087	470,662	556,114	504,419	522,659	630,279	934,679	1,217,207	1,282,254	1,781,167	1,953,632	1,941,053
RAW MATERIALS	281,014	371,914	550,398	500,408	514,270	525,046	641,433	799,960	827,033	804,629	1,071,457	1,318,260	1,351,115	1,085,791
TEXTILE MATERIALS	129,750	200,824	223,677	179,415	162,122	176,948	208,238	286,394	354,735	334,109	482,711	581,044	485,918	
METAL ORES & SCRAP	6,176	5,011	10,515	8,510	16,884	16,601	11,034	9,697	9,268	9,241	27,039	56,361	75,731	
OTHERS	145,088	166,079	316,206	312,483	335,264	331,497	422,161	503,869	463,030	461,279	561,707	680,855	789,466	
MINERAL FUELS	684,518	818,718	1,188,717	2,376,618	2,935,059	3,061,365	2,778,614	3,093,067	2,969,982	1,661,120	2,107,084	2,118,550	2,097,827	2,881,304
COAL	19,895	36,793	69,097	116,519	188,676	212,537	212,958	204,300	183,972	179,530	175,912	194,893	209,992	261,644
CRUDE & PARTLY REFINED OIL	654,687	758,391	1,006,219	1,951,563	2,332,893	2,340,877	2,080,959	2,344,819	2,198,789	1,188,515	1,553,239	1,601,534	2,382,248	690
PETROLEUM PRODUCTS	9,922	23,348	113,292	307,265	412,823	507,640	483,466	542,659	586,099	292,459	375,716	312,580	338,558	356,885
MANUFACTURED GOODS	319,982	467,887	770,747	953,228	1,263,100	1,227,636	1,098,332	1,408,458	1,599,445	1,830,285	2,767,098	4,564,130	5,659,971	
CHEMICALS	48,535	55,852	124,418	198,019	244,551	280,068	218,014	247,759	301,899	326,478	444,259	619,414	708,865	651,400
MACHINERY & EQUIPMENTS										37,920	63,136	149,567	340,762	513,230
ELECTRICAL MACHINERY											34,907	97,159	248,257	
PRECISION MACHINERY											20,319	41,362		
TEXTILE	184,033	307,029	485,716	533,042	551,387	572,759	621,662	887,961	956,806	1,132,537	1,615,848	2,437,824	3,253,985	3,194,309
Apparel	60,840	87,151	173,906	238,979	250,881	273,555	278,369	371,608	459,960	555,466	833,118	1,447,863	2,206,655	2,385,413
Yarns, fabrics, etc.	123,193	219,878	311,810	294,063	300,506	299,204	343,293	516,353	496,846	577,071	782,730	989,961	1,047,330	
METAL PRODUCTS											264,336	711,159	475,491	556,329
OTHERS	87,394	105,006	160,613	222,167	467,162	424,809	258,656	272,738	340,740	333,350	379,519	646,166	880,868	
NONTEXTILE MFD. GOODS	135,929	160,858	285,031	420,186	711,713	654,877	476,670	520,497	642,639	697,748	1,151,250	2,126,306	2,405,986	
RE-IMPORTS, Etc.	9,389	10,248	12,632	22,458	23,266	33,951	46,319	25,843	151,547	139,110	173,536	76,716	83,217	

Source: Tausho Hakuho, White Paper on International Trade, MITI, the Japanese Government, 1978 to 1990.

Table A.6: JAPAN'S DFI TO ASIAN COUNTRIES

Fiscal years	1981/82	1983/84	1985	1986	1987	1988	1989
	- Annual rates -						
<u>Manufacturing DFI (\$ million)</u>							
<u>To Asia</u>	<u>615</u>	<u>629</u>	<u>465</u>	<u>804</u>	<u>1,679</u>	<u>2,371</u>	<u>3,220</u>
Korea	30	35	37	143	247	254	251
Taiwan	48	67	110	273	255	263	302
Hong Kong	15	9	14	52	108	85	116
Singapore	161	172	93	104	268	173	678
Subtotal	<u>253</u>	<u>282</u>	<u>254</u>	<u>572</u>	<u>878</u>	<u>775</u>	<u>1,347</u>
Indonesia	237	135	66	26	295	298	166
Thailand	49	59	26	87	210	626	789
Malaysia	39	113	32	65	148	346	471
Philippines	27	11	43	15	51	90	128
Subtotal	<u>352</u>	<u>317</u>	<u>167</u>	<u>193</u>	<u>704</u>	<u>1,360</u>	<u>1,554</u>
China	8	22	22	23	69	203	207
% to Asia	1.30	3.50	4.73	2.86	4.11	8.56	6.43
% to ASEAN 5	1.56	4.51	8.46	7.74	7.10	13.24	9.27
<u>Nonmanufacturing DFI (\$ million)</u>							
<u>To Asia</u>	<u>1,747</u>	<u>1,109</u>	<u>971</u>	<u>1,523</u>	<u>3,189</u>	<u>3,198</u>	<u>5,018</u>
Korea	58	84	97	293	400	229	355
Taiwan	7	18	3	18	113	109	192
Hong Kong	350	478	118	450	964	1,577	1,783
Singapore	63	102	246	198	226	574	1,224
Subtotal	<u>478</u>	<u>681</u>	<u>464</u>	<u>959</u>	<u>1,703</u>	<u>2,489</u>	<u>3,554</u>
Indonesia	1,185	239	342	224	250	288	465
Thailand	14	37	23	37	40	233	487
Malaysia	19	28	47	93	15	41	202
Philippines	26	45	17	6	21	44	74
Subtotal	<u>1,243</u>	<u>349</u>	<u>429</u>	<u>360</u>	<u>326</u>	<u>606</u>	<u>1,228</u>
China	36	95	78	203	1,157	93	231
% to Asia	2.06	8.57	8.03	13.33	36.28	2.91	4.60
% to ASEAN 5	2.76	21.09	11.56	36.38	209.60	7.88	9.42

Table A.6: (cont'd)

Fiscal years	1981/82	1983/84	1985	1986	1987	1988	1989
	- Annual rates --						
<u>All Industry DFI (\$ million)</u>							
<u>To Asia</u>	<u>2,361</u>	<u>1,738</u>	<u>1,436</u>	<u>2,327</u>	<u>4,868</u>	<u>5,569</u>	<u>8,238</u>
Korea	88	118	134	436	647	483	606
Taiwan	55	84	113	291	368	372	494
Hong Kong	365	487	132	502	1,072	1,662	1,899
Singapore	224	274	339	302	494	747	1,902
Subtotal	<u>731</u>	<u>963</u>	<u>718</u>	<u>1,531</u>	<u>2,581</u>	<u>3,264</u>	<u>4,901</u>
Indonesia	1,422	374	408	250	545	586	631
Thailand	63	95	49	124	250	859	1,276
Malaysia	57	141	79	158	163	387	673
Philippines	53	56	60	21	72	134	202
Subtotal	<u>1,595</u>	<u>665</u>	<u>596</u>	<u>553</u>	<u>1,030</u>	<u>1,966</u>	<u>2,782</u>
China	44	117	100	226	1,226	296	438
% to Asia	1.86	6.73	6.96	9.71	25.18	5.32	5.32
% to ASEAN 5	2.42	12.47	10.70	26.43	80.45	10.91	9.35

Source: Kaigai Toshi Kenkyujoho, the Export-Import Bank of Japan, May 1989 and November 1990.

Chart A.1: COMPOSITION OF JAPAN'S EXPORTS TO CHINA

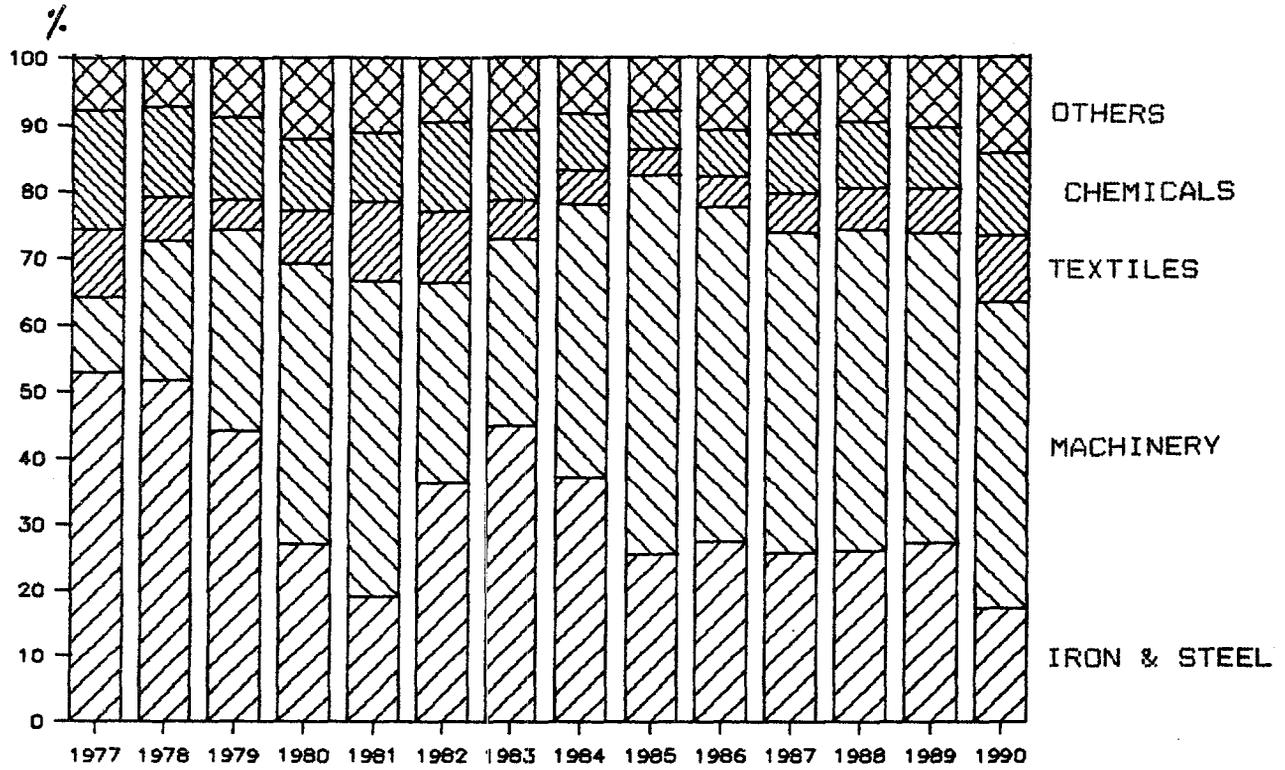


Chart A.2: COMPOSITION OF JAPAN'S IMPORTS FROM CHINA

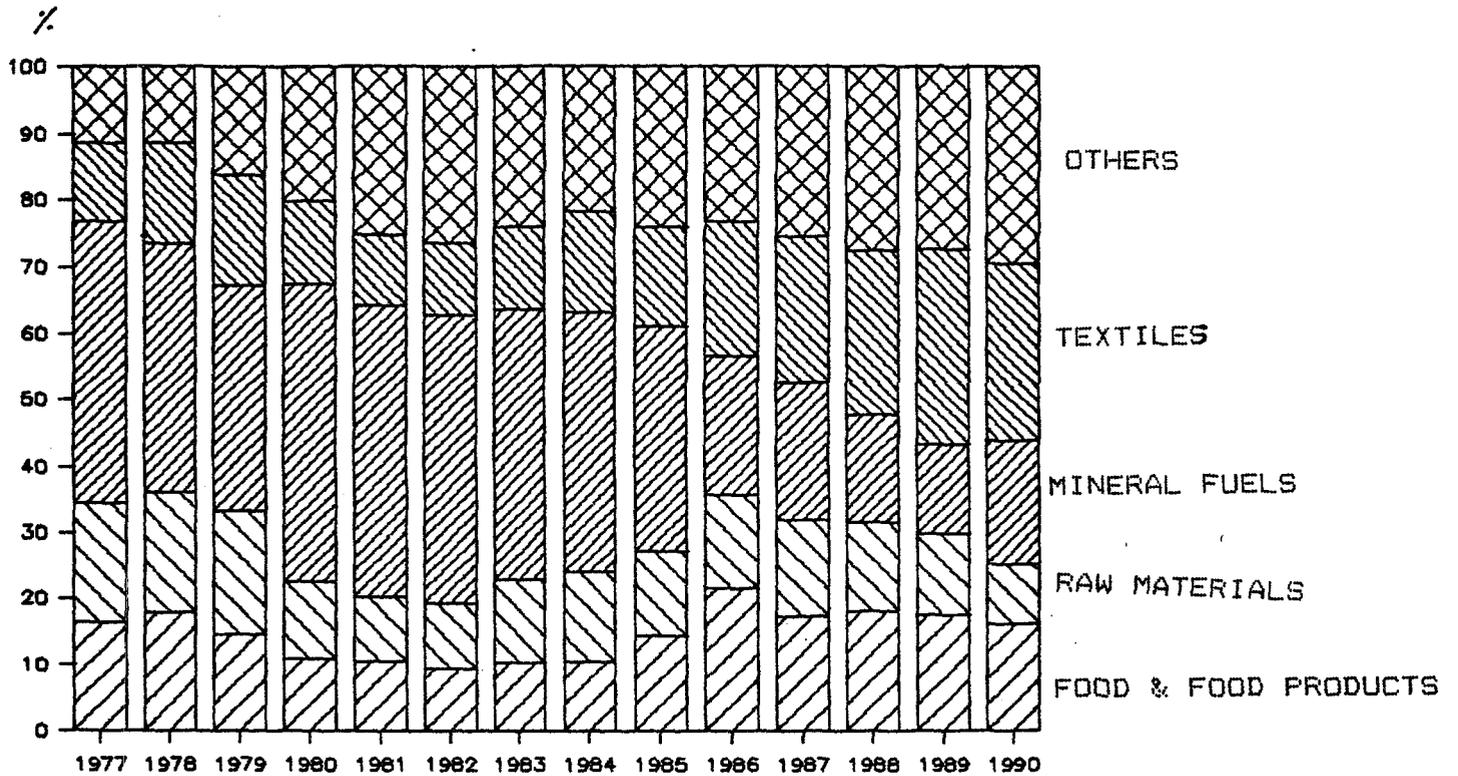


Chart A.3: BREAKDOWN OF JAPAN'S MACHINERY EXPORTS TO CHINA

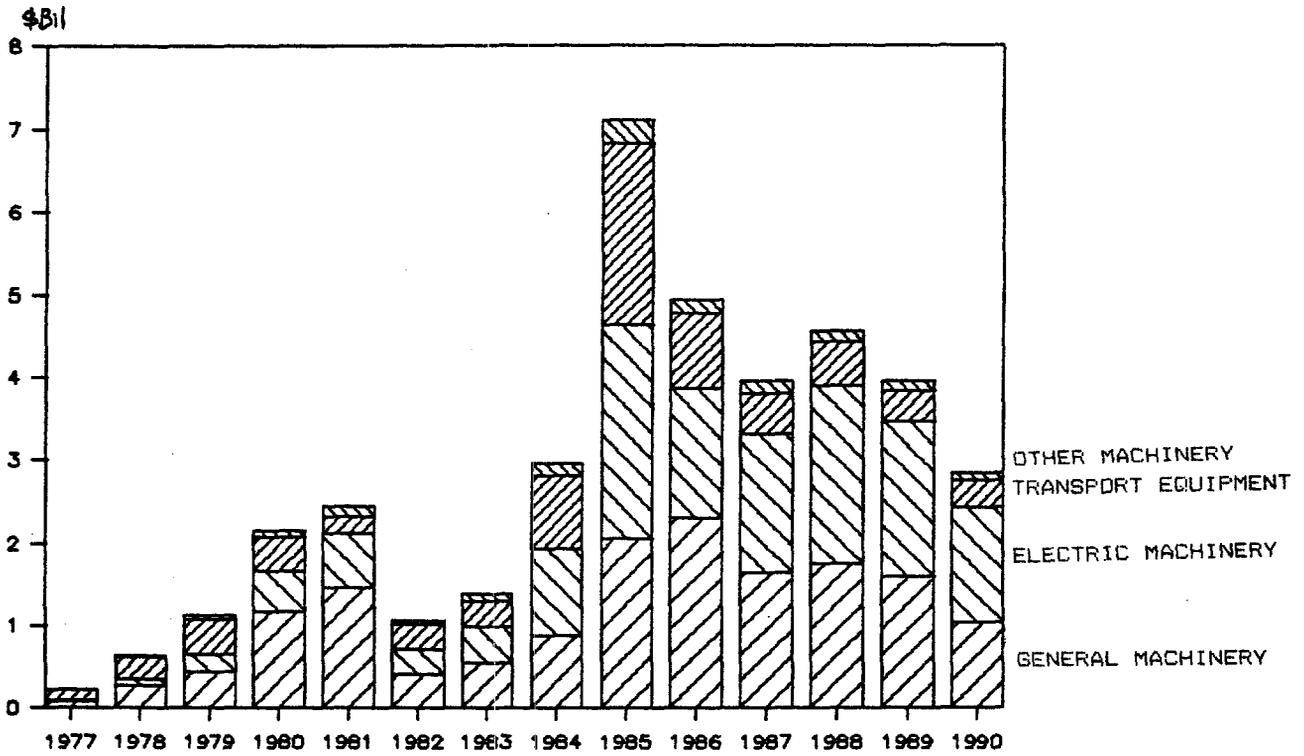


Chart A.4: CHINA'S PLANT AND TECHNOLOGY IMPORTS

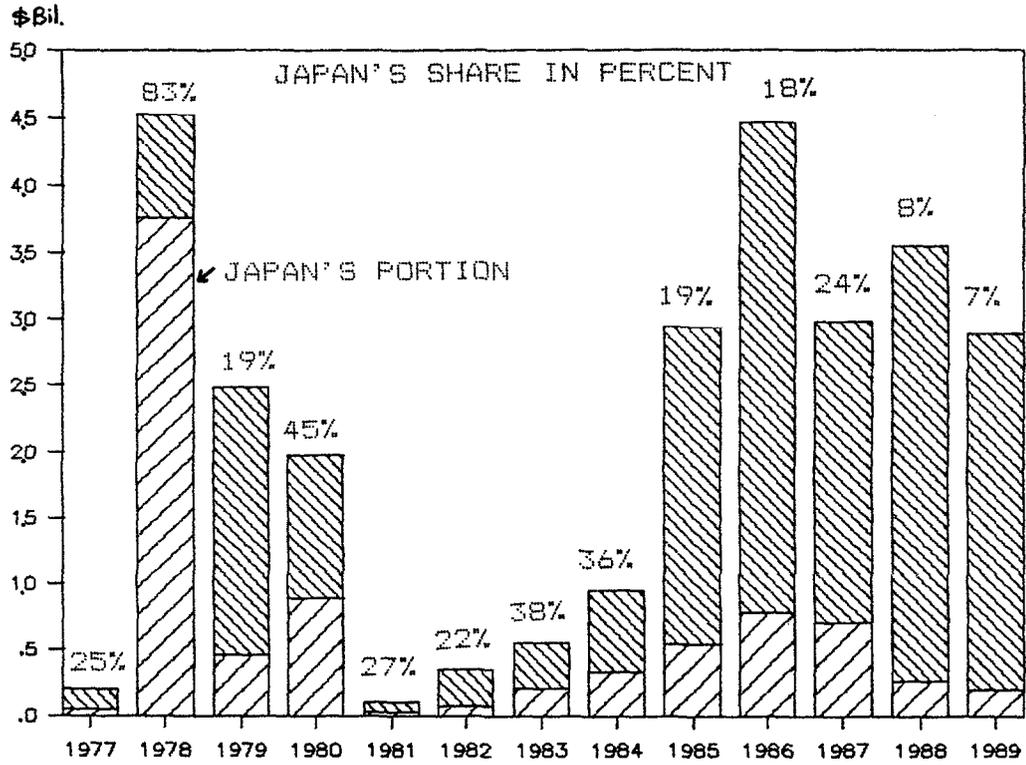
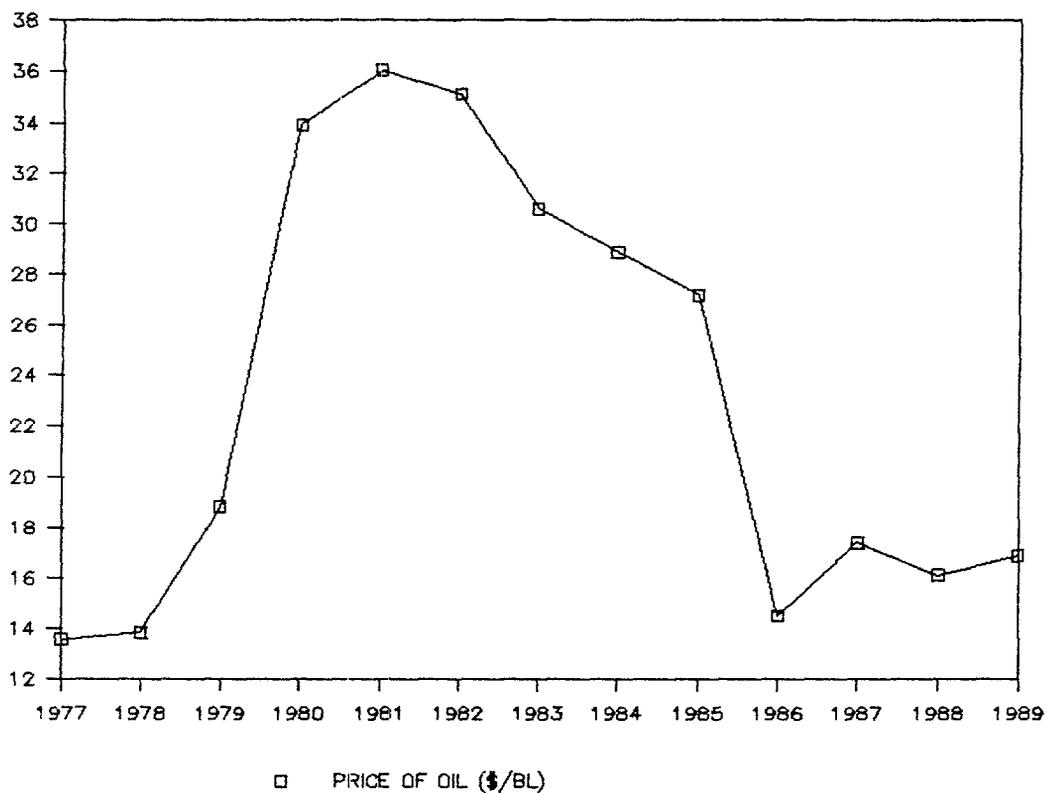


Chart A.5: JAPAN'S IMPORT PRICE OF OIL FROM CHINA



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