The Policy Implications of Japanese Foreign Direct Investment in Australia

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Synopsis

Japanese Foreign Direct Investment (FDI) presents challenges to Australian policy makers concerning the role of government in an era characterised by globalisation and liberalisation. Policy questions also arise from some peculiar characteristics associated with Japanese enterprises and their overseas expansion.

This thesis argues that Australia's current response of assessing incoming FDI to screen out harmful cases is inadequate. The policy calculus required cannot be performed. However, extending Australia's otherwise comprehensive financial and foreign exchange liberalisation to FDI raises questions concerning the sustainability of its external position given the growth in the current account deficit to the limit of its historical range and the rise of private, foreign debt to unprecedented levels.

A theoretical approach to the issues provides the rationale for new policies based on views of Japanese FDI as both benign and malign. The reasoning requires a move beyond the current, eclectic orthodox theory of FDI which is found to be enervating for policy.

The policy agenda is deduced from theories of FDI as monopolising and as transaction cost economising. It stresses firstly the role of government in leading a process of institutional innovations both within Australia and between Australia and Japan. Secondly, it conceives of FDI as a means to deal with difficulties associated with the interaction of the industrial structures in Australia and Japan and this leads to policies aimed to assist the process of bilateral restructuring. Finally, it interprets Japanese FDI as anti-competitive and responds to that possibility with competition policies pursued in conjunction with Japanese authorities.

In reaching these conclusion the research also develops an understanding of Japanese FDI as a distinctly Japanese phenomenon, more bilateral than global. And it reasons that Australia's strategy of welcoming but regulating and guiding Japanese FDI is

advantageous and sustainable, even though it builds an economy which lacks the efficiencies of solidarity and cohesion associated with national economies of predominantly domestic ownership.

Preface

This study grew out of policy development work in which I was engaged during the early 1990s. Politicians, not unexpectedly, want economists to rank policy alternatives by value and with some surety. But that is rarely possible. My experience was that the assumptions needed to generate straightforward options were often unrealistic and the estimates were incomplete so that great uncertainty attached to the net result. The best recommendations were not always in line with the numbers.

Keynes was right to observe that in making policy we must "allow ourselves to be disobedient to the test of an accountants' profit" (quoted in Skidelsky, 1992, p 478). But that is a difficult message to sell, especially when one is involved directly in the policy development policy.

This thesis grew out of that experience. It looks at a particular policy question and attempts to show how it is possible to proceed rationally, practically, sensibly, even though we lack a policy calculus.

Beyond that, the topic was chosen because of the importance which attaches to financing Australia's current account deficit. That matter has occupied Australian policy makers for generations and it is important to conceive clearly of the role investment from Japan might play in that strategic thinking.

There are many who have assisted in this task. I would particularly thank my supervisors, Dr Peter Burns and Professor Kyoko Sheridan and those who have read and commented on drafts, especially Hugh Stretton, John Hatch and Chris Charles.

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Declaration

This work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made in the text.

I give consent to this copy of my thesis, when deposited in the University Library, being available for loan and photocopying.

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List of Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
AFR	Australian Financial Review
AIDC	Australian Industry Development Corporation
AJBCC	Australia-Japan Business Cooperation Committee
AJEI	Australia-Japan Economic Institute
ALGA	Australian Local Government Association
ALP	Australian Labor Party
AMC	Australian Manufacturing Council
AMLC	Australian Meat and Livestock Council
APEC	Asia-Pacific Economic Cooperation
AQIS	Australian Quarantine and Inspection Service
ATSIC	Aboriginal and Torres Strait Islanders Commission
BIE	Bureau of Industry Economics
CQCA	Central Queensland Coal Associates
DAE	Dynamic Asian Economy
D & I	Develop and Import
DPIE	Department of Primary Industry and Energy
FDI	Foreign Direct Investment
FIRB	Foreign Investment Review Board
FPI	Foreign Portfolio Investment
FTC	Fair Trade Commission
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GM	General Motors
IC	Industries Commission
IEA	International Energy Agency
IMF	International Monetary Fund
JCDC	Japan Coal Development Company
JETRO	Japan External Trade Research Organisation
LDC	Less Developed Country
LIPC	Livestock Industry Promotion Council
MAFF	Ministry of Agriculture, Forestry and Fisheries

MAI	Multilateral Agreement on Investment
MITI	Ministry of International Trade and Industry
MLA	Meat and Livestock Australia
MNC	Multinational Corporation
MNE	Multinational Enterprise
NCP	National Competition Policy
NIE	Newly Industrialised Economy
NGO	Non-Government Organisations
OECD	Organisation of Economic Cooperation and Development
OLI	Ownership-Location-Internalisation
PC	Productivity Commission
PRC	Peoples' Republic of China
RBA	Reserve Bank of Australia
R & D	Research and Development
SA	South Australia
TNC	Transnational Corporation
TPA	Trade Practices Act
TRIMS	Trade-Related Investment Measures
UNCTAD	United Nations Committee for Trade and Development
WTO	World Trade Organisation

Chapter 1: An Outline of the Study Context and Purposes

Foreign Direct Investment (FDI) raises policy issues of considerable interest, even controversy. This study looks at the particular case of the FDI flow from Japan to Australia and seeks to isolate the FDI policies implied.

The opening section of chapter 1 provides a rationale for the study, drawing on the theme of globalisation and the popular sentiment in favour of host nation control of FDI, both in the context of the process of liberal policy reform in Australia. The following section 1.2 presents the study questions and aims. The final section provides a brief overview-cum-outline of the arguments.

1.1 Reasons for this Study

This study looks at one particular aspect of globalisation, FDI, in the context of one pairing of nations, Australia and Japan. It focusses on economic processes and outcomes and asks how, if at all, the Australian government should respond to the inflow of FDI from Japan.

Globalisation is commonly thought to be increasingly important to national economies, even though there is considerable uncertainty about how it can be defined and measured (Makhija, Kim and Williamson, 1997; Mirza, 1998, p 1; Bryan and Rafferty, 1999, p 3). In accounting for it, the stress is commonly placed on technological change, especially in telecommunications and information systems, which raises productivity differentials and reduces the costs of conducting business at a distance and among people of different language and cultural backgrounds (Lipsey, 1997, *passim*; Reinicke, 1998, p 2; Goldstein, et al, 1991a, *passim*). Whatever its underlying cause, the process of globalisation is often said to be centred on economic interactions (Dunning, 1997b, p 5; Strange, 1997, p 134; Milberg, 1998, p 69).

Some say further that FDI is the fundamental economic element of globalisation (Reinicke, 1998, p 19; Nicolas, 1995, p 5; Julius, 1990), as evidenced by the fact that growth rates for FDI have exceeded those for trade in recent years (UNCTAD, 1999; Morsink, 1998, p 2; Mirza, 1998, p 3). It is even said that competition for access to FDI is now more important to nation states than are foreign and defence policies (Stopford, Strange and Henley, 1992, p1).

This all means that FDI is important and topical. It occurs when foreign interests take control over assets situated at home (as we detail below, when they take a position of significant and lasting influence over those assets). Hence, the policy questions about FDI concern the role of government in responding to the intrusion of foreign control. This thesis then deals with a distinguishing aspect of globalisation and fits into a much wider research effort looking at the questions concerning the role of nation states in the contemporary era.

That larger question has divided scholarly opinion. There are those who argue that nation states are increasingly irrelevant (Ohmae, 1991; Fukuyama, 1995 are two prominent Japanese authors of this view; Reich, 1992; Stopford, 1997, p 457).[1] Indeed, some would distinguish between older internationalisation and the qualitatively different globalisation on the basis that the former presupposes, while the latter has no need of nation states (Tooze, 1999, p 221; Hirst and Thompson, 1996, p 4).

This distinction sees internationalisation, as the word suggests, as being about relations among nations and so as including trade, treaties, the United Nations, etc. By contrast, globalisation can be thought of as transcending the nation state.[2] Globalisation in this view is therefore a phenomenon of NGOs (non-government organisations) with a global

[1] Dunning (1997c, p 24) gives a listing of much of the relevant literature.
[2] The point has been argued in relation to FDI in Kobrin, 1997, *passim*; and, in relation to Australia, in Stilwell, 2001, p 5

purview, organisations like Greenpeace and Amnesty International and, of course, the Multinational Enterprises (MNEs) and their FDI.[3]

Seen from this perspective, globalisation challenges the status of nations. It also calls into question the effectiveness of domestic government policies, especially economic policies (Kozul-Wright and Rowthorn, 1998, p 2; Chang, 1998).[4] In particular, some see the need to match MNCs with world government, because the global reach of companies makes single national government impotent (Tooze, 1999, p 217; Firth, 1999, p 273; Crough and Wheelwright, 1982, p 28). Others see that as unrealistic and yet call for much greater degrees of supranational organisation and control (Reinicke, 1998, p 85).

Despite the weight of opinion that globalisation is important and qualitatively different from preceding forms of international activity, others argue that the distinction between globalisation and internationalisation is overstated (Hirst and Thompson, 1996, pp 3-6; Sachs and Werner, 1995; Bairoch and Kozul-Wright, 1998; Notermas, 1993, p 149). From this perspective, the suggestion that the nation state is dead is premature (Milberg, 1998, p 70; Reinicke, 1998, p 52) and, given the important economic functions the state performs, probably dangerous as well (Hymer, 1970, p 53; Kozul-Wright and Rowthorn, 1998, p 19; Bryan and Rafferty, 1999, p 37). This study considers FDI policies in the context of this thinking about MNCs and nation states.

The question of how national governments should respond to globalisation is controversial also because many economists argue that economic outcomes should be determined by 'the market' because markets are less prone to failure than are

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[3] Nicholas and Maitland (forthcoming) want to differentiate further between FDI *per se* which can be a phenomenon of internationalisation and FDI as an aspect of globalisation. The latter occurs when the investment creates "interdependencies across the subsidiaries within an international firm" ie creates a company based on global interactions and not simply those related to a home base.

[4] Kozul-Wright and Rowthorn report this as a common view, not their own, that globalisation is inevitable and that the nation state must be dismantled to allow people to participate in it.

governments.[5] This "liberal policy agenda [is] in the ascendancy" in Australia (Hill and McKern, 1997, p 203) and in many countries, where it has been associated particularly with widespread liberalisation of FDI flows (Mucchielle, Buckley and Cordell, 1998, introduction; UNCTAD, 1996).

The liberalisation of FDI policies coincides with what is said to be a significant and widespread shift to more optimistic, it might even be sanguine assessments of MNEs (Dunning, 1997a, p 209). Such assessments contrast sharply with the pessimistic view of FDI which is said to have predominated in the 1960s, 70s and early 80s when it was thought to be much in need of close government control if it were to be of net benefit to the host economy (Stopford, Strange and Henley, 1992, p 5). In the context of this shift it is somewhat paradoxical that, despite Australia's embracing liberalisation seemingly wholeheartedly, FDI policy is one of the few areas of economic policy where a considerable regulatory framework has survived the liberal reform process to date. This study investigates that apparent anomaly.

Another motivation for the research is that it deals with an inherently interesting pairing of nations. As will be detailed below, Japan stands out. This study places particular stress on its extreme FDI asymmetry; so that it seeks an understanding of policies for Japanese FDI in Australia which is consistent with the preponderance of Japan's outward over inward FDI. As detailed in Chapters 3 and 5 below, Japan also has developed some unusual organisational forms in its business sector (Imai and Itami, 1984; Murakami, 1989; Aoki, 1984 and 1992; Motoshige, 1992; Hodgson, 1998; *et al* are all used in this study as important, general references) and unusual institutional arrangements between government and business (Johnson, 1982; Dore, 1986; Fruin, 1992; Calder, 1993 give the influential views of some non-Japanese). These egregious aspects of Japan's situation all impact on the policy deliberations.

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[5]There are many such references, two of perhaps the most influential such views used in this study are Krugman, 1996 and Stiglitz, 1996. It is a view often found

So too does the fact that, in contrast to the strong globalisation view which sees MNEs as nationless, many large Japanese companies which invest in Australia (eg Mitsubishi, Toyota, etc) are readily identified with Japan. They have been described as "reluctant transnationals" (Machado, 1994, p 299) and as retaining "strong home country ties" (Boyd, 1996, p 188) so that "Japanese firms remain the least internationalised" (Patel, 1995, p 151).

That view is concordant with the long history of Japanese policies, now in many cases reformed, which have aimed to build Japanese firms within a protected Japanese market (Uchino, 1983 *passim*; Eccleston, 1987, p 262; Miwa, 1996, *passim*[6]; Ozawa, 1997; Graham, 1992, p 176). While most MNEs from all nations are said to have definite home bases, despite that their operations are international, it is said to be especially true of Japanese firms (Rugman and Verbeke, 1995, p 9; Stopford, 1997a, p 476).

The Japanese case also stands out because of the apparently mercantilist attitude displayed in some of its development policies (Johnson, 1982, *passim*; Murakami, 1989[7]; Boyd, 1996, *passim*), especially in the international arena (Hollerman, 1988; Aaron, 1999, p 21) which have been the cause of considerable international tensions (Shimotami, 1997, p 5; Graham, 1992, p 176).[8] Japan has also recorded an unusually long, unusually large succession of current account surpluses and outward FDI is seen as a key means by which these accumulating funds can be recirculated to ease international tensions associated with them (Ozawa, 1989, *passim*). In short, Japan remains very Japanese in the globalisation era and focussing upon it as a source nation for FDI brings the nation state sharply into view.

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in academic references to Australian policy eg Pincus, 1993, *passim;* Keating, 1993, p 71.

[6] Miwa, it should be noted, emphasises that this view is anachronistic.

[7] Murakami talks of Japan as combining government and private interests by "promotional intervention" (p 46) "aptly summarised in the concept of *gyosei shido* (administrative guidance)" (p 47).

[8] Graham makes the point that tensions arise not just with Japan's trade policies but particularly with the controversies surrounding Japan's unusually low ratio of inward to outward FDI, a point of which this study makes much.

Australia is very different from Japan. Where Japan has persistent current account surpluses, Australia has deficits. Where Japan has an asymmetry built on low inward FDI, Australia has long been foreign capital dependent and has long had high levels of inward FDI (Butlin, 1964, *passim*; Sinclair, 1976, pp ; ABS, cat no 5363.0). Australia lacks the large indigenous firms and well developed business organisations found in Japan (AMC, 1990, *passim*; Crough and Wheelwright, 1982, pp 203-4; Matthews, 1991, p 201; Stewart, 1994, p 188). This creates a very different organisational environment in which there is few local and many foreign firms and raises the question of what this might mean for Australian FDI policy.

The pairing of Australia and Japan is also interesting because the FDI flow between them has a comparatively long history in comparison to other destinations for Japanese FDI and has been brought sharply into focus during the recent period of dramatic growth experienced in the late 1980s and early 1990s (Purcell, 1978, *passim*; Edgington, 1990, p 149; Drysdale, 1993) and by its subsequent decline. There is evidence that the contractionary phase is now over and, coincident with renewed growth in global flows after the fallout from the Asian financial crisis, Japanese FDI is, according to one influential Japanese observer, at a "turning point toward a new era of 'Globalization' " (Tejima, 1998, p 216; also Hatem, 1998, p 143).

Regardless of the current trend, as before the acceleration, Japan is an important source of Australia's FDI inflow and Australia remains an important destination for Japan's outflow. Moreover, judged from the current shape of their external accounts (an indicative but not a wholly reliable basis for judgement, as discussed below), the FDI flow is likely to persist so that it will play an important role in linking Japan's capital export and Australia's capital import. That is further reason for this study of its policy implications.

Another reason for the study is that it accords with community concerns over FDI policy. As Chomsky has observed, people generally "remain opposed, instinctively" to the

multinational challenge to the power of the democratic nation state (Chomsky, 1998, p 24). Available indicators suggest this is true in Australia. Popular concerns are held over Japanese investment in particular, concerns which lead to calls for strident and discriminatory policies (Goot, 1990).[9] Indeed, the desire for a policy response to FDI grew strongly as the amount of investment from Japan increased in the 1980s (Garnaut, 1989)[10], a point not lost in Japan (JETRO, 1990)[11].

More recently, the issue of FDI policy has been prominent in the deliberations by OECD nations to develop a Multilateral Agreement on Investment (MAI) under which host government discrimination against FDI by MNEs would be subject to challenge and claims for restitution in supranational courts. The Australian government was actively involved in the process and, despite its having reservations (Ranald, 2000 and 1998, *passim*; FIRB, 1997), appeared willing to accede to the Agreement before October 1998 when it was withdrawn by the OECD in the face of mounting popular opposition in many nations (Goodman and Ranald, 2000).

It was not clear which of Australia's remaining FDI regulations would have survived the signing of the MAI but the episode at least revealed the views of some influential Australian organisations concerning government's role in dealing with FDI. For

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[9]The overall impression formed from polling since the late 1950's is said to be that "Australians want 'a little' rather than 'a lot' of foreign investment and want the Government to have 'lots of controls'.." (p 249). Australians also support foreign investment in manufacturing but are much less enamoured of investment in mining, agriculture and real estate. The results also show that support for Japanese investment has been consistently less than that for investment from the UK.

[10]Polling has been sporadic but much quoted is the result of a survey undertaken for the highly influential Garnaut Report prepared for the Australian Prime Minister and Minister for Foreign Affairs and Trade in 1989. This asked Australian adults if they wanted the same or more investment from Japan, the US and the UK. While some 70% said yes to investment from the latter two, less than half wanted the same or more Japanese investment. This was compared with data from the early 1970's and showed no change in support for investment from the US or the UK but a significant drop from the two-thirds who gave qualified support for investment from Japan at that time (Garnaut, 1989, p 96).

[11]The JETRO have noted that "(the) dramatic increase in Japanese investment has

example, an association of Australian municipal governments described limiting national government controls on FDI as incompatible with sovereign authority (ALGA, 2000) and the peak Australian trade union body argued the MAI was not in Australia's interest (Harcourt, 2000). Some groups of Australian business also opposed moves which would reduce the ability of government to implement national development policies, including by the use of means which discriminated against foreign firms (The Australian Industry Group, 2000) or restricted its role in attracting and guiding Multinational Corporations (MNCs) (Australian Business Chamber, 2000). The MAI was opposed also on a range of non-economic grounds, as fundamentally flawed (Uniting Church, 2000) and as likely to undermine the rights of the vulnerable (ATSIC, 2000). In short, the MAI shows that FDI policy is a problem area where the views of Australian policy makers do not coincide with those of the majority of Australian. That gives further reason to conduct the study.

In summary, this study has been undertaken to look at the inherently controversial issue of economic policies which surround an important aspect of a significant economic development, approached not in general but for an interesting particular case. It deals with an issue which is pressing.

1.2 Questions and Aims

This section raises the preliminary questions which the study will answer. By way of introduction, it is important to stress what might seem an obvious point: that this is a piece of economic analysis and as such is limited in its scope and by its assumptions. Fundamental to the approach are the assumptions that private sector interests pursue self-interested, economic goals in a rational manner. Those are limiting assumptions. Individuals are not just rational, they have other than economic goals, they pursue other than self-interested ends and their choices are limited by history and context. In addition,

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given rise to criticism and alarmist sentiment in Australia" (1990, p 24).

the world includes economic causes that have non-economic effects and non-economic causes of economic effects.

These gaps from reality are significant and limit the insight which can be gained from this study. The issues surrounding FDI are, in fact, multi-dimensional and the study approach used here is not of the interdisciplinary kind which would be needed to attempt a complete view of the underlying phenomenon or its policy implications. Only at a few points are broader issues considered. Nonetheless, despite its narrow confines, the study does provides critical insights into the economic policy implications of Japanese FDI in Australia.

As to the preliminary questions:

- The first is that implied in section 1.1 above, do national governments and their economic policies have a role in the era of globalisation? Alternatively, do they constitute impediments to the processes of competition among private interests which, being less likely to fail, as some suggest, would provide the more effective means of allocating global investment? That is a big question to which this study answers only for FDI, although an understanding of economic policy emerges which has wider implications, especially for competition policy.

- The second question is whether policy can be derived from what we know already, so that the understanding of Japanese FDI and its policy implications are in fact clear and to hand. Alternatively, do existing sources of information suggest that there are significant gaps and imply the need for further work? If so, of what kind?

- Having looked at what is already known, the third question is to determine whether current Australian policy is soundly based? The reasons given for current policy reforms are critically assessed.

- The specific pairing of Japan and Australia suggests other, more particular questions. Are there characteristics of Japanese FDI which imply the need for other, possibly

additional policies? Conversely, are modifications to any general policy for FDI required because of Australia's particular position?

- The policies implied by this study are also set in relation to the current liberal trend in Australian policy. In particular, it asks what is the relation of FDI policy to policy liberalisation in general and to Australia's National Competition Policy in particular?

- Finally, the study examines three Australian industries which receive significant amounts of Japanese FDI (coal, beef and motor vehicles) and asks how relevant is the proposed policy approach?

The answers to each of these explicit questions are provided in the body of the text and are consolidated in the final chapter.

In positioning this study, it is also important to stress its practical objectives. The aim is to avoid concluding simply that more work is required, although that view proves to be unavoidable at some points. However, the study is not aimed to isolate let alone fill all the gaps in our understanding of the phenomenon. Rather, it asks what is the best answer to the policy questions which an economic study can currently offer. To the extent that policy uncertainty exists, it is isolated and an assessment is offered as to its importance. However, this study takes on the task of reaching either positive proposals or good reasons for inaction. It does not settle on the proposition that more study and more researchers are required.

1.3 Outline of the Study

The scope of the study is given by the definition of FDI provided in Chapter 2 but, as already indicated, broadly, it deals with policies related to investments which confer significant Japanese influence over assets in Australia.

Such investments have a number of different forms. FDI can be undertaken by subsidiaries and branches of foreign firms; in situations of outright control and in joint ventures, including positions of minority ownership; and in so called greenfield as opposed to takeover or merger and acquisition investments. A considerable literature deals with choices among these alternatives (Nicholas and Maitland, forthcoming provide an overview; Hennart, 1988; Kogut, 1988; Buckley and Casson, 1976). This study does not deal with those choices but deals with all forms which fall within the internationally accepted, official definition of FDI. It focusses broadly on the policy implications of situations where it can be reasonably inferred that Japanese interests have a significant and lasting influence over Australian assets.

Chapter 2 begins by presenting Australian and Japanese data collected by official agencies and by reporting on the somewhat vast literature on Japanese FDI and the much more limited literature on Japanese FDI in Australia. It asks how the FDI flow fits into the external accounts of each nation and, in particular, whether Japanese FDI exerts a beneficial influence on the composition of Australia's capital account. This process also sizes the investment flow by placing it within the larger contexts of global FDI and of FDI from Japan and FDI into Australia. It also places the flow against the aggregates of domestic economic activity in Australia and Japan.

Chapter 2 also addresses the question of whether Japanese FDI is different from that of other nations and whether it is converging on some previously established and nationless pattern as some believe (Encarnation, 1995, p 227; Nicolas, 1995a, p 41; Drysdale, 1993; Access Economics, 1991, p 5; Edgington, 1990, p 14).

One fact does stand out about Japan's FDI position, it is highly asymmetric in that the outflow predominates hugely over the inflow. So outstanding is this fact that, to be

comfortable with any reasoning about the policy implications for Australia, it seems important to also give a plausible account of Japan's FDI position.

Chapter 2 reports what little data exist about Japanese FDI in Australia. The lack of information is said to be a problem for FDI research in general.[12] Current knowledge is contrasted to the considerably greater information which would be required to investigate fully some of the apparently policy-relevant hypotheses.

Existing data and studies give only broadly supportive but uncertain policy conclusions and, in response to that unsatisfactory state of affairs, Chapter 3 examines whether it is possible to determine, in general, the effects of FDI on the host nation and to progress to policy by that means. That discussion then leads on to a critical assessment of Australia's current FDI policy, premised as it is on a screening process performed by the FIRB.

In short, there appears to be an inherent ambiguity and an inescapable uncertainty in the effects of FDI which is at odds with the apparent expectations which underlie the current Australian policy approach.

This uncertainty about policy is reinforced by comparisons with the FDI policy positions of other nations (principally, Japan, Canada and Sweden). It creates a dilemma for the study: how to proceed in the face of immeasurabilities, uncertainties, ambiguities and cross-nation disparities? There are two possible responses: to investigate particular cases of Japanese FDI in Australia and reason by induction to a policy position or to use a general conception of FDI derived from the theoretical literature and reason by deduction to a policy position in this particular case.

There are weaknesses whichever path is chosen but, on balance, deduction is best suited to the policy purposes for reasons given at the start of Chapter 4. Chapter 4 then

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[12] In a soon to be published collection of essays on FDI research issues (Bora, forthcoming), 6 out of 8 contributors make the point. Those works are by Holmes

examines the general understanding provided by FDI theory. It is critical of the policy \ provided by current theory, especially Dunning's eclectic view, and it bifurcates Dunning's synthesis in order to move beyond it. This process creates and maintains a dichotomy in theories of FDI between, on the one hand, the benign view that FDI is an economising behaviour and, on the other, the malign view that it has monopolising purposes. With Dunning's synthesis, instead of attending to both, policy makers are just as likely to see one effect as traded off against the other and to address neither.

However, the purpose is not to sort out issues in the history of FDI theory. Rather the theory is used to create a more comprehensive policy agenda which is elucidated in some detail in Chapter 6. Before that, Chapter 5 shows how the two theoretical perspectives, one based on transaction cost theory, the other on the theory of imperfect competition, can both deal with the asymmetry of Japan's FDI position.

Chapter 6 then expands upon the policy agenda. It argues simply that, in the face of ambiguity about the phenomenon and a dichotomy in the theory, the best policy position is one of ambivalence which addresses the policy implications of both theoretical understandings. This leads to an agenda with three elements.

From transaction cost theory, which generates the economising view, we understand that FDI is a partial and imperfect response to the impediments which make it expensive for Japanese interests to do business with Australians. Hence, there are two roles for government. Firstly, government should act to reduce transaction costs generally in dealings within Australia and between Australia and Japan by supporting institutions and other arrangements which help overcome impediments to activity.

Secondly, government should help manage the process of industrial restructuring which FDI partially controls and which, by targetted support, government can influence to the benefit of residents. We find reason to believe that government can fulfil this function in

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and Hendrin; Kokko; Bora; Robertson; Petri; and UNCTAD (also available as UNCTAD, 1996).

circumstances where private interests would find the transaction costs prohibitive. Importantly, this argument in favour of industrial structure policy in some ways contrasts with and in others closely parallels the rationale for such policies put forward by Japan's MITI and can also be understood in relation to the works of some influential authors such as Krugman, Porter and Hirschman.

The third policy element comes from imperfect competition theory. It is simply that FDI might be motivated by the desire to restrict competition and so requires the application of anti-monopoly legislation. In addition, because intra-firm dealings among Japanese interests are so widespread and in some respects based on subtle or opaque understandings, Japanese FDI requires the vigorous application of anti-monopoly legislation based on an intimate understanding of Japanese economic organisations and of interactions among them. This is particularly the case with FDI where, in addition to efficiency considerations, the redistribution of gains in favour of the interests with monopoly power is therefore in favour of the foreigner.

But the imperfect competition theory of FDI suggests that the relevant oligopolists and barriers to entry are international and we reason in the case of Japan that they are especially bilateral and this has implications for the way in which Australian authorities try to apply their anti-monopoly legislation to Japanese FDI.

Chapters 7 and 8 then illustrate the policy agenda by examining Japanese FDI in three Australian industries: beef, coal and motor vehicles. They illustrate the relevance of the theories and the ambivalence with which it has been reasoned they should be regarded. However, these investigations do not attempt to test theory or their policy implications empirically and formally. Instead, they show the plausibility of each approach and indicate how the elements of a comprehensive response in each case fit well with the issues confronting policy makers.

Chapter 9 consolidates the study results. It answers the questions posed in section 1.2 above and others which arise within the study itself, especially surrounding the role of indigenous firms.

Chapter 2: Japanese Foreign Direct Investment in Australia

2.1 Introduction

The immediate task is to be precise about the meaning and measurement of the phenomenon itself: what is Japanese foreign direct investment in Australia? In the process two implicit policy questions are addressed. Firstly, by examining the role Japanese FDI plays in Australia's macro-economy, particularly its role in financing Australia's persistent current account deficits, an assessment is made of its desirability: does Japanese FDI help in aggregate or should Australia provide for its own investment?

The answer turns partly on whether Australia can sustain and succeed with its savings-investment imbalance or will equilibrating mechanisms require that the current account deficit and therefore the need for a capital inflow be temporary only?

Secondly, this chapter asks whether there is something distinctive in the size, shape and nature of Japanese FDI which makes clear what, if anything, Australia should do about it? In the process it also assesses the view that Japanese FDI is an attempt to dominate foreign economies and is undertaken because control of foreign production is crucial to the success of the Japanese economy.

Those questions are answered in large measure, as comprehensively as possible. However, the answers remain incomplete. The major result of the investigation is to report that little is known of Japanese FDI in Australia and, while a lot has been written about Japanese FDI globally, opinion is divided as to whether it is different and, if it is, what might be the source of any difference. Moreover, the investigation shows that sorting through some of the questions seemingly more relevant to policy would require very large numbers of comparative and longitudinal studies and amounts of data: far more work than some researchers have used to base their policy claims.

The chapter is structured as follows. Section 2.2 defines FDI, places it within the current and capital accounts of the balance of payments and describes its relation to foreign debt and other forms of foreign investment. Section 2.3 then describes Japanese FDI by placing it within its historical and international contexts. Section 2.4 provides an historical overview of foreign investment in Australia and describes the recent rise in the private foreign debt and the windback in the capital importing role of government. Section 2.5 then describes Japanese FDI in Australia as best as possible, making comparisons with other investing nations and making use of previous studies. Section 2.6 draws together the reasoning over policy.

2.2 Definitions of Foreign Direct Investment

Defining FDI and describing it in relation to other statistical aggregates addresses the first and perhaps most obvious policy question: is it not true that foreign investment is an unnecessary intrusion such that the host nation would do better by saving more, consuming less and providing for its own investment?

The first task is to understand FDI in relation to a nation's international transactions by placing it within the balance of payments statistics, as they are defined by international conventions (IMF, 1993; OECD, 1996; ABS 2000, appendices A and B). The balance of payments data record all transactions between foreign and resident entities (people, corporations, official bodies, etc.) and are broken into two basic parts.

The first is the so called current account and measures transactions related to the current period.[13] The second is the capital account (more recently renamed the capital and financial account) and measures the flow of transactions which are generally more long

[13]The current account includes payments for imports and exports together with any (net) payments made to foreigners because of previous transactions. These latter include interest due on previous loans, profits payable on previous investments and other payments such as rent, some leasing and hiring expenses, etc.

lived and changes in stock values (IMF, 1999, p xxvi). The capital account is made up of the various forms of foreign investment and the official transactions of government.

The balance of payments (which is the sum of both accounts) always equals zero: what residents pay foreigners equals what foreigners pay residents plus any net additions to indebtedness between the two. So, with no change to the official reserves (which this exposition assumes throughout), any deficit (/surplus) a nation may have on current transactions is equal to the surplus (/deficit) it has on its capital account. If data were collected without error, they would show this equivalence.

Although this initial point is merely one of definition, it allows a clear view of an inherent ambiguity. Consider a nation which on a net basis has some excess of current outgoings over incomings. Such a country is said to have a current account deficit, the result of which is either an increase in its foreign indebtedness or an increase in the foreign ownership of local assets (or a reduction in the indebtedness of foreigners to it or in local ownership of foreign assets). Both these items constitute credits on the capital account and a nation with a net credit is said to have a capital account surplus.

The important point is the direction of causation implied by this illustration. The circumstances seem to compel the view that the current account deficit causes the capital account surplus. However, strictly speaking, a current account deficit only requires a capital account surplus as an accounting identity. There can be no presumption as to the direction of causation (Caves, et al 1990).[14]

Despite this inherent ambiguity, the same causality seems to be implied in the case of a nation running a current account surplus: its excess of income from current international transactions can be seen as causing the accumulation of assets overseas and the nation is said to run a capital account deficit. It is implied that the current account surplus creates or enables the outflow but, again, the equivalence relies only on the definition of terms.

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[14]The point is that "no clear presumption exists as to the direction of causation. In general the various accounts are in reality determined simultaneously" (p 355).

That the causation could run the other way is more readily seen by recasting the illustrations so as to incorporate the relation between the nation's external and internal (the so called national) accounts. From a national point of view, that part of current income (from all sources, domestic and foreign) not used up in the current period is national saving. These funds are available for investment (at home or overseas) or to reduce national indebtedness to the rest of the world. A nation which sends savings overseas (in excess of foreigners' savings sent to them) has a deficit on its capital account and a nation which has a net inflow of saving has a surplus (Goldstein, et al, 1991, p 20).

Therefore, the nation running a current account surplus could just as well be seen as using its savings to invest or lend off-shore, doing less of these things at home than could be done otherwise, thereby creating a relative deficiency of local demand and hence a surplus on the current account. The capital account is then the outcome of autonomous factors and determines the current account outcome, reversing the previous, apparent line of causation. Similarly, for the nation with the current account deficit, it can be thought of as so well endowed with investment opportunities that foreigners' desire to lend to locals or to buy local assets creates a capital account surplus. This then creates an abundance of local demand and hence a deficit on the current account. The foreign investment flow then connects current account surplus nations with current account deficit nations (Nicolas, 1995b, p 314).

In other words, significant net flows of foreign investment can be thought of as de-coupling national investment from national savings, so that economic growth is no longer wholly endogenously determined (Sinn, 1992, pp 1162-1170). However, the degree to which this is universally true is open to dispute (Akyuz, 1998; Caves *et al*, 1999).[15]

[15] Akyuz describes the independence of national investment from national savings as a proposition in "serious doubt" (p 288). Caves *et al* refer to the so called, "savings-retention ratio" which they describe as the change in domestic investmetn which accompanies an exogenous change in savings, which is estimated to average nearly 0.9 for advanced nations. This is considered tobe

The point of all this for policy is that the two facts, that Australia has a current account deficit and that it receives Japanese FDI, are ambiguously related, with correspondingly uncertain policy implications. Some see Australia's position as a deficiency of saving (Commonwealth, 1997, *passim*; Catley, 1996, p 109; Whitelaw and Howe, 1992; p 14), but that is so only relative to comparatively high levels of local investment (some international comparisons are given in Table 1.1 in Appendix 1). However, it is not obvious what causes what, only that the declines in net savings during the 1980s and 1990s have accompanied growth in Australia's current account deficit (Hill and McKern, 1997, p 216; EPAC, 1992, p 2.7). It is simply not clear that Australia should reduce investment or otherwise cut back its current account deficit, nor its associated capital account surplus (Pitchford, 1992).[16]

There is a second thread here: while it is not clear that government should act to correct a persistent imbalance on the current account, it might be that the imbalance will be self-correcting by adjustments to the exchange rate. Put simply, the argument is that a current account deficit signals excess demand for foreign currencies and this will bid down the host currency and lead to an expansion of exports (which are now cheaper in foreign currency terms) and a contraction of imports (now dearer in the domestic currency). Both consequences will tend to correct the current account imbalance and to reduce the need for a capital inflow.

The exposition here makes clear that there is nothing inevitable about that causation. Firstly, the capital inflow which is the other side of the current account deficit, might forestall the devaluation (Mundell-Flemming, 1968, pp 160-163). More fundamentally, the demand for the local currency relative to any other will depend on the relative degree

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unexpected; it would be zero if there were no relation between domestic savings and investment as a result of high levels of capital mobility (pp 445-447).

[16]Pitchford makes the same dual points, that concern with the current account deficit is often over done and that "(t)he optimal amount of foreign investment at any time is not something which policy makers should expect to be able to calculate" (pp 19-20).

by which it is used internationally (as a medium of exchange, a unit of account or a store of value) and this has little to do with a nation's current account position or the relative value of imports and exports (Tavlas and Ozeki, 1992, p 19).[17]

Some would argue that, despite the ambiguities in causation and the lack of self-correction, there remains a current account limit on growth. For example, Thilwall and McCombie (1994) argue that, in the long term, domestic growth cannot exceed "the rate of growth of exports divided by the income elasticity of demand for imports" (p 233) i.e. if imports respond strongly to increases in income, the emerging external imbalance will limit growth, unless exports grow fast enough to compensate. However, even this more subtle rule has only the force of what the authors call a "stylised fact" (p 233) rather than of a causative law as might hold in the physical sciences.

In short, there is no sure reasoning which leads from the simple facts that Japan is a source and Australia a recipient of the flow of FDI (both bilaterally and on a global basis) to any certain Australian policy responses. That there is no obvious but adequate interpretation of the international investment position of any nation is indicated by data (reported in Tables 1.1 and 1.2 from Appendix 1) which show that the foreign investment position varies considerably among nations, including between those more and less developed and those fast and slow growing.[18]

It is now possible, having examined the equivalence of the current and capital accounts, to examine the latter more closely and to focus upon our subject matter, FDI. The capital account measures foreign investment in four parts: foreign direct investment (FDI),

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[17] It is quite possible for a current account deficit to be associated with excess demand for the local currency and a bidding up of the exchange rate if, for example, most import contracts were written in the local currency.

[18] The tables give three snapshots of the external accounts of a number of OECD nations in the 1980's and 1990's. Table 1.1 shows the great variety which exists in the international investment positions of advanced economies. Table 1.2 describes the net flows of capital among advanced nations and reports their savings and investment ratios. Again, there is great variety among nations and the relation between national saving and investment is seen to be weak.

foreign portfolio investment (FPI), other foreign investment and, in some classifications, reserve assets held by central banks (IMF, 1982, chapter 8).

FDI is defined as occurring when the investor has "..a lasting interest " (IMF, 1999, p xxvii) in an enterprise in a second nation (i.e. it is not a current transaction) and an interest which provides

> "... a significant influence, either potentially or actually exercised, over the key policies of the enterprise" (ABS, 1991, p 12).

FDI is generally undertaken by branches or subsidiaries of foreign companies, the latter being incorporated in the host nation and the former not.

This study then is concerned not simply with Japanese ownership of assets in Australia but, more broadly, with Japanese influence over them. There is of course a positive relationship between the two: the greater the level of ownership, the greater the degree of influence, leading to outright ownership and control. But control can also be exercised through other means such as the financial relations between lender and borrower or the commercial relations between buyer and seller. The international standard for FDI reflects this uncertain relation of ownership and influence by dividing FDI data into three parts: equity capital, reinvested earnings and other capital, the latter being inter-company transactions such as loans and trade credits (IMF, 1999, p xxvii). An increase in any one is an increase in FDI.

The breadth of the definition of FDI is reflected in the flexibility applied in measuring it. Australia and many other nations base the definition largely on the equity link and consider that if a foreigner holds at least 10% of a corporation's voting stock, this constitutes a direct investment relationship (IMF, 1993; OECD, 1996; ABS, 2000)[19]. However, the definitions can be and, in Australia they are, interpreted flexibly so that

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[19]Prior to 1985-86, the equity threshhold was 25%. In addition, Australia also considers a direct investment relation exists when more than one foreign interest (and regardless of their nationality) holds greater than or equal to 40% of the

borrowings and other elements of debt finance are included when assessing the potential for influence.

To reiterate, a direct investment relationship does not require that the investor has control. That stronger notion is defined by the ABS as occurring if the equity stake is at least 25%. But the definition of FDI does mean that this study focusses broadly not just on instances where a foreign investor simply buys an asset outright (although, as we shall see, these constitute the vast majority) but include situations of joint venture, even at minority equity levels, and, at the margin, situations where ownership is secondary.

The other elements of the capital account may now be defined in contrast to FDI i.e. portfolio and other investment involve a relationship where significant influence cannot be reasonably inferred. Foreign portfolio investment (FPI) is long-term investment, again both equity and debt, and has the sense of being part of a portfolio of interests held by the foreigner. The "other" category is both a residual for long-term investment and includes short-term investment not included elsewhere: this being the great majority of short-term investment.[20]

From the previous discussion, it is clear that a surplus or deficit on the current account can be coupled with any combination of the four capital account terms so long as, on a net basis, the capital account provides a matching surplus or deficit. There is no necessary relationship between the current account and any single part of the capital account including FDI. This further weakens any line of causation within the external accounts which might explain a given FDI flow and, hence, it weakens any policy implications derived from the position described by those accounts.

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voting stock (Dept. of Treasury, 1989, p 2).

[20]The inclusion of short-term investment transactions is significant. While foreign investment is often a long-term phenomenon it cannot be clearly distinguished from other international transactions on this basis alone. Short-term investments, in the form of trade credits, other loans, deposits, debentures, etc. make up a significant proportion of the total.

There are two other ambiguities to highlight. Firstly, FDI does not necessarily involve a flow of capital from one nation to another. It is entirely possible for the foreign investor to borrow money from host nation sources to finance the investment. This will create a credit on the FDI account and a matching FPI deficit as foreign influence and indebtedness by foreigners both rise.

The definitions of capital account items also make clear the essentially ambiguous relationship between FDI and the foreign debt (i.e. the accumulated borrowings and some other forms of non-equity funds provided by foreigners). From the preceding it can be seen that the argument such as put by a Japanese government agency, that "(FDI) should be promoted because it does not result in increased external debt ....." (JETRO, 1992 a, p 12) is not strictly reasoned. For example, when a subsidiary of a foreign company borrows from the parent or from foreign banks, this increases both FDI and the foreign debt. Furthermore, not all equity investments occur within an FDI affiliation. Nonetheless, because the definition of FDI relies on the transfer of significant influence and this most often requires a significant equity holding, there is a tendency for it to be equity-rich and so to contribute less to foreign debt than do other forms of capital inflow.

This might have some policy relevance because high debt levels can have an enervating effect on the economy by increasing the cost of further borrowing by all residents not just current borrowers and it can lead to greater exchange rate volatility (Pitchford, 1992, *passim*).

Another feature of FDI is that, because of the strong equity links which often accompany it, it tends to involve the acceptance of risk and the supply of managerial resources by the investor. This further suggests a degree of stability and commitment and implies some productive rather than merely speculative or *rentier* intention (UNCTAD, 1995).[21] It

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[21] "In contrast (to FDI), portfolio equity investment flows are typically more speculative in nature and respond quickly to changing perceptions of risk and reward. As a result, portfolio investment is more unstable than FDI" (p 5).

suggests that FDI can play a positive role in the composition of the capital account surplus, providing a preferred means of financing a given current account deficit.

The final introductory points concern the quality of FDI data and the usefulness of the empirical relation between them and other economic parameters. In recent years the liberalisation of exchange controls has reduced the official reporting requirements in many nations and the growth and diversification of capital flows has led to a deterioration in coverage so that it is said the "world capital account statistical systems are in crisis .... problems are widespread" (IMF, 1992, p 2).

This is a limiting but not prohibitive restriction for this study. Australia's foreign investment and balance of payments data are believed to be relatively robust (UNCTAD, 1999, p 467; EPAC, 1992, p 2.3; ABS, 1991).[22] More fundamentally, most of the data reproduced here are for stocks (i.e. levels) of investment not annual flows and they are used to give only an overview of the shape and dimensions of the subject matter. More finely accurate data, such as might be needed to monitor annual flows or to measure highly disaggregated parts of the total, are not relied upon.

As to the quality of empirically tested relationships, these appear to have been difficult to establish and are generally thought to be unstable (Goldstein et al, 1991, p 1). Recent attempts to establish empirically the determinants of FDI in Australia and internationally, which we review in more detail below, have come up with a long list of sometimes unexpected variables (Hatem, 1998; Yang, Groenwald and Tcha, 1997).[23] Apparently, as

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[22] ABS consider FDI data to be the most accurate of their foreign investment data, with an estimanted margin of error of 5-10% (p 28).

[23] Hatem's survey on behalf of the UN concluded that, on average, the 4 most important causes of FDI, in order of importance are: access to foreign markets that grow faster than domestic; to acquire strategic assets; to make use of a more favourable business environment; and, to access cheap, available resources (pp 28-32). An example of unexpected results which can turn up occur in the recent work by Yang, et al for Australia which included the prevalence of industrial distputes as a significant positive variable. Other unexpected results are reported in section 2.3 below for studies of Japanese FDI.

the IMF have observed, foreign investment is an economic activity neither readily measured nor modelled (IMF, 1991, p 21).

Before moving on to focus on Japan and Australia, this section concludes by briefly describing recent developments in global FDI flows. Through the early part of the 20th century FDI flowed mainly from advanced to developing nations, although FPI not FDI made up the great majority of the capital flows associated with colonial expansion (Caves, Frankel and Jones, 1990, p 198; Dunning, 1972, pp 10 - 11).

By contrast, the growth of FDI flows in the post-war period has been largely between developed nations. Less developed nations accounted for only one-quarter to one-fifth of the annual flows and Asia was the only developing region to experience steady growth in FDI, at least until the downturn associated with the Asian economic crisis of 1997 (UNCTAD, 1995, p5; BIE, 1993, p 50).

In the early post war period, FDI focussed predominantly on primary industries, then on import substitution in manufacturing in the 1960s and 1970s (Hatem, 1998, p 120). Outflows of FDI were dominated by the US, although the UK was also a major source nation. By 1960, Japan accounted for less than 1% of the global total.

The early 1970's mark a watershed in the development of global FDI. The US, which had dominated the outflows, became an occasional net recipient and the EC nations and Japan became increasingly important as sources of FDI. Since the early 1970's the industry composition of FDI has also changed markedly, with industries in the tertiary sector accounting for an increasing part of a quickly increasing flow.

During the 1980's, FDI growth accelerated further to a rate four times that of GNP (Julius, 1990, p 6). In addition, the concentration on flows between advanced nations increased and there developed what has been called the trilateral structure or Triad of FDI in which the great majority of the flow is between the three regions of the EC, North America and Asia, centred on Japan (BIE, 1993, p 20; JETRO, 1992, p 15). This is

reflected in the fact that developed countries, of which the Triad economies make up the vast majority, accounted for 92% of outflows and 72% of inflows in 1997 (UNCTAD, 1999, p 19). Most of this inward investment to the Triad went into service industries, whereas the majority of FDI in developing countries goes to manufacturing (primary industries have a declining share in both) (UNCTAD, 1999, p 11).

The trilateral pattern has been associated with the development of what has been called "multinational regionalism" (Edgington, 1995, p 86) and Japan has contributed strongly to its emergence. It is said that a number of clusters of receiving nations exist about each node in the trilateral flow and that "of these clusters, the Japanese network appears to be the most highly evolved" (BIE, 1993, p 21). These Japanese networks are said to concentrate in Asia (JETRO, 1992 a, p 21) and are described in more detail in 2.3 below.

Global FDI outflows, which are summarised in Table 1.3 of Appendix 1, show a peak in growth rates around 1990, followed by decline in the next two years. Since then, global FDI growth has resumed and outflows reached nearly US$648.9 bn in 1998 (UNCTAD, 1999) and, in 1997, Japan accounted for 6.2% of the global outflow, having reached a peak at 20% of the total in 1990. The variability of recent years is not new but is said to be typical of FDI flows (Hatem, 1998, p 119). Total FDI was undertaken by 60,000 parent companies in 500,000 foreign affiliates. The largest 100 non-financial TNCs had assets of US $1.8 tr and sales of $2.1 tr and 90% of these were from Triad nations (UNCTAD, 1999, p 2).

Some have suggested that this growth has meant that FDI reached a mature stage in the 1990s, surpassing trade as a force shaping the international economy, especially when intra-company trade is seen as part of the FDI phenomenon.[24] It suggests that the late 20th century saw "a new level of economic integration through direct investment" (Julius, 1990, p 6). Unlike trade or the previous period of FPI, large scale FDI means that

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[24]In 1995, total sales by foreign-controlled enterprises is estmated at US $5.2 tr in 1992 (UNCTAD, 1995, p 8). This compares to total global exports of US $4.9 tr. What is more, of those exports, intra-corporate trade makes up some one-third.

significant foreign influence is extended over local activities and this intimate process is then "the major means of international integration" in the modern era (Nicolas, 1995a, p 5).

FDI can be seen as signalling an important diminution in the national character of economies. As a Japanese government publication has put it, FDI is creating a situation where "a simple understanding of national interests (is) difficult" (JETRO, 1992, p 239).

We can now use the definitions and this broader context to describe Japanese FDI.

2.3 Japanese Foreign Direct Investment

In describing Japan's FDI position the fact which emerges directly and immediately from the most aggregated data is the limited extent of the inflow, despite the recent growth in outflows. This is so outstanding a fact that whatever understanding is reached of policies for Japanese FDI in Australia must be consistent with it. The following table shows the point by calculating the ratio of FDI inflows to outflows for selected nations.

Table 2.3.1: Net FDI Position of Selected Nations (ratio of inflows to outflows)

Year	Japan	Australia	Canada	Germany	Sweden	UK	US
1990	0.04	6.82	1.46	0.1	0.14	1.68	1.6
1991	0.04	2.59	0.47	0.17	0.88	0.99	0.7
1992	0.16	1.73	1.37	0.13	0.01	0.85	0.42
1993	0.01	1.6	0.82	0.13	2.47	0.58	0.63
1994	0.05	1.84	0.88	0.11	0.94	0.27	0.59
1995	0	3.37	0.79	0.35	1.31	0.51	0.6
1996	0.01	0.95	0.59	0.09	1.08	0.73	0.96
1997	0.12	1.59	0.51	0.01	0.86	0.62	0.77
ave. 1990-7	**0.05**	**2.56**	**0.86**	**0.14**	**0.96**	**0.78**	**0.78**

Source: IMF Balance of Payments Yearbook, 1998

Japan has the lowest average ratio of inward to outward flows of FDI among advanced nations, being nearly a third of the next lowest shown in the table above. For Japan, the ratio exceeded 10% only twice in the 1990s. By comparison, Germany, the nation with the next lowest average ratio, fell below 10% only twice. Other advanced nations are nowhere near these ratios, especially Australia which has the highest average ratio of those nations selected.

The point is confirmed by recent calculations to construct an index of the "transnationality" of nations (UNCTAD, 1999b, p 17). The index is an average of four measures: FDI inflows relative to gross fixed capital formation; inward FDI stocks as a share of GDP; value added of foreign affiliates in the local economy as a share of GDP; employment of foreign affiliates as a share of total employment. It found that "among developed countries, New Zealand has the highest transnationality index and Japan, the lowest" (p 15). Australia, by comparison, was fourth highest.

The extent to which Japan is an outlier in this regard is also shown by the unsuccessful attempt to fit it within the so called "investment development path" (Dunning and Narula, 1998, *passim*). According to this notion, countries pass through five stages which, it is claimed, can be "usefully classified according to the propensity of those countries to be outward and/or inward direct investors" and as measured by the ratio of their net FDI position in relation to GDP (Dunning and Narula, 1998, p 1). Japan should now be in the stage where inflows of FDI predominate so as to equate, eventually and roughly, inward and outward stocks. But this is not happening (Lall, 1998, p 433). Japan is not the only outlier in this regard. Sweden is also unusual in the same way and we return to this pairing in reviewing FDI policies in Chapter 3 (Lall, 1998, p 430).

The persistence of Japan's FDI asymmetry implies that "Japan seems to 'deviate' from the 'norm' " (Ozawa, 1998, p 164). This is undoubtedly because the pattern of growth and FDI flows depends on "contextual variables" (Dunning and Narula, 1998, p 18); and this could be thought to call into question the usefulness of Dunning's notion, although

that is not his view. It remains an open question whether Japan will converge to the pattern of other nations in this regard but the point here turns on the strikingly egregious position Japan occupies.

The FDI asymmetry is one aspect of a broader Japanese external imbalance which extends back to the Meiji Restoration at least and includes asymmetry in trade and other capital flows. Despite that the Restoration was prompted, at least in part, by the need to deal with foreigners, dealings with them were circumspect. Foreign loans were said to have been "taboo" and any entry into foreign capital markets by Japanese interests were sporadic and small, ordered by the national government and usually followed quickly by redemption of the debt (Okita et al, 1967).[25]

FDI, which has been defined as providing for foreign influence or control, was even less favoured than other forms of capital inflow and was "never really considered a possibility" (Hirschmeier and Tsunehiko, 1975, p 87). Indeed, Japanese economic development has been financed almost entirely from domestic savings, encouraged by the central government (MacPherson, 1987, p78).

Focussing now on the FDI outflow, the historical data in Appendix 2 show that, Japan's outward FDI, while it is a relatively recent phenomenon, is not without its antecedents (Wilkins, 1998, p 110; Storry, 1972, p 43; Jones, 1996).[26] It began in the pre war years and was seen as crucial to national interests (Morris, 1974, p 46). The investments made in the

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[25]During the 19th century, the Japanese government raised overseas loans on two occasions, though these were repaid by 1899. In addition, one-half of expenditure for the Russo-Japanese War (1904-5) was provided by foreign sources and, up until the Great Depression, industrial companies (especially those involved in urban electrification) issued overseas debentures - although again these were redeemed by the Japanese government after 1929 (p 147).

[26]For example, the international expansion of Japanese control has early historical expression in the establishment of an outpost on the Asian mainland in the late 16th century (although this is best seen as an episode and not a central theme of Japanese history) (Storry, 1972, p 43). The first instance of Japanese FDI is said to have been made in cotton spinning in China during the 1920s (Wilkins, 1998, p 110), although Jones claims that an earlier investment was made by Japanese soy sauce manufacturer Kikkoman in Denver, US in 1892.

puppet state of Manchukuo provide an instructive example. They show a high level of public sector involvement in developing off-shore production and also the Japanese desire to develop a degree of extra-territorial, regional integration of economic activity as a means of overcoming perceived limits to national growth (Myers, 1982, p 34). As we will see, this parallels some of the more recent developments in Japanese FDI.

To look closely at the phenomenon of Japanese FDI in more recent times we must make use of data from three major sources: the Ministry of Finance which collects data on approvals and notifications; the Bank of Japan's balance of payments statistics; and the occasional MITI surveys of trends in Japanese enterprises operating overseas. None of these are entirely satisfactory.[27] However, the first will be relied upon initially in this section and it provides the following Tables 2.3.1 (a) and (b) which show the size and spread of Japanese FDI over the post war period. (This section is supported by data and text in Appendix 2.)

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[27]Japanese data reported in the previous section 2.2 were from the Bank of Japan's balance of payments statistics. Briefly, the major problems with each data source are that, with MoF data there is a lag, of unknown and variable length, between approval and actual initiation (Saelens, 1986, p 90). Moreover, not all approved investments eventuate and the data do not include retained earnings (Farrell, 1997, p 3). This means that the Ministry of Finance data overstates outflows of FDI, compared to the Bank of Japan and compared to the inflows of FDI recorded by other nations (Thomsen, 1990, p 112). The balance of payments data from the Bank of Japan are subject to the same weaknesses noted for all balance of payments data at 2.2 above and, in addition, Japan fails to maintain the appropriate distinctions between the elements of FDI previously described (UNCTAD, 1999, pp 467-469). Balance of payments data are also unavailable by industry (Farrell, 1997, p 3). MITI's surveys are widely quoted but are only occasional and generally only available, in complete form, in Japanese.

Table 2.3.2 (a): Japanese outward FDI by nation (% of the total)

Year	Australia	North America	U S	E C	DAEs	China
1961-70	0.07	0.25	0.19	0.19	-	-
1971-75	0.05	0.24	0.22	0.15	-	-
1976-80	0.08	0.29	0.27	0.1	-	-
1981-85	0.04	0.36	0.35	0.14	-	-
1986	0.04	0.47	0.46	0.15	0.08	0.01
1987	0.04	0.46	0.44	0.19	0.09	0.04
1988	0.05	0.47	0.46	0.18	0.10	0.01
1989	0.06	0.5	0.48	0.21	0.10	0.01
1990	0.06	0.48	0.46	0.23	0.09	0.01
1991	0.06	0.45	0.43	0.21	0.09	0.01
1992	0.06	0.43	0.46	0.19	0.10	0.03
1993	0.05	0.43	0.41	0.20	-	0.05
1994	0.03	0.45	0.42	0.15	-	0.06
1995p	0.05	0.46	0.44	0.16	-	0.09
1996p	0.02	0.48	0.46	0.15		0.05
1983 stocks	0.05	0.29	0.27	0.11	0.12	0
1994 stocks	0.05	0.44	0.42	0.18	0.10	0.02
ave ann growt 1983-94	23.5	28.6	28.6	29.9	19.4	58.0

Sources: for tables 2.3.2 (a) and (b)

1. 1951-80: MITI Research Institute (1990)

2.1983-94: OECD International Direct Investment Statistics Yearbook (various issues).

Both sources are derived from Ministry of Finance Statistics of Approvals/Notifications of Overseas Direct Investment.

Table 2.3.2 (b): Japanese outward FDI by industry

Year	Agricultur	Mining	Mfd Food	Vehicles	All Mfg	Business Services	Real Estate	All Tertiary
1951-60	0.02	0.30	-	-	0.45	-	-	0.22
1961-70	0.03	0.31	-	-	0.25	-	-	0.31
1971-75	0.02	0.25	-	-	0.33	-	-	0.39
1976-80	0.03	0.15	-	-	0.37	-	0.02	0.45
1981-85	0.01	0.10	-	-	0.25	-	0.05	0.64
1986	0.00	0.03	0.01	0.04	0.17	0.27	0.20	0.77
1987	0.00	0.02	0.01	0.04	0.23	0.28	0.17	0.73
1988	0.01	0.02	0.01	0.03	0.29	0.26	0.18	0.67
1989	0.00	0.02	0.02	0.03	0.24	0.37	u/a	0.73
1990	0.00	0.02	0.01	0.03	0.27	0.39	u/a	0.69
1991	0.01	0.02	0.02	0.05	0.30	0.34	u/a	0.66
1992	0.00	0.04	0.02	0.03	0.29	0.35	u/a	0.66
1993	0.00	0.03	0.02	0.03	0.31	0.10	0.17	0.65
1994	0.01	0.01	0.03	0.05	0.34	0.17	0.12	0.63
1982 stocks	0.01	0.13	0.01	0.04	0.26	0.18	0.16	0.55
1994 stocks	0.01	0.04	0.02	0.04	0.28	0.29	0.30	0.66

Before analysing these data, the following Table 2.3.3 extends a more limited data set to 1998.

Table 2.3.3: Stock of Japan's Outward FDI

Year	Equity & reinvested earnings	Other capital	Total FDI
1980	-	-	19.6
1985	-	-	44.0
1992	171.5	76.5	248.1
1993	184.4	75.4	257.8
1994	199.4	76.1	275.6
1995	194.8	43.6	238.5
1996	215.5	43.2	258.6
1997	243.4	28.5	271.9
1998	244.5	25.5	270.0
ave ann rate of grow	6.06%	-16.7%	1.4%

Sources: 1. 1980 and 1985, UNCTAD, 1999.
2. 1992-98, IMF, 1999

In overview, Japanese FDI began growing again after the Pacific War in the early 1950's but did not get well underway until 1972, when it passed the $2 bn. p.a. mark (Wilkins, 1998; Komiya and Wakasugi, 1990).[28] The most important feature of the early post war period was the so called "D and I" activities i.e. "develop and import" investments, which were aimed to secure supplies of raw materials at reasonable terms (Ozawa, 1979).

In addition, the development of Japan's FDI owed much to the involvement of government (Ozawa, 1979, p 37) and to the role played by the *sogo shosha,* or trading companies, which assisted broadly with Japanese internationalisation (Eccleston, 1987; Shinohara, 1982).[29] There is also some evidence that Japanese FDI relied predominantly on domestic sources of finance and therefore represented net exports of Japanese capital, especially in the 1950s and '60s when the current account constraint impinged most closely and, thereafter, when Japanese banks undertook overseas expansion, they are said to have provided the bulk of finance to Japanese affiliated companies abroad through their FDI affiliates (Komiya and Suda, 1991, p 103; Hamada, 1972; Ozawa, 1979).[30]

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[28]This is the so called *gan-nen* or very first year of FDI according to the MITI Research Institute (Komiya and Wakasugi, 1990, pp 4-5). Wilkins describes Japanese FDI before the late 1960s as establishing "meagre precedents for subsequent growth" (1998, p 119).

[29]As Japan's specialists in international economic activity, these organisations have played an "invaluable role ... and in their method of operation lies one of the secrets of Japan's high growth ... it is not too much to say that the trading companies are a 'comparative advantage' for Japan ...." (Shinohara, 1982, pp 44-5). Shinohara reports that, between 1960 and 1973 the *sogo shosha* accounted for half of Japanese exports, 63% of imports and 40% of overseas investment.

[30]Referring to data from the Export-Import Bank, Hamada states that: "(g)enerally, long-term funds for fixed investment are mainly supplied by shareholders. Short term funds or operating funds are mostly supplied by banks in the host country or by branches of Japanese banks" (p 184).
According to Ozawa, by the mid 1970's, Japanese FDI was financed in the proportions of approximately one-third borrowed from government-affiliated organisations, one-third from internal sources and the remaining third from "private" sources (one presumes these were private financial institutions) (p 37). The ultimate source of these components of capital is not stated but it is strongly

The pattern of outward FDI is also said to have responded to the restructuring of Japanese industry concomitant with the growth in Japanese wages and other production costs (Komiya and Wakasugi, 1990, p 4), the emergence of acute environmental problems and with government-sponsored policies to shift activity away from the resource intensive, heavy industries and towards clean, low energy, knowledge intensive industries (Sheridan, 1995, pp 163-4; Shinohara, 1982, p 36). Restructuring also led to increased FDI as firms' "business strategy changed from exporting to foreign production" (Itoh and Kazahura, 1986, p 66). This link between FDI and restructuring at home and abroad is an important insight with significant policy implications, which will emerge in later chapters.

Once it got underway, the acceleration of Japanese FDI was "one of the most remarkable recent developments in the world economy" (Komiya and Wakasugi, 1990, p 1). The outline of this acceleration and the subsequent periods of decline and recovery can be followed from a number of secondary sources (Akyuz, 1998, pp 288-292; Tejima, 1998, pp 216-225; Strange, 1993, pp 68-70).

In overview, by the mid 1990's, Japan was home to 3,650 of the world's 38,500 parent companies for FDI. This position was the result of accelerated outflows during the 1980s, as is indicated by the fact that the outflow from 1986 to 1989 was greater than the sum of all preceding years (Komiya and Wakasugi, 1990, p 6). In 1989 Japan became, for the first time, the leading source nation for FDI, a position held through 1990 and into 1991 (JETRO, 1992, p 3).

Then followed the first decreases in the FDI outflow in eight years with significant declines in 1991 which accelerated in 1992. The period of decline ended in 1993 and, by 1997, outward FDI was again growing strongly and had recovered to $26 bn., 88.4% above the trough and

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The ultimate source of these components of capital is not stated but it is strongly implied that, apart from retained profits earnt overseas, only a part of the last third could be raised outside Japan.

48.5% below the 1990 peak. 1998 data show another modest reduction to $24.6 bn (IMF, 1999, appendices and Table 1.3 of Appendix 1).

The phase of rapid growth since 1980 was associated with significant changes in the destination of Japanese FDI. It no longer focussed on LDCs to such a degree and now flowed predominantly to North America (which received nearly half) and to Western Europe. These developments contributed strongly to the emergence of the trilateral, global structure noted in the preceding section.

This pattern of Japanese FDI has also been linked to the so called "tripolar" or "three-legged" business strategies by which large Japanese firms establish semi-autonomous headquarters in Asia, Europe and North America (Tejima, 1995, p 38). Associated with this development has been the emergence of clusters of Japanese FDI activities about the three major centres, although it is also suggested that a fourth cluster exists in Latin America (Morsink, 1998, Ch 6).

The analytical significance of this "bunching" behaviour (Giddy and Young, 1982, p 72) will be considered in more detail in Chapter 5 below. Here we are concerned to describe it in relation to the co-location of Japanese FDI affiliates abroad, often with transactional or ownership links among them. This issue has attracted considerable attention.

Some see the tendency for one instance of Japanese FDI to make further instances more likely in the same location and in quick order, as a "defining element" of Japanese organisation and to have wide empirical support (Smith and Florida, 1994, p 27). Certainly, many see it as a distinguishing characteristic (Head, Ries and Ruckman, 1998, p 53; Mayer and Mucchielli, 1998, p 137; Dunning, 1995, p 216; Nicolas, 1995b, p 336).

The clustering of Japanese FDI is said to be emerging particularly strongly in Asia where the DAEs (dynamic Asian economies) had been important destinations before the Asian economic crisis of 1997, as shown in Table 2.3.2 (a) above (see also Kahkonen, 1995, p 23). Japanese FDI is reported to be the prime source for China's emergence as a major recipient nation of

FDI (Tejima, 1995, p 37). It is said that Japan's continued interest in East Asia is central to a systematic process of regional expansion through the division of labour and the integration of production (Machado, 1996, p 39) and this is said to be reproducing business relations among Japanese firms on a regional basis (Machado, 1994, p 308). A similar point is made concerning Japanese technology development and dissemination in Asia (Simon et al, 1990, pp 204-216) which is seen as part of the integration of the "natural trading bloc" of East Asia which is being led by Japanese FDI (Kreinin, Lowinger and Lal, 1998, p 195). To emphasise the vertical nature of this division of labour, the FDI flows are uni-directional from more to less developed countries in the regions and have evolved from an outflow initially from Japan alone to now include an outflow from East Asia's newly industrialised economies (NIEs) of Korea and Taiwan as well (Kreinin, Lowinger and Lal, 1998, *passim*).

The emergence of a network of relations within Europe is also said to be evident in a "regional strategy" of Japanese FDI in the manufacturing sector there (Dunning, 1990, p 224). It is said that this is strongly associated with the co-location of related Japanese firms (Nicolas, 1995b, p 336; Belderbos, 1997, p 101). Whether or not it is unique, this process of bunched Japanese FDI is, like Japan's FDI asymmetry, an important characteristic which should be incorporated into the understanding of a host nation policy response.

As well as changes in destination, the industry composition of Japan's FDI has also changed, as is shown in Table 2.3.2 (b). The importance of mining and resource projects declined continually. The period after 1980 also saw a new phase of relative decline for the manufacturing sector and, consistent with global trends, the growing importance of the tertiary sector, especially investment in the finance and insurance, transport and real estate sectors.

It is possible to gain some insight into Japan's outward FDI by comparing it to that of other nations and the MITI (Komiya and Wakasugi, 1990) notes the following distinctive characteristics. (To the extent possible, section 2.5 below compares these global features with the characteristics of Japanese FDI in Australia.)

Firstly, by industry, Japan's presence in foreign manufacturing is relatively low, while that in services is relatively high (UNCTAD, 1999, p 428).[31] Secondly and related, the profile of Japan's earlier investments is still reflected in the relative concentration of outward FDI in resource development and export marketing, particularly by the *sogo shosha*. Thirdly, by size of investor, FDI from Japan is more often carried out by small and medium sized enterprise, especially in manufacturing and in Asian countries.[32]

Another distinctive characteristic of Japanese FDI is the relatively large proportion undertaken as new, overseas subsidiaries, rather than as branch offices or by mergers or acquisitions. FDI outflows from advanced nations are most often 100% owned by the parent, and this is especially true for Japanese FDI (Encarnation, 1995, pp 207-8; Strange, 1993, p 368; Dunning, 1990, p 216). It is also said that Japanese foreign direct investors have a marked preference for greenfields projects, built up from scratch (Kahkonen, 1995, p 32). Some have also argued that the Japanese decision making processes and cultural traits lead to closer control of overseas operations than is the case with US foreign direct investors (Dunning, 1990, p 212).

A recurring issue is the degree to which Japanese FDI enterprises source inputs and sell outputs locally. MITI data are widely reported in this regard. As to purchases, data reported by Nicolas (1995b) show that, in Europe, the vast majority of sales are made within the host

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[31] The following table makes some of the comparisons:

FDI Outward Stock by industry, 1997

	Japan	US	UK	All developed nations
primary	6.2	7.3	15.3	9.0
secondary	29.6	38	34.4	33.6
tertiary	64.2	54.7	50.3	57.4

Source: UNCTAD, 1999, Table A.1.21

[32]The JETRO report that small and medium sized firms make up half the number of foreign direct investors. These investors operate predominantly in Asia (and increasingly in ASEAN nations and the PRC) and North America and are inordinately concentrated in the "other industries" classification in the non-manufacturing sector and, in manufacturing, predominantly in the electrical machinery and transport equipment. Their purpose is often to supply intermediate inputs to assembly firms in Japan (Itoh et al, 1995). Franko (1983) reports that nearly half of Japan's foreign direct investors in 1979 had less than

economy, although significant and increasing amounts are sold within Europe as a whole. Only in foodstuffs are significant proportions of output sold back to Japan. Milberg (1998) reports data for Japanese manufacturing FDI affiliates that confirm the point, both for Asia and the world as a whole. He adds that sales to Japan from either region are predominantly inter-firm.

Perhaps even more importance attaches to purchasing behaviours because these show more clearly that FDI can have additional effects on the host by its upstream linkages. Local sourcing is said to be enhanced both by the Co-migration of Japanese suppliers and by the development of in-house capabilities (JETRO, 1992, p 35). However, it is also said that Japanese FDI affiliates maintain strong links with their suppliers back at home and that this leads to high import intensities (Kahkonen, 1995, p 32; Strange, 1993, p 386), although this is said to be generally true of the behaviour all countries' FDI affiliates (Lall, 1996, p 59).

The MITI data show that, on a global basis, a much greater proportion of purchases come from Japan than are sales made in Japan and this is also true in Asia and in the EU (although, in both cases, the local economy is the major source of inputs). The data show change over time so that Japan is a declining source of inputs and this is consistent with the view that, while Japanese FDI enterprises believe local suppliers to be generally inferior to their traditional Japanese suppliers, they make particularly vigorous efforts to improve the performance of local firms over time (Dunning, 1990, p 219).

But, if this is so, it would be despite concerns, expressed by Japanese firms themselves, regarding the dangers and difficulties in achieving greater supply from local firms (JETRO, 1990).[33] In addition, as we describe in section 2.5 below, there are dangers and difficulties in interpreting these data. But we can already flag the major point: that the policy implications of relative degrees of embeddedness are not obvious. For example, if deeper integration were

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300 employees (p 63).

[33]As a Japanese electrical appliance maker operating in Germany has said: "Our local content ratio is now 40%. To increase it further without the cooperation of a Japanese affiliate would run undue risks in quality, delivery and cost" (p 20).

forced by local content requirements, it can impose considerable costs which might limit investment and expansion (Moran, 1999, pp 41-8). Further, it would need to be shown how increases in local sourcing provided benefits to other than the foreign investor and so would be available in the host economy. It is also likely that the benefits derived from local sourcing will vary among activities and this would need to be taken into account in any policy deliberations. Suffice to say that there is a raft of issues to be considered in this regard.

A final matter to which the MITI data refer is that of the profitability of Japanese FDI and it is claimed that, especially in comparison with the US, the rate of return on Japanese FDI is low. This is said to be due to the early stage of Japan's FDI (Legewie, 1999, p 198) and some commentators suggest that as the investment portfolio matures, the rate of return will approach that of the US (Kahkonen, 1995, p 32). Again it is a point taken up in 2.5. Combined with the relatively low profitability, the MITI also observe that Japanese FDI operations repatriate only a small part of those profits.[34]

Another matter which has been investigated empirically is that of the motivations for Japanese FDI and it has been suggested that Japanese FDI is strongly influenced by potential host market size, per capita income and trade intensity (Morsink, 1998, pp 139-143). All these motivations fit with the relatively high proportion of sales by Japanese affiliates which are made in the host. Less important but still significant were cultural differences and labour costs while other candidates like exchange rate change and volatility were not.

These results appear to offer important, perhaps even crucial evidence about Japanese FDI. However, the statistical techniques on which they are based can throw up associations from which it would be wrong to imply causation. The danger is reinforced by the results of the same study which the author describes as "strange" and "surprising" and as varying among regions in which Japanese investors operate eg transport costs are signed counter-intuitively (*ibid*, p 141).

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[34]The MITI state that:"Japanese overseas subsidiaries repatriate only a small part of profits, with three-quarters of the total profits being reinvested in the host country. On the other hand, for example, US subsidiaries in Japan repatriate over

Such admissions undermine the importance which can be attached to such studies, as does other work which have come to different conclusions. For example, Tejima, a well placed Japanese bureaucrat, uses official survey results to suggest that Japanese FDI has four prime motivations: to access lower factor prices; to avoid trade friction by supplying third nations from outside Japan; to supply Japan; and, to supply the Asian region (Tejima, 1998, *passim*).

These studies are also of less use in this thesis because, as noted in Chapter 1, the concern is not to explain Japanese FDI in Australia but to examine its policy implications. The two are related in that the view of causes should be consistent with that of policy implications but they are also different, as is evident in the fact that investment decisions are different to policy decisions. Hence, the empirical work on motivations for Japanese FDI might be descriptively significant but analytically unimportant from a policy point of view. The point is reinforced in examining similar data for Australia in section 2.5 below.

Before summing up, the final matter to be considered is whether Japanese FDI is different from that of other nations and its corollary, if Japanese FDI is different, is it converging on some global norm? They are large questions and will be considered in the case of Japanese FDI in Australia in section 2.5 below. Here we can show that there is a good deal of opinion on both sides, although most researchers equivocate to some degree.

Some (such as Graham and Krugman, 1995; Dore, 1994; Fajnzbyler, 1990) consider the possibility that Japanese FDI is different in that it reflects a different economic system.[35] Others see it as different but in limited ways (Belderbos, 1997, p 351) and, often, because it is of recent origin and therefore will converge to the global norm (Kahkonen, 1995, p 32; Encarnation, 1995, p 227; Nicolas, 1995a, p 41). Others simply report the view that it is different (Gittleman and Graham, 1995, p 157); others that it is simply the same (Sachwald,

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60% of their profit" (Komiya et al, 1990, p 15).

[35]Graham and Krugman write that "there is a general sense that Japanese firms may behave differently from other firms, either because of their protected domestic base or because they have a different culture and institutional structure" (p 23).

1995, p 72; Strange, 1993).[36] Clearly, there is no agreement on this matter and one can imagine that it would require very large amounts of comparative data to clinch the point one way or the other.

Having described the subject matter, it is important, for the purpose of an overall assessment, to set FDI in relation to total Japanese economic activity. While, from the foregoing, especially from the spectacular growth in Japanese FDI in recent years, it might seem reasonable to conclude that FDI is a matter of central importance to the Japanese economy, that would be a mistake. Overall, the unusual international investment position of Japan is not just that inward FDI is extraordinarily small but also that, while increasing quickly, outward FDI is still not as important for Japan as for other, comparable nations and production abroad remains a much smaller part of the total output of Japanese companies (Legewie, 1999, p 196; Hatem, 1998, p 77; Patel, 1995, p 151; Komiya and Wakasugi, 1990).[37] In other words, activity controlled by Japanese interests in other nations is a small part of the picture of Japanese controlled activity, the vastly overwhelming majority of which is undertaken in Japan. There is no evidence that Japanese FDI is a "Trojan horse" for Japanese expansion and infiltration (James, 1989, *passim*).

But it is also more than that. Not just for FDI but more broadly, Japan's participation in the international economy is relatively limited (Dore, 1986, p 245). Hence, while Japan is a major exporting nation "the significance of exporting to the Japanese economy should not be overstated" (Itami, 1993, p 32, emphasis added). Indeed, Japanese growth

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[36]Strange argues that "(f)irst and foremost, it is important to reject the idea that FDI undertaken by Japanese companies is fundamentally different from that carried out by firms of other nationalities" (p 357).

[37]The MITI data on the portion of manufacturing output of Japanese companies overseas cf. those of the US and Germany show the following for 1997 while an earlier survey gives the data for 1986 (1987 for Japan).

nation	1997	1986
Japan	9.9	4.0
US	25.0	21.0
Germany	21.0	17.0

Similar results obtain from other measures of FDI (Julius, 1990, p 38).

has been fundamentally associated with internal not external demand (Ozawa, 1991, p 44). Further, "(r)elative to their exports the scale of overseas production by Japanese companies is even smaller.." (Itami, 1993, p33). Whatever Japan's importance in it, the international economy is not the centre of focus for Japanese economic activity.

2.4 Foreign Investment in Australia

As a prelude to looking at Japanese FDI in Australia, this section sets the current size and composition of foreign investment in Australia in the context of historical trends and the current make up of its external accounts. It finds discontinuities in recent changes in the capital account and in the build-up of Australia's foreign debt and it shows the importance of FDI in these developments.

Just as the fundamental fact about Japanese FDI was its extreme asymmetry. So, for Australia, the first fact is the persistence of its current account deficit and its import of foreign capital. The two nations have long been complements of each other and, with no surety in self-equilibrating mechanisms, they may remain so for some time.

Official data show that Australia's international investment position is the result of a limited trade intensity, a typically small but intermittent trade surplus, and relatively large and persistent net income transfers overseas (see Table 3.1 of Appendix 3).

To give some measure of Australia's chronic current account deficit, between 1860 and the 1990s, Australia's current account was in surplus only 24 times and only once, in the anomalous years immediately after 1945, did the surplus exceed 5% of GDP. By contrast, current account deficits exceeding 5% of GDP are not uncommon, there being 45 such years, and deficits greater than 10% of GDP have occurred a handful of times (last in 1952).

The current account deficit in recent decades have been consistent and consistently high by historical and international standards. As Table 3.1 in the Appendix shows, only in the 1860s and 1880s has Australia's current account deficit averaged anything close to the 4.7% and the 4.4% recorded for the 1980s and 1990s. Between, 1982 and 1994 Australia, along with the US, was the only nation among those listed by Milberg to have had 13 consecutive years of deficit, the accumulated amount being 311% of the value of Australian exports in 1994 (cf. 243% for the US; Milberg, 1998, p 82).

Australia's long term dependence on foreign capital has been associated with relatively consistent economic development built on high investment and population growth and with high levels of consumption built on high incomes (Sheridan and Chapman, 1992, pp 6-17). Some see this as typical of young and fast growing economies where investment opportunities abound and capital is relatively scarce (Kojima, 1978)[38] and we have already noted in section 2.2 the ambiguity as to whether this is because of a relative lack of saving or a relative abundance of investment.

Looking at Australian economic development in the 19th century, it was closely associated with the importation of British capital, mainly as FPI (Butlin, 1964, p 5), although there is considerable dispute in the literature as to whether the current account deficit drove the capital account surplus or vice versa (ibid; Donnelley, 1970, p 8; Hall, 1968, p 151 give alternative views).

The public sector played an indisputably important role, so much so that so called Australian "colonial consuls" sold in London made foreign capital cheaply available and were viewed by other 19th century borrowers with "envy" (Butlin, 1964, p 337). The capital funds this provided to government allowed it to stimulate Australian economic development under a system which has been called "colonial socialism" (ibid, pp 5-6).

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[38]As Kojima has put it: "when a country chooses rapid growth, domestic investment will exceed domestic saving; this necessarily causes an import surplus which requires capital borrowing from abroad" (p 51).

Over the first four decades of the 20th century, the public sector continued to play a key role as capital importer (Sinclair, 1976, pp 170-5). However, neither growth nor the pattern of Australia's external accounts were consistent. In particular, the conjunction of current account deficits and capital account surpluses was broken during the Great War and again in the Great Depression of the 1930s which showed (as had the depression of the 1890s before) that a combination of declining export markets and reduced capital imports could have a dramatic effect on local growth and employment.[39]

It is said that this period in the first quarter of the 20th century also marked a watershed in Australian economic development after which further growth relied less on developments at the extensive margin of land-based industries and more on intensive development of industrial activities, stimulated by immigration and promoted behind protective barriers (Sinclair, 1976, p 175; Pincus, 1967, p 301). This was associated with the beginning of a significant shift in the pattern of international finance away from public borrowing and towards greater reliance on private sector inflows. In particular, it marks the beginning of large scale FDI in Australia.

The following Table 2.4.1 focusses on more recent times and shows levels of foreign investment in Australia at the start of each decade since 1950 and in 1995 and 1999. This covers a period of rapid industrialisation, population growth and high levels of capital formation during which the current account deficit grew significantly, moderating only in the 1970s and reaching its apparent historical maximum of around 6% of GDP in a number of years during the 1980s and 1990s.

TABLE 2.4.1 : Levels of Foreign Investment in Australia ; 1950- 1999.

	Total F I (% GDP)	**Official F I (% GDP)**	**FDI inflow (% GDP)**	**FPI & Other FI (% GDP)**	**Official as % of total F I**	**Equity as % of borrow-ing**

[39]Overseas income payments peaked at 8.1% of GDP in 1931 (52% of exports receipts) and only strong export growth and declining interest and profit remittances during the recovery restored a sustainability to Australia's external position.

1950	36.5	21.8	13.4	1.3	59.7	n.a.
1960	25.6	10.4	13.4	1.8	40.6	n.a.
1970	26.0	5.1	16.6	4.3	19.6	2.14
1980	32.5	4.8	17.1	10.6	14.8	2.95
1990	68.4	9.8	24.6	34.0	14.3	0.76
1995	81.7	13.8	26.9	41.1	16.9	0.74
1999	106.6	6.2	29.9	76.6	5.0	0.79

Source: 1. 1950-1990: Reserve Bank of Australia, 1991, Table 1.20c

2. 1995 and 1999: ABS Catalogue No. 5305.0 and 5363.0

Since the 1970s, foreign investment has grown very strongly; indeed to nearly treble its size in relation to domestic production by 1999. FDI has been an important form of private capital inflow although, since 1970, portfolio and other foreign investment have grown faster still, increasing from only one-tenth the size of FDI in 1950, to nearly two-fifths greater than it in 1990 and more than double it by 1999. The Table also shows that the capital raising role of the public sector has continued to decline markedly.

Along with these changes in its composition, the relative size of the stock of foreign investment has increased significantly. This has been associated with a vastly increased reliance on foreign borrowings rather than sales of local equity (shown by the last column of Table 2.4.1) and with the rapid increase in Australia's private, foreign indebtedness, which reached 45.4% of GDP in 1999 and was 70.4% of the total gross debt.[40] The trends also show that much of this debt has been accumulated by Australia's financial sector which has operated as an intermediary between foreign financiers and local firms.

[40] The data for Australian gross foreign debt are as follows:

Year	Total debt as % GDP	Public debt as % of private	Private Financial Sector ($bn)	Private Non-Financial Sector ($bn)
1981	13.0	62.9	1.7	9.9
1985	22.5	57.9	6.1	26.0
1990	46.3	57.3	51.5	65.2
1995	55.8	60.3	101.5	63.6
1999	58.9	29.6	197.3	72.4

The country composition of the foreign investment inflow also changed markedly after 1950 and these changes have largely mirrored shifts in the country composition of Australian trade. As reported in Table 3.2 in Appendix 3, Japan grew strongly as a source of FDI to 1990, when it reached 18% of the inflow, almost exactly that from the US and the UK at the time, but has declined to 7.4% of the total by 1999 (compared to 23.9% and 26.4% for the UK and the US respectively). This trend mirrors Japan's position as a trade partner.

Overall, the current state of Australia's external accounts show some important discontinuities in the long term pattern. On the one hand, the average current account deficits of the 1980s and 1990s have been at the limit of the historical range; on the other, the emphasis on private capital inflows has greatly increased along with the level of Australia's foreign debt. Meanwhile trade has been a growing part of the economy, itself reversing an unbroken trend of declining importance that had lasted all the 20th century to the early 1980s.

These developments signify a shift in the pattern of Australia's international engagement. The shift has placed progressively more emphasis on the private sector, initially on foreign interests to provide FDI capital and, more recently, on local interests (both indigenous and foreign) to organise portfolio inflows. Our subsequent study of policies intersects with this strategy change at a number of points below.

With these matters in mind, the next section examines the characteristics of Japanese FDI in Australia before the initial consolidation of policy issues is made in section 2.6.

2.5 Japanese FDI in Australia

Source: ABS Cat No 5363.0, Tables 59 and 60

The previous sections have defined the subject matter and described its global characteristics and the contexts in which it takes place. This section focusses on Japanese FDI in Australia as closely as possible. It provides Australian data on a range of matters previously reported for global Japanese FDI and other more detailed data compared, wherever possible, with those for the US and the UK and the all nation average.

We also examine in more detail and from a policy point of view some major propositions put forward by other authors. In particular, this section provides an initial consideration of the policy issues surrounding the notions of embeddedness, co-location, relative maturity and convergence of Japanese FDI in Australia. It concludes only that much more work would be needed to follow what are currently weak and uncertain policy implications.

The prime source of Australian foreign investment information is the Australian Bureau of Statistics (ABS). The Bureau collects data regularly and frequently by survey of private firms and augments these with data from public enterprises and estimates for non-respondents. As detailed in section 2.2 above, the data are considered to be timely and of good quality. However, they do suffer from confidentiality restrictions which severely reduce the amount of disaggregated information available so that data for particular industries, particular components of FDI or FDI from particular source nations is scant.[41] In addition, in recent years, the breadth of the ABS's activities has been curtailed so that, since 1993, FDI data by nation are generally unpublished.

As a result of these limitations, this section not only reports the most readily available data but must also rely on unpublished information in some instances. However, the restricted availability and expense of those data limit the degree to which inter-country comparisons can be made.

Partly to address the resulting gaps, the ABS data are used in conjunction with a directory of Japanese business activity in Australia, prepared by a now defunct private sector body, the

[41] The reason is that the more disaggregated are the data, the more likely that agents with knowledge of any single firm can infer the data related to other firms.

Australia-Japan Economic Institute (AJEI, 1996), and covering some basic information for 522 Japanese companies and a similar number of branches in Australia. Despite its being invaluable, this source is limited in scope and the classification by industry which it employs is idiosyncratic.[42]

Hence, this section also relies on additional references such as those of the Australia-Japan Research Centre's Pacific Economic Papers series which include numerous short studies of Japanese investment in Australia (prime among them Drysdale, 1993). There have also been some government surveys made in the 1970s and 1980s and a few commissioned reports (such as Access, 1991; PA Management, 1966). There is only one dedicated text (Edgington, 1990), and it has a particular economic geography focus. These sources can be augmented somewhat by the separate industry studies, a selection of which are used in Chapters 7 and 8.

This all amounts to a limited stock of information on Japanese FDI in Australia and is consistent with the fact that the comparative literature on FDI in Australia by other nations is also thin. But it stands in contrast to the relatively large literature on Japanese global FDI and the deductions made in subsequent chapters are, of necessity, evaluated in relation to both information sets. And, to reiterate, this thesis is not aimed at describing or explaining the phenomenon of Japanese FDI *per se* but is rather concerned with the policy implications associated with it. Nonetheless, the relative lack of information about Japanese FDI is a significant fact.

As described above, Australia has a long history of foreign investment inflows and a substantial history of FDI inflows. By comparison with FDI from other nations, Japanese FDI in Australia is of relatively recent origin.[43] The AJEI (1996, p vi) shows that more than 200 of the 412 firms for which the data are available were established in Australia after 1985.

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[42]The basis for this classification system is said to be a "balance between the organisation's activities in Australia, the main activity of the parent and the interests of the users of the directory" (AJEI, 1996, p xii). The second is not stated in the Directory and the last is obscure.

[43]For example, at the time when Brash (1966) surveyed 208 US firms operating in Australia there were probabaly no more than 40 Japanese affiliated firms, most of

Drysdale is of the view that Japanese FDI in Australia is also relatively recent when viewed against the important and long established bilateral trade links (Drysdale, 1993, p 1). However, he notes that, at least in the motor vehicle industry, Japanese FDI in Australia came 10 years before that to the US, encouraged by the Japanese and Australian government and this point is reinforced in other studies (Edgington, 1990, p 110; PA Management, 1966, p 16).[44]

Table 2.5.1 below shows that Japanese FDI in Australia has developed markedly since it was separately reported in the early 1970's. The Table shows the importance of Japan as a source of FDI in Australia since 1972-3 by summing the annual flows of FDI from Japan and from all nations.

TABLE 2.5.1: FDI in Australia by Type and by Nation 1973-1999

	Total FDI ($m)	**Share of total FDI (%)**	**FDI as % of total FI**	**Reinvested earnings as % total FDI**
1970s:				
Japan	450	7	50	19
US	2657	42	77	60
UK	2826	45	111 (1)	68
All Nations	6287	100	76	59
1980s:				
Japan	8759	33	29	3
US	7133	27	29	47
UK	9142	34	34	53
All Nations	26693	100	25	36
1990s(2):				
Japan	4836	5	219	53
US	29775	33	31	83
UK	9145	10	16	123

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which were relatively small.

[44]It was claimed, in 1966, that MITI was "known to be encouraging local (vehicle) assembly in Australia".

All Nations	89760	100	31	77

Sources: ABS Catalogue Nos. 5305.0 until 1990-1; 5363.0 to 1992-3 and unpublished ABS data thereafter

Notes: (1) In the 1970s UK investors reduced their portfolio and other investments in Australia by $281m.

(2) 1990s data are to 1998-99.

The summed flow data show that Japan accounted for nearly one third of the total inflow in the 1980s before it declined relatively in the 1990s. The latest annual data (Table 3.2 in Appendix 3) shows that the share has recovered somewhat since to be 7.4% of the total inflow in 1999. Table 2.5.1 also shows that FDI is now the predominant form of Japanese foreign investment in Australia.

Stock level data have become consistently available only in recent years and they too show the same declining trend in the 1990s.[45] By 1998-9, Japanese FDI made up 8.7% of the stock of FDI in Australia, considerably smaller than the shares of the US (32.7%) and the UK (24.4%).

Table 2.5.1 also reports data showing the importance of retained earnings in the FDI flow. It shows that, compared with other nations, the FDI inflow from Japan has relied little on the return on previous investments. This might reflect one aspect of the previously stated immaturity thesis: that Japanese FDI will pass some early growth phase and as the rate of new investment falls and the rate of profit rises, the low ratio of retained earnings in the cumulative value of the investment will disappear. The data seem to suggest this is true in the 1990s but had not been so in the 1980s. However, it is not clear that the apparent normalisation is because of the maturing of the stock or because of the substantial reduction in the flow during the 1990s.

[45] Table: Country Shares in FDI Levels in Australia, 1993-1999

year	Japan	UK	US
1993-4	12.9	25.2	29.2
1994-5	13.4	24.8	28.4
1995-6	11.7	26.0	29.8
1996-7	10.4	25.7	29.0
1997-8	9.6	22.5	33.6
1998-9	8.7	32.7	24.4

Whatever accounts for the trend in the relative importance of retained earnings, Table 2.5.2 provides some further data concerning the relative profitability of and equity share in Japanese FDI compared to that for other nations and for other forms of foreign investment. The Table shows firstly that the average rate of return on Japanese investment in Australia, measured over the long term, is comparable to that of other major investing nations and to the all nation average. This is true for FDI and for other forms of foreign investment and has been so, set against the all nation average, since the early 1980s and, against the US and the UK standards, since the mid 1980s at least. These data since 1980 offer little support for the previously reported claim that global Japanese FDI has low profitability, a claim taken as a sign of its relative immaturity (Komiya, et al, 1990, p 15).[46]

Table 2.5.2: Average Rates of Return by Type and by Nation 1980-1999, percentages**(a), (b)**

	FDI income as % of equity	**FDI income as % of total funds employed**	**FDI equity as % of all FDI**	**PFI & Other FI in(as % total funds employed**	**Total FI income as % total equity**
1980-85					
Japan	13	7	50	7	42
US	37	14	46	10	47
UK	19	12	77	9	23
All Nations	22	7	56	7	32
1986-90					
Japan	9	8	47	8	56
US	11	8	74	8	19
UK	7	6	86	6	11

[46]However, the data offer limited support for the immaturity thesis more generally. Estimates of the profitability of FDI from various nations during the 1970's (appended to the Table) suggest that, at that stage, Japanese FDI was much less profitable than the all nation average (even more so than in the early 1980's). Of course, it is not clear whether this progression owes to the maturing of Japanese FDI or whether some other, global developments account for the convergence of returns on all FDI in the mid 1980's.

All Nations	9	7	72	7	20
1991-95					
Japan	29	17	58	6	24
US	17	15	86	4	12
UK	13	12	94	4	8
All Nations	21	17	82	5	14
1996-99					
Japan	22	16	74	6	18
US	16	14	89	4	10
UK	17	16	94	4	8
All Nations	20	18	87	5	12

Source: ABS Cat No 5305.0 to 1990-1, unpublished ABS data thereafter.

Notes: (a) Profitability in the 1970s is not reported by the ABS but can be calculated as the average total FDI income for all years of the decade expressed as a ratio of the sum of the FDI inflows for the 7 years after 1973 i.e the years for which we have the relevant data.

The data are: Japan= 5.3%; US= 22%; UK= 14.9%; and all nations =17.4%

(b) ABS shifted to valuing at market prices in 1985-6.

(c) 'Total' refers to the sum of funds employed as borrowings and equity.

Only in the first column, which shows rates of return set against levels of FDI equity does Japan appear different and, as column 3 suggests, this is likely because of the relatively low level of equity in FDI for Japan compared with the US, the UK and the all nation average rather than on differences in underlying profitability. When we look at the FDI return on total funds employed, we see that Japan is little different.

Nonetheless, the relatively low equity share for Japan suggests that Japanese FDI affiliates in Australia have had relatively high gearing ratios. It is interesting for a number of reasons. Firstly, high gearing ratios are said to be a feature of Japanese FDI everywhere, just as corporate activity in Japan favours indirect forms of debt finance (Suzuki, 1992, p 23; Franko, 1983, p 47; Ozawa, 1979, p 38).

Secondly, the low equity figure for Japanese FDI as a whole does not signify that Japanese investors take small, minority equity positions in individual instances of FDI. On the contrary,

more than three quarters of the 457 Japanese firms in Australia for which data are held by the AJEI are 100% owned by their parent and 87% are majority owned (AJEI, 1996, p vii).[47] This tendency towards majority ownership is not unusual for Japanese FDI anywhere and for FDI in Australia by US firms in the 1960s.[48] It means we can be confident that the highly geared Japanese affiliates are very likely to be majority owned.

Thirdly, the relatively low proportion of equity and the high proportion of borrowings suggest that Japanese FDI affiliates in Australia have high gearing ratios of the sort which could only be expected in take-over proof companies where the share registry is stable and the capital is patient. It implies that the capital is obtained from the parent or is underwritten by it and that the source of this capital is in Japan where the parent is best represented. This is the view of other researchers (Drysdale, 1993)[49] and would mean that, just as the equity in Japanese FDI enterprises in Australia is overwhelmingly in Japanese control, so too is the debt. It is consistent with the view, reported in regard to global Japanese FDI at 2.3 above, that FDI relies primarily on Japanese sources for its long term funds and finds only some of its short term requirement in the host capital market. It is also consistent with Drysdale's reporting of MITI data showing only 16% of long term funding for Japanese FDI in Australia came from local banks.

And yet it is still not absolutely certain that the FDI represents a net addition to Australia's capital stock, even if the majority of it is channelled through Japanese banks. These might operate in Australia and access Australian funds or operate elsewhere and access Australian (or other non-Japanese) funds through off-shore, international capital markets.

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[47]This compares to data quoted by Drysdale (1993, p 36) which showed 77% as wholely owned.
[48]The following table uses data from (Brash, 1966) and the data from AJEI referred to in the text:

% of total equity	US Firms	Japanese Firms
100%	60%	76%
> 50%	86%	87%

[49]Drysdale states that "Japanese firms in Australia have relied on borrowing from

Unfortunately, the data do not exist to follow this matter. Such data as do exist in Australia are fragmentary and unpublished, covering only the borrowings by branches of Japanese companies when the greater majority of activity takes place in subsidiaries which, because they are incorporated in Australia and are therefore Australian entities, do not report data separately. Nonetheless, we can assume the purpose is similar to that with similar arrangements for US affiliates; the high levels of borrowing from the parent constitute a "rather flexible inter-company loan" (Brash, 1966, p 90). And, we can suggest, although we cannot know, that Japanese FDI is more likely to be financed from the source nation than is the case with other nations' FDI.

The next issue which can be followed from existing albeit unpublished ABS data is that recorded in Table 2.5.3 which shows the development of Japanese FDI in Australia by industry and compares that to the all nation average.

Bearing in mind the data on the global spread of Japanese FDI (Table 2.3.1 (b) and footnote 20 above), a number of points can be made. Firstly, mining accounts for a steady and significant part of the Australian total (in the global scene it is smaller part of the total and has declined strongly in relative terms during the period of rapid growth in the 1980's). To this is added the increased portion to agriculture in the 1980's[50] so that, overall, Japanese FDI is much more heavily represented in Australia's primary sector than it is globally (19.2% cf. 6%).

Secondly, at only 15.1% of the total, manufacturing represents a destination less important for Australia than globally (where Japanese FDI in manufacturing made up 29%). There is also a strong trend of decline, especially since the late 1980's. Currently, Japan's manufacturing investments in Australia concentrate in the automotive sector, both component production and vehicle assembly. These cases are used as an illustration and are reported in more detail in Chapter 8.

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the parent firms and Japanese based financial institutions" (p 13).

[50]This trend is also apparent in the AJEI (1996) data which show that "(f)oodstuffs and mining have been the main areas of new investment in the 1990's" (p i). It is also point we follow up with the illustration from the beef industry at Chapter 7.

Table 2.5.3: Japanese FDI in Australia by Detailed Industry, % of total stock, 1980, 1988 and 1995

	Japan			All Nation	
Industry	**1980**	**1988**	**1995**	**1980**	**1995**
Agricult., etc.	0.8	2.9	1.8	1.0	0.2
Mining	17.5	17.4	17.4	14.4	9.6
Manuf'r'ing	*27.7*	*23.8*	*15.1*	*28.4*	*18.4*
Food, etc.	0.1	0	4.7	3.9	4.8
TCF	n.p.	n.p.	n.p.	0.6	0.2
Wood, paper	n.p.	n.p.	n.p.	0.9	n.p.
Chemicals	0.1	n.p.	0.7	5.1	4.3
Metals	3.7	5.4	n.p.	6.3	4.3
Machinery	2.1	2.8	7.3	2.4	1.6
Vehicles	20.3	14.1	n.p.	6.0	n.p.
Other	1.4	1.6	2.4	3.2	3.1
Energy, etc	n.p.	n.p.	n.p.	0	1.1
Construction	n.p.	n.p.	n.p.	0.8	1.0
Trade/Comm	41.0	25.3	14.6	17.5	6.5
Transport	0	0	0.5	0.9	2.2
Finance, etc.	2.3	25.7	25.9	32.2	34.0
Services	4.9	2.4	17.7	2.1	5.0
Other	6.0	2.5	7.0	2.8	22.1
Total	100.0	100.0	100.0	100.0	100.0

Source: ABS, unpublished data

Notes: (a) n.p. = not published due to confidentiality restrictions.

(b) Data for Japanese FDI in agriculture, etc. is for 1993, the last year for which data were published for that category.

(c) ABS discontinued publishing country-based data by industry in 1995[51]

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[51] This is for three reasons: because sampling problems made the data unreliable; because classifications accord with major activity of the largest estsblishment within an enterprise group which need not be industry in which the investment activity takes place; and, because borrowings on-lent to locals are categorised in the finance sector.

The relatively early establishment of Japanese FDI in Australia is partially confirmed by two surveys of FDI in Australian manufacturing undertaken by the Commonwealth government. These show that Japanese involvement began in the early 1960s[52] and that, by the mid 1970s, there were 28 instances involving 38 Japanese companies (Commonwealth, 1976).[53]

Perhaps the most striking feature of the data from Table 2.5.3 is that they show that the increasing importance of the tertiary sector in the global spread of Japanese FDI is reflected almost exactly in Australia. The strong (albeit declining) Japanese presence in Australian commerce began early in the post-war period and undoubtedly owes something to the re-emergence of the *sogo shosha* and their role in primary product procurement (Purcell, 1978).[54] Table 2.5.3 also shows the relative importance of other tertiary industries, particularly the trade/commerce and services sectors.

While the data in Table 2.5.3 include real estate investment, these are allocated to the line of business predominant to the enterprise established on that site and not to a 'real estate' category per se. Hence, the strength of real estate purchases during the 1980's and early 1990's is not evident from these data. This is unfortunate given the degree of attention Japanese investment

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[52]Data from the then Department of Trade and Industry show six instances of Japanese investment in Australian manufacturing, half of which were in textile production, two in chemicals and one, producing PVC pipes and fittings, in miscellaneous manufacturing.

[53]The incidence of these investments and the total amount of Japanese equity are shown below:

Mfg Industry	Number of Cases		
	100% equity	**<100% equity**	**TOTAL**
Textiles	1	3	4
Forestry	1		1
Chemicals		5	5
Basic metals		4	4
Motor vehicles	1	1	2
Other machinery		5	5
Other mfg		7	7
TOTAL	3	25	28

[54]Purcell lists 27 Japanese trading firms as operating in Australia in the period 1932 - 1941, with ancilliary services provided by "on-site" banks, shippers and insurers.

in real estate has attracted, in Australia and elsewhere (Garnaut, 1989, p 95). Farrell (1997) provides a useful overview of many relevant matters, although his tracking of Japanese FDI in Australia overstates its importance by relying on Foreign Investment Review Board (FIRB) approvals data which are likely to overstate the amount of investment that actually goes ahead. There has also been a significant retreat of Japanese investment from Australian real estate in recent years, although it is difficult to determine just how much.[55]

Japanese FDI in Australia can also be described in part by reporting some surveys which have been made of motivations for them. We have reported on similar studies for all FDI and for Japanese FDI in other regions.

The situation in Australia has been described, probably accurately but unhelpfully, as "a balance of motivations, opportunities and constraints" (Edgington, 1990, p 7). Studies commonly point to issues such as the appreciation of the yen; trade restrictions in Australia and between Japan and third nations; high asset prices at home; and, financial deregulation (Access Economics, 1991, p 5; Drysdale, 1993, p 6). In addition, there are two recent surveys: one covering manufacturing, financial services and tourism (Nicholas et al, 1996) and one for all industries (reported in Pritchard, 1990, p 12).

The latter shows that nearly half of the reasons given for investment, in Australia had to do with penetrating the host or third markets. In Australia's case rather more emphasis is given to securing or reducing the price of raw materials (27% cf. 8% globally) and far less emphasis on reducing labour costs (1% cf. 12%) or on overcoming trade friction (nil responses for Australia cf. 2% for the rest of the world). These reasons fit well with the profile of Japanese FDI in Australia by industry, although it is somewhat surprising that, given the relatively small domestic economy, market penetration should rank so highly in Australia's case. However, this might be due to the fact that Japanese FDI in Australia provides the means to penetrate other

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[55]It has been reported in the Australian media that $8 billion had been lost by Japanese real estate investors in the period 1989-1994 (The Independent, Oct 1994, pp 4-6).

markets, although this is not the view of Pritchard (1990)[56] (nor does it appear to be confirmed by the discussion which follows concerning Japanese control of Australia's exports to third nations).

The survey by Nicholas et al (1996) is more detailed and gives an average score to a range of reasons for Japanese FDI. The survey allows weights to be assigned to various motives and shows, for example, that Japanese investment in manufacturing intended primarily to service the domestic market, although promoting trade with Japan (often with other, related Japanese interests) and supplying other nations were also considered to be important reasons. The survey questions also cover issues to do with corporate strategy including such matters as the role of Australian operations in the parent's global network.

As with previously discussed studies of this kind, these surveys of disclosed intentions might provide insights into the causes of the phenomenon without alone telling us anything about the policy implications. There are other factors which also limit their usefulness.

Firstly, it is very difficult to separate reasons which determine Australia as the site for the investment from the reasons for FDI as the form. Hence, Pritchard's conclusion that Japanese FDI seeks to secure access to cheap raw materials jumbles together the decision to supply from Australia with the decision to use FDI as the means of securing access. The problem is that, from the viewpoint of the incumbent, the FDI has multiple and overlapping objectives. Even more sophisticated approaches (such as Nicholas et al), which address this entanglement problem explicitly by supplementary survey questions, must still contend with answers which overlap.[57]

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[56] "In Australia's case, [investment to expand markets] refers mainly to the local rather than export markets ....." (p 12).

[57] For example, Nicholas et al break up the initial response that Japanese tourism seeks to "supply the Japanese tourist market" (Table 7) into "ownership advantages and locational factors" (p 11). However, the resulting list of ownership advantages such as "a knowledge of Japanese tourists preferences and tastes", knowledge of the Japanese language and "employment of Japanese staff" are reasons which overlap.

The second difficulty is more conceptual and is addressed in more detail in Chapters 3 on policy and 4 on theory. Essentially, the point at issue is that the reason for the FDI must not only be distinguished from the reasons for the Australian location but must also make clear why an alternative arrangement, such as Australian ownership and funding by means of FPI, is not chosen.

The question of local embeddedness, which arose in relation to global Japanese FDI also arises in Australia where it is said to be a matter "of considerable and .. general interest" (Drysdale, 1993, p 27). Section 2.3 discussed some secondary sources of information for Japanese FDI affiliates globally and in major destinations in Europe, North America and East Asia. Unfortunately, similar studies for Australia do not provide any deeper insight.

Drysdale (1993, p 26) presents MITI data concerning the export performance and purchasing patterns of Japanese firms' overseas operations.[58] He states that they show Japanese firms in Australia sell relatively little of their output locally and, consequently, have a relatively high average export to sales ratio, although it is reported as being in steady decline, falling from more than 70% in 1972 to less than 45% in 1990 (p 26). By comparison, the ratio was reported as much lower for US manufacturing firms in Australia (p 30).[59] Compared to the global picture reported at 2.3, these figures suggest that Japanese firms in Australia also have a greater propensity to export than is average for Japanese manufacturing firms in Europe or the US, although the rate is close to that for Japanese firms in Asia.

To make good use of these data we would need to compare them to that for other nations' FDI affiliates in Australia and to describe how both have changed through time. Despite its title claiming to provide such a comparative study, Drysdale's paper does not provide the data required but its lack does not moderate his claims. He takes the decline in export shares from

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[58]Drysdale does not make clear the source of these data but they seem to relate to MITI data displayed in his Figures 6, 7, 8 and 9 (it is not possible to be sure) which show data for Oceania (sometimes shown as Australia) and give data for exports to Japan alone (not to all destinations).
[59]The figures quoted by Drysdale are 14.2% for US manufacturing firms in Australia in 1992 and 13.3% in1982.

Japanese affiliates as important evidence of both the growing maturity of Japanese FDI in Australia and its similarity to that of other nations.

However, an alternative view might better explain the differences. It could be that these data merely reveal another aspect of the way in which the industry composition of Japanese FDI in Australia is different from those of other nations. We have already seen that Japanese FDI concentrates outside of Australia's largely import competing manufacturing sector and within the primary and tertiary sectors, both of which have higher export intensities in Australia. Such a structural interpretation is actually implicit in some of the data Drysdale produces.[60] Indeed, when considering only data for FDI in Australian manufacturing, the differences between the US and Japan, on which Drysdale wants to base his claims of immaturity and convergence, are hardly significant, suggesting that there is little difference between the nations once the compositional bias is removed.[61] But, lacking comprehensive historical, sectoral and comparative data, on none of this can we be sure.

There is one last matter of interest on the sales side for which Drysdale provides some further, unreferenced evidence: that, for Japanese manufacturing affiliates in Australia, while the export orientation has fallen, the proportion of output going to Japan appears to have retained its overall importance and at a level in excess of that for the US (Drysdale, 1993, p 31). These data are telling us that Japanese FDI affiliates are not only more export oriented, they are also more oriented to supplying the source nation than are US firms.

Turning now to the other side of the ledger, MITI data for Oceania show that imported inputs declined from nearly half of total inputs in 1980, with more than three-quarters of those from Japan, to nearly one-third in 1990, with more than four-fifths from Japan (Drysdale, 1993, p

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[60]He reports some MITI data which show that, in the early 1970's, 81% of sales from Japanese FDI firms in the mining sector were exports and 90% of sales from agriculture. By contrast, only 10.7% of manufacturing sales by Japanese affiliates in Australia were for export (pp 28-29).

[61]Drysdale provides US Dept. of Commerce data concerning US manufacturing operations in Australia. These show 9.4% of output was exported in 1982 and 10.2% in 1989 (p 30) but the comparisons with 10.7% for Japan (reported in the preceding footnote) is not made.

33). Drysdale takes this all as evidence of a high and growing integration of Japanese FDI activities into the local economy from which he concludes that Japanese firms are following the "histories of multinational corporations" (ibid, p 35), they are not fundamentally different and therefore that any policy should not be based on existing distinctive characteristics which are only temporary.

To assess that view we should be aware of another, based on contrary evidence, that Japanese FDI has peculiar, systemic characteristics which limit the involvement with local firms. Kreinin (1988) reports survey results showing the purchasing patterns of US, European and Japanese subsidiaries in Australia. Based on a survey of 62 firms, 20 of which were Japanese (and 10 of these were in motor vehicle and parts manufacturing) he found that 80% of the plant and equipment used by 15 out of the 20 "is of Japanese origin" (ibid, p 535). Kreinin also claims (although he provides no data) that "(a) similar disparity between American-owned and Japanese-owned subsidiaries exists in the case of purchases of materials" and that, compared with US and UK firms, Japanese affiliates in Australia buy "either from their parent company or from its traditional suppliers in Japan" (ibid, p 537).

Not only are there disputes as to the facts concerning the degree of local embeddedness, there are also dangers in interpreting the data. For example, the presence of subsidiaries of the *sogo shosha* in Australia can make it appear that some Japanese companies are buying and selling locally when it is only that the transactions are made through these trading companies which operate in Australia simply as intermediaries for other Japanese firms elsewhere. What appears to be a local purchase or sale can, in fact, be foreign. Possibly related to this is Drysdale's claim that the presence of the *sogo shosha* can lead to "double-counting" (Drysdale, 1993) although the effect is better described as a "statistical illusion" (Graham et al, 1995, p 4).

And the problem arises not just with the *sogo shosha*. The clustering of FDI by Japanese suppliers and their customers which, as we saw above, is commonly thought of as a characteristic of Japanese FDI behaviour, can also create the impression of embeddedness when the reality is that dealings remain largely among Japanese interests and, while some of

those might be located in Australia, the supply chains associated with the purchasing pattern will be relatively short, extending little beyond the co-located Japanese FDI affiliate.

These differences in interpretation recall the point made previously in describing growth of global FDI that, by its nature, FDI represents the penetration of foreign control and so clouds the notion of national interest. In the words of one researcher "(i)t raises questions about which inputs should be included and what indigenous means" (Ecclestone, 1989, p 254).

Not only are the data inconclusive, in any case the policy implications of varying degrees of embeddedness are unclear. At the very least it is simplistic to suggest that if Japanese firms source lots of local inputs and sell lots of local output there are no major policy matters associated with them. Conversely, it would be naive to suggest that low levels of embeddedness are necessarily a matter for policy: it is not obvious that Australia would be better off by insisting that, say, Japanese mining firms who might currently import capital equipment be made to purchase locally or that Japanese firms which predominantly export back to Japan be constrained from doing so.

Although the issue of local sourcing and selling remains under-researched, we can report some data on an associated matter; that of Japanese control over Australian trade. There is some historical evidence that the pre-war bilateral trade (which was mostly fibres from Australia and textiles and clothing back from Japan) "was almost exclusively controlled by (Japan)" (Purcell, 1978, p 3) and that the post war recovery in the raw materials trade was organised by the purchases and D & I investments undertaken by the *sogo shosha* (Edgington, 1990, pp 58 - 64).

Data for more recent years are available from the ABS but only for 1984-5 for imports and 1986-7 for exports (ABS Catalogue Number 5348.0), when the data were collected by special survey. The results show that, with regard to Australia's exports, Japanese control was limited and certainly was less than that exerted by the US and the UK and that the variation between the US and the UK was greater than that between Japan and the other two.

As to imports (ABS Catalogue No. 5341.0), foreign control was more prevalent than for exports but, overall, Japanese control was not nearly as important as that by the US or the UK. However, this is because of the US and the UK controlled imports from third nations. Regarding control of imports from the source nation, Japanese control was particularly high, indeed the highest of any country for which data were reported. This result coincides with analysis of similar data for US-Japan and Europe-Japan trade (Encarnation, 1995, p 227) showing consistently that Japanese FDI affiliates control a large proportion of Japanese imports.

Overall, these data and studies are inconclusive descriptions of the phenomenon of Japanese FDI in Australia because they are incomprehensive. They are not inconsistent with the view that there is nothing fundamentally different about Japanese FDI, nor are they inconsistent with the so called convergence thesis, that Japanese FDI in Australia is merely immature compared with that for other nations (held not just by Drysdale but see also Access Economics, 1991, p 5; Edgington, 1990, p 14). This ambiguity and uncertainty repeats similar views we have seen expressed about global Japanese FDI. However, the evidence is inconclusive and the reasoning that there are then no distinctive policy implications associated with Japanese FDI does not appear to be justified.

A final matter of interest for which there is some equally dated data is that of foreign control of local R & D in Australia (ABS, Catalogue No. 5330.0). These show that very little R & D was undertaken by foreign corporations in Australia and that, in 1984-5 and 1986-7, Japanese controlled corporations accounted for only 5% and 3% respectively of that small total, less than their stock of FDI and much less than their share of the flow at the time. Japanese FDI contributed little to Australian R & D and, whenever it did, it occurred under conditions of 100% ownership. A broader study into international R&D links showed similarly that, despite the close trade relationship between Australia and Japan, the link between Japanese R&D and Australian growth is very weak (Coe and Helpman, 1995, pp 872-3).

These data are consistent with a widespread and long-held, although not undisputed view that MNCs undertake their R & D at home (Stopford, Strange and Henley, 1992, p 157; Caves,

1982, pp 244-249; Granstrand, 1979, p 129; Lall, 1979; p 329). It is consistent also with views held concerning R & D by Japanese FDI affiliates on a global basis (Papanastassiou and Pearce, 1997, p 11). These views are also consonant with studies comparing Japanese and US multinationals in UK manufacturing (Dunning, 1990) which found that linguistic and cultural distance were important in explaining the lower R & D undertaken by Japanese firms, a notion reflected in a similar study of Japanese investment in Australian manufacturing (Hutchinson and Nicholas, 1994, pp 9-10) which will be examined in greater detail below.

Before pulling together the policy implications of this chapter in the following section, there are two tasks remaining: to summarise the description of Japanese FDI in Australia and to place it more broadly within the context of global flows of Japanese FDI.

We have considered but not decided on the question of whether Japanese FDI is unlike that of other source nations and, if so, whether this is due to structural or other considerations, such as its relative immaturity. The results of our review of available data and studies for Australia are ambiguous and this reflects the results of studies of global Japanese FDI reviewed above.

Nonetheless, despite the overall ambiguity, there is relatively strong evidence that Japanese FDI affiliates in Australia are different in some limited ways. They tend to have higher gearing ratios, probably with debt representing an inflow of off-shore capital and matched by high degrees of source nation influence exerted through tight equity and managerial control. The FDI inflow is also relatively rich in equity compared to other forms of foreign investment but not compared to other source nations of FDI. There is also an apparent link between the development of the industry composition of Japanese FDI in Australia and changes in the composition of Japanese trade and domestic production.

However, perhaps the major conclusion of this section is that little is known of Japanese FDI in Australia. Official data on Japanese FDI in Australia are collected primarily for balance of payments purposes and there is little detailed, additional research available. Moreover, important hypotheses seem to require a great deal more comparative material than is available.

At the end of section 2.3 we placed Japanese FDI within the context of global FDI and argued its relative size suggested it was not fundamentally important to Japan. Here we can overview Australia's place in the global spread of Japanese FDI.

It is a matter of judgement whether it is low or high. Given the important bilateral trade links, in view of Australia's particular dependence on foreign capital and knowing that the stock of Japanese FDI globally is relatively small compared to other advanced nations, it is not obvious that Japanese FDI in Australia is in any way extraordinary. The data from section 2.3 showed that, at some 5% of the total stock of global Japanese FDI, Japanese FDI in Australia is neither an amount so small as to suggest unambiguously that it is under-represented, nor is it an amount so large as to suggest Australia has been singled out by Japanese investors. At some one-twelfth of the stock of FDI in Australia, the same ambiguity emerges from Australian data.

Perhaps the broadest assessment is that, while both the Japanese FDI outflow and Australia's long term capital inflow are remarkable phenomena, Australia's share of Japanese FDI is unremarkable. In addition, just as it was concluded at the end of section 2.3 that a global Japanese strategy prosecuted by FDI is unlikely, so it can be added that, because Australia is not centrally important in the spread of Japanese FDI and because Japanese FDI is important but not dominant as a source of foreign capital for Australia, it is unlikely that a Japanese strategy exists in which influence over the Australian economy is central. Of course, none of this is to imply that Japanese FDI does not have important policy implications.

2.6 Conclusions

This chapter has relied on existing data and previous studies to describe the subject matter and place it in context as well as possible. These procedures imply a broadly supportive attitude to Japanese FDI in line with its more beneficial characteristics but they do not have strong policy implications, partly because they are only partial descriptions, based on work which has been more concerned with the phenomenon itself than with its policy implications.

In summary, the understanding developed here is that Australia is likely to continue its long term practice of importing capital and running current account deficits. Similarly, despite some variability, Japan seems likely to continue to run a capital account deficit. There is therefore an on-going complementarity to the FDI flow between the two nations.

This is not to suggest that Australia has no current account constraint nor that Japan can go on accumulating current account surpluses indefinitely. However, without fundamental shifts in the long term pattern of their growth, the current external positions of Australia and Japan are likely to maintain that complementarity. Hence, the potential exists to further deepen the economic relationship by means of further increases in and possibly shaping of the Japanese FDI flow.

Importantly, the complementarity does not amount simply to Australia's being spendthrift and Japan frugal. Instead, the more accurate description appears to be that the flow of FDI reflects some combination of the desire for higher levels of investment in Australia than local savings allow and, simultaneously, a desire by Japanese interests to accumulate and control particular foreign assets. There is little to show that Japanese FDI is a global phenomenon and much to suggest it is part of the response to developments at home in Japan.

While a degree of continuity is anticipated in the flow of Japanese FDI to Australia, this chapter has also shown that, in the post-liberalisation era and set against historical standards, the composition of Australia's capital account surpluses in the 1990's is somewhat unfamiliar. Private foreign debt is at a much higher level than ever before (largely due to the increased importance of FPI and net short term inflows) and the role of the public sector as a capital importer is more limited than has been typical in Australian economic development. In addition, the size of Australia's current account deficit has averaged at the limit of its historical range since liberalisation.

A number of policies are implied. Firstly, but outside this study's scope, are policies to increase the current rate of savings in Australia which is low by historical and international

standards (see Table 1.2 in Appendix 1) and this implies the need for policies to restrain consumption spending and to enhance the return on savings. Such policies help constrain the current account deficit and might be needed in the short and medium terms.

Secondly, and more relevant to this study, policies are suggested to address the capital account and, in particular, to address its composition. To the degree that Japanese FDI has characteristics more desirable than other forms of capital inflow, increasing its place in the mix becomes a policy objective.

This chapter has provided equivocal evidence as to whether and how Japanese FDI is distinctly helpful in this regard. However, three tendencies of Japanese FDI appear relevant. Firstly, because it is foreign direct investment, it is more long term, less volatile and less speculative an inflow than others on which Australia might rely. Secondly, again because it is FDI, this inflow is likely to have a higher equity content than other forms of foreign investment and hence to add less to Australia's foreign debt than other forms of capital inflow. However, because it is Japanese FDI, the equity content is not as high on average as FDI inflows from other large investing nations. Thirdly, because it is Japanese, the FDI inflow is likely to involve funds obtained through Japanese financiers and so constitutes a net transfer of capital, although our information on this is inconclusive. Given the importance of this last issue, it would seem unarguable that more effort should be devoted to collecting the relevant data and making it available to researchers and policy makers.

These three aspects of Japanese FDI in Australia are present as beneficial tendencies and they lead to a broadly supportive policy attitude. However, this is not to suggest that Japanese FDI is, in itself, likely to be a panacea. It can be helpful in adding stability and diversity to the capital inflow and in maintaining confidence in Australia's ability to avoid a forced correction of its external imbalance but, within likely limits, Japanese FDI in Australia can do no more than play a role in a strategy to address the Australian current account deficit. If there are more policy implications associated with it, they must come from a deeper understanding.

While much of the rest of the evidence is even more equivocal, three points do stand out. Firstly, we have seen Japan's egregious FDI asymmetry and this links to low levels of Japanese internationalisation more generally. Secondly, it is much said that Japan's outward FDI is creating regional networks, especially in East and South East Asia. Related to this is the third point, that of the co-location among Japanese interests operating overseas which is seen as a distinguishing characteristic.

All three points allude to issues outside the micro decision of firms to invest in Australia or not. They allude to relations among Japanese interests which we will follow in subsequent chapters.

The final point which can be made with some surety is that there is little to support the proposition that Japan is prosecuting a strategy of global or regional dominance via FDI. With the possible future exception of East Asia, the flows are simply not large enough. Especially, Japanese FDI in Australia is not so large as to suggest some kind of strategic takeover.

In conclusion, this chapter has defined and measured Japanese FDI in Australia as well as may be done. However, definition and measurement are nothing more than description and classification procedures and this work has not led to firm policy conclusions. Some hypotheses have been proposed concerning the relative immaturity and possible convergence of Japanese FDI to a global norm but this work has not been sufficiently extensive to support unambiguously any particular policy conclusions.

This chapter has therefore shown the limits of description and of previous studies. It leads into the question for the next chapter: if good policy is not just a matter of responding to issues arising from accurate description, perhaps it can be a matter of well-reasoned anticipation, backed-up by good monitoring? We begin it by trying to generalise about the effects of inward FDI.

Chapter 3: Policy Problems and Practices

3.1 Introduction

In this chapter the focus shifts from a description and detailing of the phenomenon itself to a canvassing of the policy issues which surround it. This section gives an overview.

Section 3.2 considers the full net effects of FDI. It looks at the indirect effects which might be associated with FDI, using the balance of payment impacts as an exemplar and shows that no useful generalisations are possible about FDI. Moreover, the effects most relevant to policy are indirect, multifarious and inherently difficult to measure so that there is simply no ready reckoning in some policy calculus. This is especially true when we include the counterfactual possibility of there being a domestic alternative.

This work provides the background for considering in section 3.3 current Australian policy largely based, as it is, on a case-by-case screening function performed by the Foreign Investment Review Board (FIRB) that intends to filter out those instances of FDI which provide no net gain.

In section 3.4 we make some comparisons between Australian policy and that which applies in Japan, which is examined in some detail, and in Canada and Sweden, which are paired with Australia and Japan respectively.

The final section pulls together the conclusions: that measurement and data problems abound in FDI policy; that Australia's current FDI screening within the context of a deregulated economy makes little sense; and, that good policy making requires reform and much greater effort than Australia currently makes. However, the uncertainties revealed mean that it is not clear how policy making could proceed and that becomes the first question for the next chapter.

3.2 The Net Effects of FDI on Host Nations

This section investigates the effects of FDI. The objectives are to determine whether any generalisations are possible about net effects and whether case-by-case assessments are feasible. The answers to those questions have implications for FDI policy making, as is shown in the remainder of the chapter.

We begin by tracing the effects FDI might have on the balance of payments. In Chapter 2, it was argued that the FDI inflow from Japan has a role in addressing Australia's chronic and, recently, acutely large current account deficit. However, that chapter looked only at the immediate effects of FDI as a capital inflow. Here we are looking at what would be required to reckon the full balance of payments effects and we find that this points to general problems which arise in following the net impacts of FDI.

On the face of it, there would seem to be no great difficulty. As described in Chapter 2, FDI is an inflow on the capital account and matches a deficit in the current position so as to maintain a balance of payments. These simple relationships can be measured but, in extending the analysis, the problems mount and quickly and become insuperable. Essentially, there are difficulties in anticipating all the immediate and long term effects of FDI and, worse still, in determining the counterfactual case.

Taking each point separately: because FDI need not involve the direct transfer of capital but could be financed by borrowing in the host market (in which case the initial impact on the external accounts would be to create a matching debit and credit to the capital account, involving greater foreign ownership in Australia and greater foreign indebtedness to Australians but no net financing of the current account), its immediate impact on the categories of the balance of payments is, in fact, problematic.

Further, there is the oft-cited problem that, over time, FDI will be associated with the repatriation of some profits and these too need to be taken into account (Holland, 1991, p 30; Carr, 1978, p 50 and Perkins, 1972, p 29 for references in the Australian context). The subsequent income payments overseas might grow as the investment portfolio matures and exceed any subsequent inward transfer of FDI capital, hence leading to a systematic tendency for a deficit on the current account which will then require corresponding capital account surpluses, possibly establishing a kind of growing addiction to FDI (Domar, 1950).[62] Indeed, Penrose shows that increasing foreign ownership can be associated with an outflow of capital: a state of deepening dependence and penury and this effect can now have a number of causes (Penrose, 1956).[63]

The aggregate effects of the inflows and outflows associated with FDI can be traced using the ABS data reviewed in Chapter 2. However, tracing the total effects is more complicated than that and it would be a mistake to leave the analysis there, as some Australian research has done (Crough and Wheelwright, 1982).[64]

One such complication arises when we try to include the effects of FDI upon trade which are in addition to "the more obvious effects .... of a greater capital inflow and the subsequent remittances of dividends and interest" (Perkins, 1972, p 291). It might be that

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[62]Domar constructs the case for capital exporters so that if the rate of growth of new investment overseas is less than the rate of interest/profit on existing foreign investment, then the current account will be in surplus and the capital account in deficit. This is the mirror of the importing nation's tendency to capital surpluses and current account deficits.

[63]If earnings on past investments are made at a rate faster than new investments, "then the foreign equity of the firm grows without any new foreign exchange - i.e. foreign investment in the firm is increasing while there may be a net outflow of funds." (p 220). Further still, since 1985-6, Australia has valued inward foreign investment (direct and portfolio) at market values, wherever possible and, hence, the effect to which Penrose refers would now be observed not just through the effect of repatriated earnings but also when capital gains or currency movements increase the level of foreign ownership and influence without a capital inflow.

[64]This comparison of FDI and remittances would appear to be the basis of the simple calculation made by Crough and Wheelwright who then claim (probably erroneously) that, as a result, during the 1970's and early 1980's, "there has been a net outflow from (Australian) manufacturing almost every year" (p 153).

FDI and trade are substitutes, so that Japanese FDI in Australia replaces imports by transferring to Australia the factor used relatively intensively in the production of Japanese exports (Mundell, 1957). Or, it might be that FDI complements trade and can even add a factor endowment basis for it where one did not previously exist (Markusen, 1983).

Other effects on the balance of payments are also conceivable. FDI might reduce exports because the investor places trade restrictions on the local activity or it might increase imports because it funds promotional and marketing activities in the host nation (Komiya, 1972, p 145; Carr, 1978, p 50). Even FDI in non-traded goods can be conceived as freeing-up resources for investment in traded goods and thereby as having effects upon the balance of payments (Holland, 1991, p 29).

The full effects are made even more uncertain by problems collecting and analysing appropriate data, owing to the fact (extant in Australia) that the foreign firms incorporated locally rarely report separately from locals (Strange, 1994, p 41). In short, FDI can affect each of the elements of the balance of payments; commodities trade, services and income payable, making the overall impact problematic (Jones, 1991, p 9.3).

Having raised many uncertainties which, of themselves, suggest policy concerns, it can be added that FDI does not necessarily lead to balance of payment problems (Julius, 1991).[65] The complexities mean only that the balance of payment effects of FDI cannot be analysed in general. It is "extremely difficult to assess and even more tricky to quantify" (Nicolas, 1995b, p 315).

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[65] Julius points out that, if the rate of return on FDI is greater than the interest rate necessary to finance a current account deficit by other means, there need be no snowballing deterioration in the nation's current accounts (p 90). Of course, this will depend, in part, on the rate of profit and the degrees of distribution and repatriation. However, the key point is that, if the FDI is productive investment, it is less likely and therefore, at least this is Julius' point, it is unlikely to cause a fundamental problem to the external accounts.

But is this also true of other impacts associated with FDI? We can make an assessment by delving into a few more specific possible effects of FDI to be found in the substantial literature on the subject, again biasing the references to Australian work.

An oft-claimed benefit of FDI is that even if it does not bring capital, it comes with foreign technology and techniques (UNCTAD, 1999, p 31; Brown and Carey, 1999, p 31; FIRB, 1998, Appendix A). Some have seen this aspect of FDI as having played a crucial role in Australian economic development (Hutchinson and Nicholas, 1992, *passim*). However, it is incautious to conclude in that way.

We saw in Chapter 2 some data which showed that Japanese R & D in Australia is very low and some opinion that it is true that MNCs generally undertake their R & D at home. But, even if this were a reliable generalisation, and it meant that some technology at least must be obtained by transfer under FDI, what would be the effect on the host?

The only point which would seem self-evident is that the interaction of imported and locally developed technology is likely to be exceedingly complex and, although it is not clear that more of the first does not lead to less of the second (Safarian, 1972, pp 65-6), our ignorance is considerable. For example, it has been suggested that instead of forestalling local technological development, the presence of FDI affiliates permits and incorporates the use of local technology (Paparastassiou and Pearce, 1997, p 6). Others have suggested the effect of FDI depends on the mix of technology, the pairings of nations and the technological gap between indigenous and foreign firms (Kokko, 1994, *passim*; Perez, 1997, p 189).

This matter intersects with the large amount of recent literature on the subject of national innovation (Hirst and Thompson, 1996, p 61 lists the major works). Confining the discussion to the relation of local innovation and the imported technology which might accompany FDI, a number of authors have endorsed the view that there is no basis "for resolving the argument" (Stopford, Strange and Henley, 1992, p 157). Not much progress seems to have been made since one researcher wrote in the late 1970s that "no

hypothesis can be even suggested" (Carr, 1978, p 15). The difficulties are compounded by the fact that, as we shall consider below, FDI is not the only means to transfer foreign technology.

Another possible effect and potential source of benefit from FDI is its ability to enhance competition. Some believe that, coming from outside the relatively small Australian economy, FDI can add crucially to local competition (Kasper, 1984, p 23). Others are aware of the potential for FDI to have the completely opposite effect i.e. that because MNEs tend to be large oligopolists themselves, their entry "can lead to an erosion of competition" (Parry, 1983, p 22) and "crowd out" domestic firms (UNCTAD, 1999, p 37; Young and Brewer, 1999, p 15). This matter is dealt with at length in the following chapters so we make no more of it here than to use it to show, again, that there is a fundamental ambivalence about the effects of FDI and that no generalisation is possible.

From a policy point of view, particular importance attaches to the so called indirect or spin off effects associated with FDI. These are effects created by the FDI but not captured by the investor and which are available either as benefits to or costs upon others in the host economy (Nicolas, 1995b, pp 322-326; Jones, 1991, p 9; Kojima, 1978, p 76; Holland, 1991, p 4). Of these external effects, special importance is attached below to what Singer called foreign investments' "effects on other industries" (1964, p 164; also Stopford, 1997, p 461).

In other words, policy makers are not equally interested in all the effects of FDI. The effects which impinge on profit or result directly from the pursuit of profit are within the purview of the investor.[66] Policy is not concerned with effects linked directly to the incentives facing investors but with indirect effects which are "over and above the strictly economic benefits that motivated the investment in the first place" (Julius, 1991, p 60). They are important both because they can be a significant source of net gain to host

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66 Although, as discussed below, there are questions as to which effects fall outside the investor's influence and as tot he way in which pursuit of individual gain can give rise to undesirable distributional consequences.

nation residents (Hatzichronoglou, 1997, p 158; Dunning, 1990, p 218) and because they fall outside the control and consideration of the investor. As one researcher has put it:

> benefits to the host depend on the inability of the investing corporation to capture all the social benefits from its investments (Johnson, 1972, p 4).

These effects which spin off from an activity are often conceived as externalities. They are thought to have particular relevance to the total technological impacts of FDI but can also exist as so called demonstration, contagion and reputation effects (Kokko, 1994, *passim*). In the next chapter, we find reason to doubt the generality of the view that sees such effects as forms of market failure and prefer instead to think of them as spin offs or simply as external effects. Essentially, they are incidental, often involuntary and are generally unmeasured and frequently immeasurable (Nicolas, 1995, p 328; Keating, 1993, p 68). As Krugman is reported to have put it,

> external effects by their very nature leave no paper trail of market transactions by which they can be measured... (Gregory, 1986, p 3).

But while these effects are undoubtedly important for policy, as with the other effects considered, it is not clear that they are particularly associated with FDI. Nonetheless, their importance means that not only can we offer no generalisations about the effects of FDI, the policy dilemma is also deeper still: what particularly interests policy makers is the subset of effects beyond the capture of the investors and these effects are difficult to identify and measure.

To further emphasise the uncertainties surrounding the effects of FDI, the least tractable problem of all has been left to last: that of the counterfactual. As Singer once put it so eloquently:

> we must compare not what is with what was, but what is with what would have been otherwise - a tantalizingly inconclusive business (1964, p 164).

Looking again at the possible impact on the balance of payments, FDI might simply forestall or displace local investment which would have happened but for the FDI and

which might have been financed from foreign sources, thus involving less foreign ownership but greater indebtedness to foreigners initially but, possibly, the same subsequent effects. Of course, equally, it might not (Strange, 1994, p 48; Komiya, 1972).[67] However, if a locally-owned alternative were in the offing but failed to materialise because of the FDI, it means that even the direct impacts of the FDI are not net benefits.

The importance of the counterfactual case is largely in that it raises the prospect of a domestic alternative to FDI (Buckley, 1997, p 50). Regarding technology, the real policy question is not whether the host benefits from technology transfers via FDI but whether FDI offers "greater net benefits than via alternative channels such as licensing [local interests]" (Parry, 1983, p 15).

It might be that FDI must be restricted by policy so as to induce a technology flow by licence (Hymer, 1966, p 178); as we will see, this is apparently the Japanese view. If so, it is a relationship which further complicates any assessment of the technological impacts of FDI. And it is a general policy problem which occurs with all possible effects of FDI: FDI can have many effects and the subsequent impact on locals is uncertain.

One of the more general counterfactual questions is that of the development of indigenous firms. We can ask two questions: if not for the FDI would Australia have developed more local firms and, if so, would that have been of net benefit?

As to the first question, concerns are said to be frequently expressed by host nations that MNEs can harm local entrepreneurship and distort the growth of domestic capabilities (UNCTAD, 1999, p 37). This proposition is backed by some studies which show that restrictions on FDI can create gains for home firms (Graham, 1992, p 192) and, equally, that allowing FDI inflows can lead to home firm losses (Perez, 1997, 189). However, the literature is divided over the details, importance and even existence of the effects on

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[67] Komiya reinforces the point: "(t)he state of affairs which would have obtained if foreign owned had not come into existence is highly conjectural" (p 145).

indigenous firms and has been described as being in a state of "debate" (Chang, 1998, p 236).

But the second part of the question is also important and the answer not obvious: if indigenous firms were to develop as the counterfactual to FDI, would this be generally judged to be superior? The answer is arguably not, but it is uncertain.

One of the most systematic attempts to capture the costs and benefits of FDI and to compare them with that of a domestic alternative was made by Kindleberger (1972, *passim*) in his ordinal and somewhat subjective comparison of the individual parameters associated with FDI compared with a nationalised alternative. That analysis can be extended here to compare also to a privately owned, domestic alternative.

In brief, Kindleberger shows that, compared to FDI, nationalisation provides profits rather than taxes to the government. However, it is likely that profits themselves are lower because, instead of control based overseas, local control reduces overseas marketing abilities and so global sales are lower. In addition, profits are lower because of the cost of compensation paid to the foreigner after nationalisation. Wages and the opportunity cost of capital are also said to be lower under nationalisation. Kindleberger also proposes that, while under FDI arrangements the transfer of foreign technology and skills would be provided at low marginal cost (Kindleberger assumes at zero marginal cost), to operate with the same techniques and efficiency, nationalisation will require the purchase of technology and management skills as well. In addition, Kindleberger suggests that the external economies associated with training and management activities would be smaller under nationalised ownership, although the reasoning seems inconclusive: it might simply be that the payment for these activities are significantly greater.

We can extend this comparison to include the elements which would pertain if, instead of nationalisation, indigenous, private interests were to buy out the foreigner with funds borrowed from overseas. The modifications suggest that local ownership instead of FDI

makes little difference to the host nation gains. The difference is the same as that between FDI and nationalisation except that, with lower sales and lower wages, compared with FDI, taxes on profits will be different. However, because these two changes have opposite effects on profit, the difference might be small.

The major impact on profits are likely to be the result of the higher capital costs reflecting the higher risks which might be associated with borrowing by local firms on international capital markets. But, given the liberalisation which has occurred since Kindleberger wrote and the enhanced access this provides to global capital, sources of inputs and destinations for output, even these differences might now be smaller. In addition, in the liberalised economy, indigenous firms can reinvest profit off-shore, just as foreign firms can repatriate them.

To sum up from our extended Kindleberger model, compared to local private control, the major economic benefits of FDI to the host nation are in the form of any higher taxes paid from higher profits and any higher wages paid. All other effects seem to be replicable under local ownership. In short, if the activity will be undertaken anyway by local firms which, like MNCs can borrow, buy, invest and sell, license from and to anywhere, the effect of FDI appears to be small.

However, there is a problem with that conclusion. Despite that the literature is in a state of debate, many nations, although not Australia, (we will review Japan and Sweden below) have placed considerable stress on policies aimed to develop indigenous firms, including and especially by restricting inward FDI (Stopford, 1997, p 463; Safarian, 1993, p 454). The analysis here suggest such policies are unnecessary but why then the considerable stress?

One suspects that, in many cases there is a simple, too ready association of national interests with those of locally owned corporations (see Stopford, Strange and Henley, 1992, p 120) and some have called this a mercantilist attitude to corporate ownership (Pempel, 1997, p 1.18; Jones, 1991, p 9.1). It is a ready association which afflicts some

economic analysts as well as policy makers. Early work, such as by Caves (1982, p 280), has been particularly prone to this problem but it is still in evidence. For example, Nicolaides (1993) argues that FDI threatens the effectiveness of industry policy because some of the gains from assistance go to foreigners. That is ill-reasoned. Similarly, Nicolas claims that competitive pressures from FDI affiliates in the domestic economy are beneficial to the host only if the local firms respond successfully to the challenge (1995, p 323).

In short, Buckley seems right to note that the reasons national firms are thought to be so important is unclear (1997, p 46) and Safarian, in summing up his comprehensive study of FDI policies, noted that the idea that a nation should have champion companies "ran into many difficulties" (1993, p 497). Nonetheless, given the widespread existence of these policies and opinions, the fact that we have found no immediately apparent economic rationale suggests the need to delve more deeply into the matter, as we do below.

The link between FDI policy and attitudes to domestic alternatives is also relevant to the shift, described in Chapter 2, in the strategy by which Australia finances its current account deficit. We saw that, in the 19th century and early 20th century, the predominant pattern was portfolio inflows organised by the public sector. In the mid 20th century, Australia placed far greater emphasis on FDI flows to the MNCs before the liberalisation which began in the mid 1980s shifted the emphasis to FPI inflows to the private sector thereafter.

We will assess that shift of strategy in chapters 6 and 9 below. Here the point is that this progression in Australian policy shows some of the range of alternatives to FDI which exist for a chronic current account deficit nation. Conceivably, all these other means of importing capital could be used to substitute completely for the effects of the existing inflow of FDI from Japan, if those financial arrangements were augmented by licensed technology inflows and other means that would replicate by purchase (although possibly at higher price) the effects of FDI.

Before summing up this section, there is a subset of FDI effects which arise particularly because the companies concerned span more than one jurisdiction; the use of so called transfer pricing as a means of tax avoidance. It is possible to minimise total tax paid by manipulating the profit declared in the host and source nations. This can be achieved by varying prices charged to transfer goods or services between parent and foreign subsidiary from that which they would be if the entities were at arm's length (BIE, 1993, p 137).[68] Transfer pricing can provide the investor with net gains because one nation's tax losses are greater than the other's gains (Plaesschaert, 1979, p 76).

However, there are reasons to believe that the ability to manipulate prices is not a major motivation for Japanese FDI in Australia Firstly, for there to be a tax advantage in distorting transfer prices, there must be a tax differential. While corporate tax rates in Australia and Japan have varied considerably in recent times, the differences between them have not been great and recent changes are said to have been made with international comparisons clearly in mind (IC, 1996, pp 101-135; Iwamoto, 1990, Table 2).

Secondly, any temptation which might exist to reduce the tax paid in Australia is militated against by the fact that Japan operates a system of international tax credits so that the Japanese government levies a single rate of tax on Japanese companies' global profits by granting credits for taxes already paid overseas.

However, the whole question of relative tax regimes is complex. For example, in addition to the base line corporate tax rate, investment tax credits and accelerated depreciation allowances offered in source and host nations can alter the effective tax rate faced by FDI enterprises through their ability to manipulate the prices of capital goods and technology (Sendlhofer and Winner, 2000, *passim*). However, it is also said that

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[68]There are also other reasons to indulge in transfer pricing e.g. it can be used to minimise *ad valorum* tariff payments or as a means to overcome host nation restrictions on profit repatriations or as a means of hedging foreign exchange

statutory rather than effective rates are "a better determinant of income shifting" among MNCs (Grubert and Mutti, 1991, p 293).

Similarly, Australia's system of imputed tax credits on dividend income can also shift the calculation, which can become highly complicated (Pender, 1991, *passim*). The use of third nation tax havens with generous tax provisions or exemptions can induce and make more complicated the tax avoidance manoeuvres (Plaesschaert, 1996, p 397-8).

Overall, the evidence on tax evasion by MNEs is not strong (Plaesschaert, 1996).[69] It is claimed that MNCs in Europe attempt to avoid tax (Strange, 1997, p 138) and evidence exists that the use of tax havens is an important tax avoidance route for some multinationals from the US.[70] Australian data show that, in 1995-6, half MNEs in Australia paid no income tax (JPSC, 1999), although many paid indirect tax and estimates suggest that average tax paid by multinationals amounts to 16.5% of turnover (Brown and Carey, 1999, p 47). However, an Australian Tax Commissioner has stated that monitoring MNE activities in Australia for tax purposes presents very significant problems (Bryan and Rafferty, 1999, p xxii).

Part of the problem for host nation authorities is that establishing reasonable pricing standards is not always simple.[71] Nonetheless, the ability of the Australian government to implement such scrutiny is not in any doubt as its tax powers include special provision (applicable to local and foreign controlled firms) to vary the prices charged for transactions between parties which are not at arm's length (Flint, 1985, p 410). In

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movements (Plasschaert, 1996, p 395, Table 1).

[69] Research in this area is said to face "intractable conceptual problems and information gaps" (p 396).

[70] As an indication of the extent of this behaviour, the regularly collected US Bureau of Economic Analysis calculates FDI data on two bases: that which includes the Netherlands Antilles and that which does not. This is because that tiny nation "does not have a withholding tax of its own and structures most taxes on affiliates to generate offsetting tax credits for US parent firms" (Thomsen, 1990, p 110).

[71] For example, there are problems with heterogeneous quality, with joint products, enterprise-specific services, etc, etc. In short, there might not be an arm's length alternative with which to compare.

addition, dealing with the tax arrangements of Japanese firms in Australia is made easier by the "explicit consensus" (OECD, 1991, p 12) such as exists between Japan's National Tax Agency and the Australian Tax Office which have, since 1989, had a cooperative agreement to deal with the problem.

There are some other ways in which the nature of FDI provides the opportunity for investor gains and host nation losses, although there is scant evidence on them. For example, suppose that Japanese control meant that large salaries were paid to Japanese nationals working in Australia who, because they stay less than one year, continue to pay tax in Japan and who save a significant proportion of their income which is then spent on their return to Japan. Compared to local investment and local employees paying local taxes and spending a high proportion of their income locally, there are likely losses to the host. Again, it depends on the counterfactual. If the alternative were that these locals worked overseas, there might well be greater losses still if there were no FDI.

We can now sum up: there can be no generalisation about the net effects of FDI. They are "ambiguous" (Nicolas, 1995, p 312) and the result is "contingent" (Chen and Clark, 1996, p 186), depending on a mix of factors (Hymer, 1966, p 177). The whole subject is beset with measurement problems (Dunning, 1997a, p 227; Julius, 1990, p 61), especially regarding the effects most relevant to policy.

This viewpoint is not new. Carr (1979) has said that, in considering the full effects of FDI, "the appraisal becomes nearly hopeless" (p 65); Julius has put it that "(u)nfortunately, it is not possible in any satisfactory way to quantify the direct or indirect benefits from FDI" (Julius, 1990, p 61); and, perhaps most eloquently of all, the notable Australian economist H. W. Arndt put the matter thus:

> I think it quite possible that the benefits, direct and indirect, of overseas investment during the past decade [in Australia] have greatly outweighed the costs, direct and indirect, and will continue to do so. My point is that I do not know and that I cannot see how anyone can find out (quoted in Brash, 1966, p 3).

Arndt is not the only one, in Australia and elsewhere, to reach that positive net assessment, while being aware of the measurement and counterfactual problems which make it uncertain.[72]

With these preliminary points in mind we are now in a position to assess Australia's current FDI policies. We find that they pay little heed to the problems isolated here.

However, before we do, there is one last point to make concerning the effects of FDI: its potential effects on the conduct of macro-economic policy. These arise from the link between FDI and the domestic financial system and operate by way of the credit flows which may accompany it. Hence, the policy implications are those that arise with freer access to international capital and not to FDI *per se* and are therefore somewhat outside our scope. However, a brief review of the policy implications is warranted.

Under conditions of high capital mobility, tight monetary policy, for example, is said to not only have restrictive impacts on domestic activity but to encourage an inflow of foreign capital, thereby reducing the policy's effectiveness. However, with floating exchange rates, the capital inflow tends to appreciate the currency, thereby leading to net import growth and restoring some effectiveness to monetary policy. The opposite impacts occur for fiscal policy so that it is more effective because of high capital mobility but less so because of floating exchange rates (Caves, et al, 1990, pp 595-8). This will alter the optimal mix of monetary and fiscal policy and may reduce the overall effectiveness of both. However, our concerns lie elsewhere, with the policy implications of FDI *per* se.

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[72] For example, Robert Holland (1991), intelligently lists the relevant issues and recounts the difficulties but then gives "a resounding 'yes'" (p 30) answer to the question of whether FDI is of net benefit. Again in the Australian context, Tsokhas reports the view of the Manufacturing Industry Advisory Council that the disadvantges of FDI "are more than outweighed by the relative benefits .. " (p 3)

3.3 Foreign Direct Investment Policies in Australia

Australian FDI policies, since the mid 1970's, have focussed primarily around screening incoming FDI under specific, legislated powers. This screening procedure is augmented by a range of administrative regulations generally not covered by statute but by policy statements and guidelines, supported by the Commonwealth's broad powers to regulate foreign exchange transactions (Flint, 1985).[73] With the few exceptions noted below, screening applies only to cases of foreign takeover of existing businesses.

The practice of regulating foreign investment by issuing guidelines predates the screening system and was first evident in the Borrowing Guidelines issued by the Commonwealth Treasury in 1965 which required that foreign firms seek approval from the Reserve Bank regarding plans to borrow in Australia. Prior to the use of these guidelines Australia's FDI policy was liberal and there were no explicit restrictions (Arndt, 1980, pp 133-4). In fact, the first Borrowing Guidelines were not an Australian initiative but were said to be a response to the announcement made "by the US government, then by the UK government, urging their companies ... to finance overseas investment by borrowing overseas" (Safarian, 1993, pp 84-5) so as to limit any outflow of capital from the source nation.

In 1969, the Borrowing Guidelines were modified slightly and explicitly elaborated to link access to local loan funds with opportunities for local equity participation (Flint, 1985, p 2). In December 1972 the Federal government instituted instead the Variable Deposit Requirement Scheme by which 25% of foreign loans (to foreigners or residents in Australia) were to be deposited with the Reserve Bank of Australia in a special interest-free account. While the intention of the Scheme appears to have been to encourage an inflow of foreign capital rather than borrowings in the local market, the

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and that, in the early 1970s, Prime Minister McMahon had "concluded that on balance foreign investment had been in Australia's favour .." (p 66).

[73]Foreign investment policy is "a valid exercise of the Commonwealth's powers"

subsequent use of the Scheme, including its temporary revival in 1977 (after being discontinued in 1975[74]) suggests that the Federal Government was also prepared to use it as an additional means of stabilising foreign exchange flows under the fixed exchange rate system of the time.

The year 1972 was also significant in that it saw passage of the Companies (Foreign Takeovers) Act and the establishment of the Interdepartmental Committee on Foreign Takeovers which outlined the system of Australian FDI screening which was to develop over the next decade (the discussion that follows is based primarily on Gunther, 1995 and various issues of the FIRB Annual Report).

Proposals to screen foreign takeovers emerged from the recommendations of a Senate Select Committee on Foreign Investment set up by the Australian Labor Party with the support of the smaller (and now defunct) Democratic Labour Party (Tsokhas, 1984, p 68). The Act was introduced to Parliament by Liberal Party Prime Minister McMahon but was enacted by the Whitlam ALP government. In 1975, this system of control was modified to establish the current policy mechanisms. In particular, the Foreign Acquisitions and Takeovers Act (1975) led to establishment of the Foreign Investment Review Board (FIRB) in April 1976.

The Act gives the Federal Treasurer so called notification powers to require submission of FDI proposals. The Minister may reject those which do not meet certain criteria, place conditions on others or unwind any transaction which takes place without approval. The Act identified four categories of foreign investment proposals: those which would provide the foreigner with control of existing businesses in Australia and were therefore covered by the Act; those to establish new businesses; foreign investment in real estate and foreign investment in other restricted areas (Gunther, 1995, p 3). These distinctions still operate, albeit with some modifications.

(p 45).

[74]Apparently because, at the time, it was expected that the $A would suffer a relatively large devaluation and this favoured debt finance from overseas, hence

The Foreign Investment Review Board (FIRB) was established to assist the Treasurer in the exercise of the Commonwealth's powers under the Act and comprises individuals mainly from the private business sector.[75] Secretarial services are provided by the Investment and Debt Division of the Department of the Treasury and the ex-officio Executive Member of the Board (to whom falls most of the day-to-day responsibilities of management) comes from the Foreign Investment Review Branch of that Department.

When initially enacted, the 1975 legislation required the Board to examine each foreign takeover proposal to determine "whether or not it was contrary to the national interest" (p 5). The initial Act also restricted foreign investment in certain sectors and, according to the Treasurer's statement at the time, it was to apply a two tier test to other proposals (FIRB, 1977, pp 35-6).

The first of these was that the proposed foreign investment be likely to produce "net economic benefits to Australia" (ibid). It was anticipated that these benefits would arise by a number of means including by the beneficial effects of foreign investment on competition, price levels and efficiency; through the introduction of new technology and managerial expertise; by improving the industrial or commercial structure of the economy; or, by assisting in the development of export markets.

The nature and content of this list of criteria is interesting in view of the discussion at 3.2 above. These criteria are not readily measurable, separably or in aggregate. But without being measured they remain uncertain, incommensurable and unsummable. Hence, the criteria are not so much parts in a cost-benefit analysis but seem to be more a list of elements in an extended taxonomy of desirable effects, with no attention given to the counterfactual.

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making the Guidelines unnecessary .

[75]The Board was established to examine proposals, to make recommendations to government concerning foreign investment generally, to provide guidance to foreign investors and to monitor and ensure compliance with decisions by the Treasurer concerning foreign investment (FIRB, 1996, p1).

The problems can be seen by examples. Suppose very detailed investigation of a particular case removed all the ambivalence and showed that a foreign investment proposal would definitely reduce competition but that, at the same time, it would unambiguously improve technology. This would constitute greater certainty than the FIRB can generally claim and yet it is still not clear how the two effects might be valued or what the net result of them might be. Similarly, a proposal might increase efficiency and exports but the two are likely to be functionally related and adding both gains together would appear to be a case of double-counting (even if they could be accurately measured). In short, the list of first tier criteria was long and presented plenty of implementation problems.

The legislation also required that a second tier of criteria be applied to proposals that passed (using the word loosely) the first, although how the two tiers might stand in relation to each other was not clear. Specifically, companies controlled by foreigners were given approval to takeover locals if they created a net economic benefit and conformed to government's other policy objectives. These other objectives included matters such as the desire to increase the level of raw materials processing undertaken in Australia, to enhance local R & D and to operate with appropriate industrial relations and equal opportunity arrangements. Proposals for foreign acquisition were also expected to fulfil the government's desire for high levels of local sourcing of components and for the involvement of locals in corporate decision making.

Again, some of these elements defy meaningful measurement and, in any case, critical levels were not stipulated. How they could be sensibly combined was also not spelled out. It is not surprising that it is said the two tiers of criteria were applied in an unstructured way and that, as a rule of thumb, foreign investment applications were approved if they had a majority of Australian control or if the foreign investors were making significant efforts to secure such Australian involvement (Gunther, 1995, p 7). This might not have been the detailed implementation of screening which the legislators'

list of criteria implied but what they had in mind was misconceived and probably unachievable.

This is the major point about Australia's FDI policy. As we have seen, case-by-case screening requires large amounts of very detailed information, not all of which are to hand, and determinations are very likely to require qualitative assessments, at least in part. To make such assessments for all new investment and to monitor past investment would require a great deal of effort. If we look at the scope and scale of the FIRB's operations, we must doubt that such an effort is being made.

The FIRB annual report shows that there are only 27 staff in the FIR Branch (many of whom, perhaps one-third, are support staff)[76], and that all of the foreign investment review activities cost only $2.3 million p.a. (FIRB, 1999, p 5). Given that 4 642 applications were reviewed in 1998-9, new proposals must be vetted at the rate of 89 per week or about 5 per week per officer. Further, approvals of previous years which were granted with conditions (and there are very many of these) presumably also require some on-going monitoring and some of these will be in dispute and must be settled. Given the volume of work, it would seem reasonable to suggest that spending $2.3 million p.a. to screen a flow of some $67 billion worth of proposals (as the FIRB did, not unusually, in 1997-8[77]) while monitoring a stock of many billions more is a strong indication that screening is perfunctory. The proposition that it could allow into Australia only those proposals which were of net benefit is untenable. In short, the screening effort required to fulfil the requirements of the Act would be very large, the screening effort made is not.

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[76] In its 1999 Annual Report, the FIRB noted that it had included 5 extra support staff in the 27 officers.

[77] In 1998-9 the FIRB examined 4754 proposals valued at $67 billion, approving unconditionally 1724, approving 2918 others with conditions and rejecting just 112 (FIRB, 1999, p vii). This pace of activity is not unusual for the FIRB, nor is the ratio of rejects which has varied from less than 1% to no more than 5% in each year since 1976 (Safarian, 1993, p 100 and FIRB, Annual Reports).

Interestingly, the Board does not see it that way and makes a positive virtue of the low information requirements on those seeking approval.[78] It is easy to see why some researchers believe that the Board sees itself as having more a mandate to attract FDI than to screen it out (Bryan and Rafferty, 1999, p 456).

We will return to sum up the position on screening but firstly, we will review the development of Australia's FDI policies during the period of liberalisation (a chronology is given in FIRB, 1999, Appendix D).

During the early years of its operation, the FIRB is reported to have applied the criteria in an unstructured but restrictive manner and the process of liberalisation of FDI policy in Australia did not develop momentum until the 1980's.[79] Indeed, policies governing inward FDI were quarantined from initial liberalisation and during the early 1980's there was some further tightening (Kasper, 1984, p 47).

The pressure for liberalisation of the Australian economy more broadly came from a number of sources. Partly, it was a response to international liberalisation (some of the relevant FDI reforms are described in section 3.4 below). In addition, powerful domestic forces, especially the Australian banks, sought liberalisation of capital flows and domestic finance, as shown in their submissions to various government inquiries in the late 1970's and early 1980's.[80] The liberal reforms were also approved by both major political parties and strongly supported by academic economists as a

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[78]"The information requirements for processing proposals have been designed to keep to a minimum the time taken ... in obtaining foreign investment approval" (FIRB, 1997, p3).

[79]As late as 1974 a last attempt was made to make the system of financial regulation more comprehensive by extending its scope to the non-bank financial intermediaries under the Financial Corporations Act of the Commonwealth Parliament (House of Representatives, 1991, p 27).

[80]The so called Campbell Committee of Inquiry into the Australian Financial System (established Dec. 1978, reported Nov. 1981) and the Martin Review Group (established Mar. 1982, reported Jan. 1983). The "intellectual roots" of the argument for deregulation can be found in the first report (Sheehan, 1996, p 395)

bipartisan reform programme ... with its emphasis on increased competition, outward orientation, .. and resistance to special interests (Blandy, 1993, p 31; see also King and Lloyd, 1993, *passim*).

Deregulation in FDI did not begin until after the high point in the pace of Australian liberalisation, reached with the float of the $A in December 1983 and the subsequent relaxation of foreign exchange controls the following June (Perkins, 1989, pp 108-109). Significant liberalisation in the operation of the FIRB did not begin until late 1985, almost last among the international financial flows.

Firstly, the opportunities test was discontinued; secondly, threshold levels of scale (above which approval was required) were increased; thirdly, non-bank financial companies were allowed entry (albeit only with some local participation) and, finally, there was some relaxation of restrictions on real estate transactions. Many of those changes were revisited and extended in subsequent rounds of reform. In all cases the trend was in favour of liberalisation but none of the reforms fundamentally dismantled FDI screening.

SO, for example, in July 1986, after a progressive extension to particular industries, the previous test of net economic benefit was reversed so that (outside the restricted areas of banking, civil aviation and the media), foreign investment proposals were no longer required to be demonstrably beneficial but would "be approved unless they are judged contrary to the national interest" (FIRB, 1988, p 52). This reversed the onus of proof from the investor to the regulator and was said to be "the most important liberalisation of the policy since the establishment of the Board" (FIRB, 1988, p 3).

However, it did not alter the implicit basis of FDI screening: whether it allows only those proposals which create a net benefit or excludes only those which would create net losses, it still remains a matter of summing costs against benefits. Indeed, it is hard to see how this was an important liberalisation and, if it were the most important, it suggests other liberalisation of FDI policy has been modest indeed.

Against the trend to liberalise, explicit tightening has occurred only once in recent years, in September 1987 when, in response to concerns at housing affordability and evidence of foreign speculative investment in Australian urban real estate in the wake of liberalisation, the government issued a corrigendum to existing published guidelines which required notification of all urban real estate proposals and set penalties for breaches.[81] These changes were significant, at least for the FIRB which now devotes more of its resources to urban real estate proposals than to anything else (FIRB, 1997, p 7).

Further, minor relaxations occurred during the late 1980s and legislative amendments were enacted to reflect and consolidate the previous changes to guidelines and regulation.[82] Further changes were made in July 1991 when the government established so called Integrated Tourism Resorts to allow for the acquisition of residential land for tourist development and, as part of the so called One Nation Economic Statement, thresholds for approval were lifted substantially and controls in mining and banking were relaxed further.

The regulations governing non-residential real estate and newspapers were also eased in 1993, 1995 and 1996 and those for uranium mining and banking in 1996 and 1997 respectively. Finally, in 1999, the Treasurer lifted thresholds very substantially so that only proposals for investing more than $50m require notification (previously $5m) and only proposals valued at more than $100m would be fully examined (FIRB, 1999).

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[81] The changes also provided for a number of exemptions, including non-residential, urban land; acquisitions from the Australian reserves of foreign financial firms; acquisitions by intending migrants; etc. In addition, the guidelines made clear that proposals would also be normally approved if the real estate were bought to be developed or was bought 'off-the-plan'; if there were greater than 50% local equity; if the purchase was for the executive of foreign firms in Australia; etc. All other proposals for residential real estate purchases would not normally be approved.

[82] These were the Foreign Takeover Amendment Act (1989) and, later, the Foreign Acquisition and Takeover Regulations (Amendments, 1991).

Despite this series of liberal reforms to FDI screening, Australia maintains significant restrictions on inward FDI in some areas as revealed by the fact that, when set against the OECD Code of Liberalisation, Australia's case is appended with a rather long list of explicit reservations (OECD, 1997). Not only are inflows vetted by the FIRB but Australia's FDI regulation maintains reservations regarding investment in real estate, mass circulation newspapers, broadcasting, civil aviation, telecommunications and mining. The Australian Federal government has also registered reservations regarding its ability to require Australian State governments to act according to international liberalisation agreements (this is despite the fact that the Federal government's ability to override the States in matters subject to international agreement has been successfully tested over other issues such as employment and environmental regulation).

Further evidence of the limited liberalisation in this area is given by the exceptions Australia registered to the major liberalisation proposed by the OECD in its Multilateral Agreement on Investment (MAI). We discuss this in more detail at section 3.4 below but can note here that Australia has reservations regarding the MAI liberalisations similar to those registered above and extending to include the so called Partnership for Development program which attaches obligations on companies which win government contracts; the position of indigenous people and Native Title claimants in relation to the FDI of MNCs; and requirements over local undertakings in areas including R & D, pharmaceutical's, shipping, social services and fisheries (Ranald, 2000, *passim*).

These reservations regarding FDI should be seen against the dramatic and comparatively thorough liberalisation of the rest of the Australian economy. In other areas within the international sphere, the relaxation of Australia's foreign transactions restrictions greatly increased the ease with which capital of all kinds, including short term and speculative investments, could move into (and out of) the country. Combined with the thorough exchange rate deregulation, the Australian dollar has become one of the most heavily

traded, quite unlike the Japanese Yen (Tavlas et al, 1992, Table 20) and is said to be vulnerable to speculation as a result (Perkins, 1989, p 17).[83]

Liberalisation has also greatly increased the scope for private businesses, resident in Australia, to borrow from overseas sources (Whitelaw and Howe, 1992, p 19). This has been especially true of banks who were previously tightly controlled and then had to cope with new, foreign entrants and also with a potential loss of business at home (because liberalisation also meant that large corporations could issue bonds overseas). One result was the surge in the foreign debt of Australia's financial sector reported in section 2.4 above.

The liberal reforms in the international sphere have also been associated with a growing internationalisation of the Australian economy, seen in the reductions of measures of assistance (especially tariffs) and the increased importance of trade and foreign investment (both in and outward) which have also been observed in Australia's external accounts (see ch 2 and Appendix 3, Table 3.1).

Our purpose here has not been to reach an overall assessment of liberalisation, albeit that it seems thoroughgoing if not incautious. Rather, the concern is to chronicle its development in Australia to provide an understanding of the apparent liberalisation of FDI policy.

In short, compared to deregulation elsewhere in the Australian economy, Australia's screening of FDI appears to remain in tact and largely unreformed. However, from what we have said, it is ineffective. Firstly, the screening focusses almost entirely on foreign

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[83]According to Whitelaw and Howe: "Concern has been expressed ... that it may be possible for the value of the Australian currency to be manipulated by currency dealers for their own advantage; and there is some reason to believe that this has happened occasionally" (p 17). The IMF Report by Tavlas et al has it that "the Australian dollar emerged as an international currency, in that it was one of the most actively traded currencies in foreign exchange markets ...... Underpinning the international use of the Australian dollar has been the complete deregulation in recent years of the Australian financial system, which until 1980 had been

takeovers because they are considered to be investment which is not additional but which merely substitutes foreign for local control. The logic is, however, not compelling: even foreign investment which creates new projects might substitute for an unrealised domestically-controlled alternative. Moreover, FDI can be funded by retained earnings but these fall outside the screening procedures, making them incomplete.

Secondly, there are the significant practical difficulties involved, especially as screening (at least in Australia) makes use of a large number of disparate criteria without assigning weights and more so given that any plausibly broad assessment involves elements such as external economies which are difficult to conceive, measure and therefore incorporate into the process. It is implausible that sufficient resources are currently available, certainly if this is meant to include monitoring projects previously approved (Jones, 191, p 9.10).

The situation has led two researchers to describe the role performed by the FIRB as "window dressing" (Hill and McKern, 1997, p 222). Indeed, the FIRB can be seen as so ineffectual that Australia's policy position is in fact "obliging to the point of indecency" (Jones, 1991, p 9.7). The net result is that Australia does not have as restrictive a FDI policy as its screening apparatus would seem to suggest.

In short, Australia appears to have moved from a pre-liberalisation position in which government screened closely and formally but was unlikely to achieve its regulatory objectives, to one in which government screens loosely and pays only lip service to popular Australian concerns. A recent report prepared by the Department of Foreign Affairs and Trade implies as much when, after making a highly sanguine assessment of the effects of FDI, it can find no reason for screening inward FDI except to provide restrictions which reflect community concerns (Brown and Carey, 1999, p 56).

That report also details some recent initiatives by the Commonwealth to reduce impediments to FDI into Australia. These include the establishment of a national

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tightly controlled" (Tavlas et al, 1992, p 20).

investment agency, Invest Australia, and of a National Investment Response Centre; the establishment of a Regional Headquarters Program to attract FDI; and assistance with feasibility studies and strategic partnering for potential foreign investors. Such initiatives are consistent with the reading that the reforms to FDI policies have been fundamentally designed to remove impediments and promote the inflow.

The final point for this section is to characterise briefly Australia's policy position regarding the development of indigenous firms. We have seen that some authors and evidence link tight control of inward FDI to policies which support indigenous firms. Our assessment is that Australia is the counter-case: its FDI policy appears more restrictive than it is and its commitments to building indigenous firms also do little more than pay lip service.

This is not to say that Australian policy makers have shown no desire to develop local firms. For example, the development of the AIDC in 1975 has been described as "a major step forward in policies for development and for Australian ownership" (House of Representatives, 1980, p 3).[84] However, the Corporation has not grown in pace with the economy and its effects have been slight. It was sold in 1997 (IC, 1998, p 171).

And, the AIDC is one of a few exceptions. It is true that a number of reports for the Australian government have supported the development of local firms as key objectives (AMC, 1990, p 129; McKinsey and Co, 1993, *passim*; Commonwealth, 1984, p 5) but these have not focussed squarely on Australian-owned firms nor have their recommendations been closely followed. There is also recent academic opinion in Australia that developing firms is a key element for future policy (Catley, 1996, p 219) but, again, there is no clear reasoning to support this proposition and no clear indication that it intends to support indigenous firms and not the subsidiaries of MNCs as well nor,

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[84]The Corporation was provided with a capital base and was empowered to raise up to five times that amount in foreign loans. It has two objectives: firstly, to operate as a development finance corporation, lending to Australians on commercial terms and, secondly, to foster Australian ownership and control.

if so, why?[85] In short, Australia's commitment to building indigenous companies has been weaker than we will see has been the case in some other nations.

3.4 Some International Comparisons

This section asks if Australia's FDI policies are unusual or even unique or do other nations also screen inward FDI in a similar fashion and with similar objectives in mind? It begins with an overview of international arrangements to provide the context for Australian policy before looking at Japanese policies in some detail, followed by comparisons with Canada and Sweden.

There are a large number of international agreements and multilateral conventions concerning FDI (overviews of them and their development can be found in Graham, 1997, *passim*; Safarian, 1993, *passim*). Many are linked to trade rules and fall under the same organising bodies. They are also likeminded in moving nations generally to liberalise arrangements.

For example, moves to link international liberalisation of FDI with the general moves on trade under the GATT began with the Havana Charter of 1948, although signatory nations failed to ratify that part of it. The removal of so called trade related investment measures (TRIMS) were again included in the Uruguay Round of GATT negotiations beginning in 1983, after failed Canadian attempts to set performance criteria for US firms (which we review below). Agreements also exist under the WTO to phase out TRIMS and to extend this to intellectual property.

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[85] Catley writes that "the development of successful private corprations in Australia is an essential component of its open economy strategy" (p 219). The text which follows refers to "Australian compaies" and "Australian firms" and to the need for training to improve the "quality of their management" (p 221). This all suggests he is speaking of indigenous firms but he does not say so.

Liberalisation is also the trend in other areas of international FDI regulation and the OECD has described the change since the mid 1960s as "nothing short of spectacular" (OECD, 1995a, p 10).

The process among OECD nations began with the first Code of Liberalisation in 1961 (Kasper, 1984, p 6) and, in 1976, the Organisation's so called National Treatment Instrument was ratified under which countries agreed to treat foreign firms no less favourably than locals, although many nations failed to do so.

The OECD signalled its intention to strike a more binding and comprehensive Multilateral Agreement on Investment in 1995 (Goodman and Ranald, 2000, p ix). The Agreement intended to allow MNEs to challenge before international tribunals "any legislation which favoured local investment, limited levels of foreign investment or required them to contribute to local development" (Ranald, 2000, p 15). The draft Agreement provided protection from expropriation and included roll back and stand still provisions (Ranald, 1998, *passim*).

As noted in Chapter 1, this attempt to reach an Agreement failed to gain support, with 25 NGOs walking out on OECD consultations in October 1997, many governments registering reservations (Australia's have been listed above) and the OECD withdrawing the draft in October 1998. Again, as with Australian screening, the impression is that this failure to agree owed more to popular sentiment than to the advice of economists or the direction of change supported by many officials.

In addition to the WTO and OECD agreements, the G77 nations of the UN included in their deliberations regarding moves to a New International Economic Order, a code of conduct for MNEs in 1982. The World Bank and IMF also provide arrangements under the Multilateral Investment Guarantee Agency to promote FDI in developing countries.

A range of regional agreements, mostly covering trade primarily, also cover FDI. The 1955 Treaty of Rome on which the European Union arrangements are built is said to have

such provisions.[86] So does Chapter 11 of the NAFTA and the APEC agreements. These generally parallel the provisions of the MAI.

The lack of a single global organisation and framework is a particular problem for FDI regulation and it is said that

> at best, the current international policy regime affecting FDI and MNEs consists of a mishmash of rules ... voluntary principles ... and half-way measures (Graham, 1999, p 500).

A similar view is put by Young and Brewer, that multilateral investment policy "is characterised by fragmentation, confusion and conflict" (1999, p 16) and it was noted in Chapter 1 that many Australian interests believed that the OECD was not inclusive enough a body to be appropriate as the forum from which a consensus could emerge (JPSC, 1999, p 76). Clearly, there is a lack of an over-arching international consensus and framework for FDI policy and reform, despite the widespread trend to liberalisation.

Turning now to the policies of particular nations, we begin with Japan, partly because of its direct relation to this study and partly because, just as Japan's net FDI position is egregious and most unlike Australia's, we also find strong contrasts in its FDI policies. Given that the contrasts are so strong, the international comparisons are extended to include Canada and Sweden.

Following Suzuki (1992), Japanese financial and foreign investment regulation has evolved from features of the system which predated the Pacific War and which operated most completely in the period of high-speed growth during the 1960's. This system was comprised of four basic elements: the financial system was segmented to control separately each of banking (long and short term), bonds and securities; many interest rates were controlled to hold them below market-clearing prices (Tavlas et al, 1992, p 10;

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86 Contradictory claims exist about this: Raines and Wishlade claim that the Treaty provides no mention of FDI (1999, p 71) whereas Graham claims it was one of the matters covered (Graham, 1997, p 485).

Sakamoto et al, 1992, p 135); all major transactions were secured by a unique financial practice of collateral guarantees (Rosenbluth, 1989); and, finally, Japan's foreign exchange dealings have been closely controlled.

These regulations were backed by legislation and by administrative procedures, both applied by a range of means, including the subtle devices aptly described as "administrative guidance" (Johnson, 1982, *passim*)[87] so that it is said of Japan's financial markets in particular that they have been regulated via "frequent use of implicit rules and long-term relationships" (Okamura, 1986, p 54). This alludes to characteristics (analysed in more detail below) which make the Japanese system seem opaque and exclusionary to foreigners, especially given that the Japanese private sector is closely involved in the formulation of policy and administrative practices (Suzuki, 1992; Rosenbluth, 1989).[88]

The general purpose of these four elements of regulation is clear: they were created to promote a steady flow of cheap investment funds but without opening the economy to significant foreign capital and influence (Tavlas et al, 1992).[89]

The Japanese authorities' control over foreign exchange transactions has also allowed for regulations which deal with inward FDI *per se* . The Foreign Exchange and Foreign Trade Control Law of December 1949 provided control over all international dealings by use of a foreign exchange budget (JETRO, 1983, p 1). The 1949 legislation applied explicitly to cases of short term foreign capital and was followed, in May 1950, by the

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[87] For example, government 'intervention' can vary from directives (*shiji*) and warnings (*keikoku*) to requests (*yobo*), suggestions (*kanoku*) and encouragement (*kansho*), and all these may fall within the ambit of administrative guidance (Johnson, 1982, p 265).

[88]Controlled interest rates, for example, have been described as being "determined through discussions among interested parties"(Suzuki, 1992, p 40). In general,"(the) bureaucracy does not control or direct the private sector but negotiates with it, relying heavily on the private sector's collaboration in the formulation and implementation of policy" (Rosenbluth, 1989, p 9).

[89]These regulations were: "designed to enhance personal saving so that the investment needs of private industry and the rebuilding of public sector infrastructure could be met at low interest rates. In addition controls on capital flows insulated the financial market from foreign influences" (p 10).

Law Concerning Foreign Investment which specifically regulated long term and direct investment.

The administration of these Laws made use of a Foreign Investment Council comprised of business people, academics and bureaucrats to screen all FDI proposals (Safarian, 1993).[90] Article 1 of the law allows for approval only in those cases of foreign investment "considered beneficial for development of the Japanese economy and improvement of the Nation's international balance of payments" (JETRO, 1985, p 20).

Thus, the Japanese situation before liberalisation looks similar to that in Australia with all FDI proposals being vetted according to some implicit calculus of net benefit. In the case of Japan, the criteria and procedure for their resolution by the Council appear even less clear than in Australia although, in addition to the general conditions set out in Article 1 above, Article 8 of the Law required that priority would be given to proposals which would contribute to external stability and would not disrupt existing business.[91]

Foreign takeovers were broadly unacceptable to Japanese authorities without the consent of the local takeover target (Safarian, 1993, p 248) and the few companies which gained approval were the so called yen-based companies which operated in Japan in the period 1956-63.[92]

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[90]The Council was established with the Mininstry of Finance and also included in its deliberations the Mininster relevant to the activity in question (in most industries this was the MITI). All FDI proposals were to be submitted to the Council and recommendations were then made to the relevant Ministers with authority to permit both the investment and the relevant transactions (p 242).

[91]These were that it improve exports or limit imports, that it lift the level of technology, that it make a contribution to "essential industries", that it was fair and did not pose a significant competitive threat to existing, Japanese firms and that it had 50% local equity (Safarian, 1993, p 242).

[92]Motivated by balance of payments concerns, these companies, unlike joint ventures, did not have the guarantee of profit repatriation - profits earned in yen must be spent in yen. Nihon IBM is perhaps the most famous company established on this basis.

In addition, the MITI used its foreign exchange powers to promote technology transfer through licensing agreements because, as contradictory as this might seem, licensing was seen as a form of foreign intrusion and it proceeded only under strict scrutiny (JETRO, 1985, p 20).[93] This technology import was thought to be necessary because of the need for the Japanese economy and its companies to catch up with the West (Ozawa, 1998, p 143) and it was a policy which is said to have forced the growth of domestic firms (Dunning, 1990, p 223) and to have been linked to the development of indigenous technology (Inkster, 1996, p 47).

The case of the automotive industry is illustrative. It is said to show how Japanese regulation of FDI "untied the package" of imported technology and foreign control and promoted the development of indigenous firms (Johnson, 1982, p 217). Although, in the contemporary era, Japanese car makers are clearly world competitive, in the past, in this activity and in others where Japan is now strong, Japanese interests have both sought out foreign involvement and sought protection from foreign competition.[94]

This can be seen, following Gunther (1990), in tracing foreign involvement back to the mid 1920's when Ford and GM were welcomed into Japan where they assembled 250,000 vehicles and held 90% of the domestic market. However, the rise of economic nationalism, reflected in the Automobile Manufacturing Industry Law of 1935, forced them out of Japan. This important legislation licensed Nissan and Toyota as the only authorised motor vehicle companies and led to the establishment of, firstly, a viable domestic truck industry and then, after 1945, to the production of passenger cars.

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[93] It was, however, said to be much preferred to FDI (EIU, 1969, p 36) as is evident in the fact that, from 1950 to 1964, while 209 joint ventures were approved (70% with less than 50% foreign ownership) some 3000 foreign assistance contracts were given the go ahead (Safarian, 1993, p 245).

[94] Foreign investment and ownership played an important role in establishing some very large Japanese enterprises. For example Toshiba emerged from General Electric's Japanese operations, Mitsubishi Electrical from Westinghouse and Yokohama Rubber from Goodrich. As Komiya points out, "the average Japanese would not know that they were originally set up with a high degree of foriegn participation" (1972, p 139).

In the post war period, the MITI resisted liberalisation of foreign capital in motor vehicle manufacture so as to protect local firms. Japanese interests wishing to enter the industry or to strengthen their products and technologies therefore relied heavily on foreign technology licensing, under public sector supervision (Uchino, 1983, p 71). In this process a series of strategic alliances were formed with foreign interests (Shimokawa, 1994)[95] and, despite not controlling the process of industry development[96], the MITI, played an active role in shaping the industry.

This case shows that Japan's concerns were not just that a foreign inflow of funds might lead to a systematic outflow but also the more general concern that foreign companies would harm Japanese firms which were both technologically less advanced and vulnerable to take over by their relatively high levels of indebtedness (Imai and Itami, 1984, p 292). However, in keeping with our observations above, aside from general claims that inward FDI would "takeover domestic firms and dominate major domestic markets" (Uchino, 1983, p152), there is no readily available explanation for this assessment (Komiya, 1972).[97]

The policy position seems to have been based on a simple and ready assumption that what was good for Japan's big companies was good for Japan, partly because it enhanced relations among Japanese firms (Safarian, 1993, p 268) and between firms and government (ibid, p 253). This, in turn alludes to points raised in section 2.5, especially that the behaviour of Japanese firms is not explained simply by reference to each

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[95]In the early 1950's tie-ups were enacted between Nissan and Austin, Isuzu and Hillman, Hino and Renault (Uchino, 1983, p 91). The tie-ups with US firms came later and included cross-ownership and joint ventures. These were Mitsubishi and Chrysler in 1969, Isuzu and GM in 1971 and Mazda and Ford in 1971 and Toyota and GM's joint venture in 1984 (Shimokawa, 1994, pp 104-136).
[96]The lack of direct control by the MITI was shown in the 1960's when it attempted to force mergers and to restrict new entrants. While some smaller companies joined with Toyota, contrary to plan, new entrants such as Honda, Mazda and Mitsubishi emerged in passenger motor vehicle production.
[97]For example, Komiya (1972), in commenting on fears of a loss of Japanese control, among other concerns at liberalisation, stated that these fears were "analytically incorrect or ... [had] ... little factual relevance" (p 163).

individual case but an understanding of it requires an analysis of relations among Japanese interests provided in later chapters.

However, it is important that any success Japan has had in purposely developing indigenous firms came not simply from restricting FDI but by augmenting the restrictions with a series of other steps. Firstly, with government assistance, local firms sought strategic partners overseas (Gerlach, 1997, p 266).[98] This partnering allowed non-Japanese MNCs to have a "profound impact" on Japanese firms (Wilkins, 1998, p 117) but not by gaining easy entry and a sustained presence in Japan under FDI.

Secondly, while Japanese authorities protected local firms and the local market from foreigners, they promoted vigorous competition among them (Johnson, 1990, p 47; Murakami, 1989, p 39). This strategy has been summed up by Ozawa's notion of "reserved competition" by which protection from foreigners increased firms size and reduced average costs (Belderbos, 1997, p 156) and competition at home provided further spurs for the growth and efficiency of Japanese firms (Ozawa, 1997, *passim*). Importantly, it is an explanation which links the growth of organisation and the promotion of competition as means of fostering efficient development.

Overall, Japan emerges as strikingly mercantilist in its view of indigenous firms and there is a link between this and the egregious asymmetry of Japan's FDI position which we noted in Chapter 2. In short, the distinguishing characteristics of Japan's FDI position and policies are their asymmetry with respect to foreign entry compared with the overseas expansion of Japanese firms. An analysis of these characteristics should underlie Australia's policy response and efforts in this direction are made by deduction in Chapter 4 and elucidated further in Chapter 5 below.

Before concluding about Japan's FDI policies we first consider the process of liberalisation. It began primarily as the result of pressure for change from outside of official circles, particularly from foreign interests who argued that Japan's system of

foreign investment regulation was being interpreted in an *ad hoc* fashion against the foreigner (Okita 1989; Rosenbluth, 1989; Drysdale, 1995, *passim*; Safarian, 1993).[99] Pressure also came from some domestic sources for whom liberalisation occurring in major financial centres outside of Japan had increased the perceptions and apparent costs of regulation.[100]

The earliest deregulationist moves are said to have begun in the relaxations of 1964 when, on joining the International Monetary Fund, Japan's foreign exchange transactions were required to be free in principle (under Article 8 of the IMF Articles of Agreement), although they remained restricted in practice (JETRO, 1983, p 1). This situation was liberalised progressively during the 1970's to the point where substantially free entry of foreign capital was allowed if effective Japanese control could be demonstrated. Foreign investment proposals were still screened in some designated industries by the Foreign Investment Management Committee, a body made up of Vice-Ministers from the relevant Ministries (Safarian, 1993, pp 245-8) but, in 1976, inward FDI was "liberalised in virtually all non-financial sectors" so that approvals were automatic and no formal screening applied, although approvals were still subject to administrative review (Saxonhouse, et al, 1989, p 301).

In 1980, a series of further reforms were begun, including passage of a more liberal Foreign Exchange and Foreign Trade Control Law and a progressive extension of deregulation across the domestic financial system.[101] In addition, FDI outflows were given in principle approval (Komiya et al, 1990, p 10).[102]

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98 Many of these are detailed for the motor vehicle industry in chapter 8 below).
99 It has been said that potential foreign investors were unable to predict official interpretations of the regulations which were said to "vary with the length of the Chancellor's foot" (Safarian, 1993, p 243).
100 Financial and foreign exchange liberalisation proceeded in the words of one Japanese bureaucrat as "the opportunity cost of interest regulation and exchange controls rose" (Suzuki, 1992, p 45).
101 Major changes included the relaxation of interest rate regulation (Chai et al, 1991), the authorisation of a number of futures markets and the entry of increasing numbers of foreign institutions (Suzuki, 1992, pp 45-55). With regard to foreign exchange markets, a number of revisions to explicit regulation have

With regard to FDI, while the new Law allowed free foreign entry, as of 1997, the OECD recorded continuing Japanese reservations over liberalisation in a number of areas of strategic and social concern and, in addition, regulations remain to govern some FPI inflows (OECD, 1997, pp 99-101).[103]

In addition to these reservations, the Japanese Law still requires notification of inward FDI and the Japanese government reserves the right to intervene if a FDI proposal would imperil national security, is particularly deleterious to the balance of payments or "seriously affects ... (Japanese) business enterprises" (Safarian, 1993, p 252, parentheses added). The Foreign Investment Council has also been reorganised as the Committee on Foreign Exchange and Other Transactions and retains its policy advice function, with reviews (limited as they are in scope and number) left to senior government officials.

Despite that they started earlier and appear more substantial than FDI liberalisation in Australia, these reforms have been interpreted as cautious, half-hearted and slow. Some changes reversible.[104] Further, the subtle practices of administrative guidance remain and can confer on-going, de facto control (von Wolferen, 1989, p 402). Some have also

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been made, centring around dealings between Japanese financial institutions and foreigners.

[102]In the 1970's this freedom had been generally the case for Japanese firms engaged in manufacturing and commerce. The 1980 liberalisation extended this to the finance and insurance sector.

[103]In particular, Japan reserves the right to intervene in oil, aviation, leather activities and some primary activities. Reciprocity conditions also apply in real estate and membership of the Japanese stock exchange. As to FPI, regulations still govern yen-denominated securities issued to non-residents which cannot be re-sold to residents within stipulated time periods.

[104]For example, the the 1980 Foreign Exchange Control Law explicitly reserves the right of the Minister of Finance "to interdict capital flows in the event of (a) deterioration in Japan's balance of payments position, (b) drastic fluctuations in the foreign exchange market, or (c) disturbances of the money or capital market" (Rosenbluth, 1989, p 57). In addition, the authorised foreign exchange system also remains and "(can) be mobilized as a vehicle for carrying out exchange control in case of its re-imposition, the possibility of which is explicitly laid down in the new law.."(Narusawa, 1986, p 46).

argued that Japan's liberalisation process has been systematically "uneven" (Schmieglow, 1986, pp 18-20).

Regarding FDI policies in particular, it has been said that Japan's industrial policy makers' attitude to inward FDI was to make "every effort to postpone liberalisation as long as possible ... (and) to soften (its) effects" (Uchino, 1983, p 153) so as to protect indigenous firms from the "Second Coming of the Black Ships" (ibid, p 152).

It has also been suggested that Japan's liberalisation of inward FDI might have been carefully staged so that it opened up only those economic activities in which Japanese firms were strong and that the net result has been the almost total exclusion of foreign control.[105] This unevenness in exposing Japanese firms to foreign competition has been called "Japanese-style liberalization" (Uchino, 1983, p 153) and has repeated the process of waxing and waning we have seen in the automobile case in which progress on liberalisation and the development of indigenous capabilities have gone hand in hand.[106]

The final point for re-emphasis is that raised by Safarian in his comparative study: Japanese FDI policies have been integrated. They have been consistent in themselves and "link(ed) with domestic economic policy" (p 278) as "an aspect of industry policy" (pp 501-2). From the Japanese perspective, particular proposals for FDI are judged selectively on the basis of their suitability to specific developmental purposes and are fitted into policies for industry development.

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[105]For example, the areas in which early liberalisation took place were in *sake* production, soya sauce, pianos, motorcycles and shipbuilding i.e. "only in those industries where Japanese enterprises are highly competitive .... or where firms are small and numerous and foreign control (of the activity) is most unlikely" (Komiya, 1972, p 154).

[106]So, for example, FDI and technology transfer by licensing "has played a significant role in Japan's development. (But) this influence has decreased as Japanese firms have expanded their own research efforts in recent years" (Safarian, 1993, p 240). Similarly, as Japanese firms "gained managerial experience and technical expertise, foreign ownership lost its *raison d'etre*" (Komiya 1974, p 138).

This provides a broader perspective than has emerged from the reviews of the effects of FDI and of Australia's FDI policies and further emphasises the role of indigenous firms and the links among Japanese interests. But how do Japanese policies compare to other nations? We will examine two others, Canada and Sweden, selected because they pair nicely with Australia and Japan (Lall, 1998, p 230).

Canada has high levels of foreign control like Australia, indeed greater than Australia by some measures (Hill and McKern, 1997, p 205) and has also developed a similar system of foreign investment regulation in response to the concerns about foreign ownership, especially by US interests in the 1960's and 1970's.[107] The Canadian Foreign Investment Review Act established an agency similar to the FIR Branch of the Australian Treasury with similar formal and explicit screening functions.

As in Australia, the Act was reformed in the 1980's but in Canada's case it resulted in a quite new piece of legislation, the Investment Canada Act (1985). This reformation represented "a dramatic change in attitude towards foreign investment" (Paterson, 1986, p 317), parallelling but in some ways differing from the liberalisation of Australian policies.

While screening remains a device to restrict some kinds of FDI, the new Act intended to " encourage investment in Canada ... and to provide for a review of significant investments... " (ibid, emphasis in the original). Thresholds for review were lifted substantially (as in Australia) and the focus shifted to take-overs (previously new foreign businesses had been reviewed with equal vigour).

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107 The following table shows the ratios of FDI to GDP for Australia and Canada (%)

Year	Canada	Australia
1986	17.5	10.7
1990	21.5	21.8
1997	23.9	27.4

Sources: FDI data from OECD *International Direct Investment Statistics Yearbook*. Data for GDP from OECD *Quarterly Accounts*.

Canada's FDI liberalisation admits exceptions in more areas than Australia, including life insurance companies, road transport and publishing and restricts government assistance to foreigners in agriculture. Foreigners cannot qualify for special status of an Investment Corporation nor can foreign firms be awarded certain government consulting contracts (OECD, 1993). Unlike the Australian case, the Invest Canada Act also maintains tight restrictions on foreign investment "related to Canada's cultural heritage or national identity" (Paterson, 1986, p 326). Unlike the Japanese case, Canada's FDI policies were not closely integrated with other development initiatives and Canada lacks a "strong and consistent set of industry policies" (Safarian, 1993, p 502).

A significant episode in the development of Canada's policy and the global FDI policy framework occurred in 1982 when the US requested a review by the GATT of the criteria by which Canada's screening process determined that a foreign investment would make a "significant contribution to Canada" (Paterson, 1986, pp 300-4). While Canadian law did not actually specify how this could be shown, to help in its deliberations the government invited undertakings from foreign investors regarding, among other things, their intentions to increase local raw materials processing, to use local managers, to undertake local purchasing and to meet export targets.

The US argued successfully that some of these were performance criteria and so contravened provisions under the GATT which require that governments allow commercial decisions to be based "solely on commercial considerations" (Paterson, 1986, p 303). It is highly likely that a similar result would come from a challenge under the current rules of the WTO. Importantly for Australia, many of the criteria Canada used for screening are also applied explicitly by the FIRB and it is likely they too would fail to meet the same kind of challenge.

If Canada's policies are similar to those of Australia, by contrast, Sweden's foreign investment policies fit more closely the Japanese type. As in Japan, FDI in Sweden "has been modest..." (OECD, 1993, p 11) and Sweden has long maintained restrictive

conditions on FDI (Kokko, forthcoming). The resulting imbalance of inward and outward FDI persists into the late 1990s (Lall, 1998, p 434).

Tight FDI regulation has been consistent with the broad aims and significant role played by the Swedish public sector which have included support for indigenous firms (Notermas, 1993, pp 140-147). In addition, some large, private, Swedish firms have included in their articles of association clauses which also restricted foreign ownership. Swedish companies without such clauses have, in the past, been required, along with foreigners, to seek authorisation for acquisitions. This again shows the Swedish government's preference for local ownership undiluted by foreign influence.

The 1982 Law on Foreign Acquisition of Swedish Firms was an attempt to limit, by requiring approval, any supposedly negative effects of FDI.[108] It included provisions that required consultation between the prospective foreign investor and any local groups such as a trade unions which might be affected (Safarian, 1993, p 192). However, doubts emerged as to the effectiveness of the legislation because its "rules were rather vague and follow-up was weak" and because "problems associated with foreign investment were seen to have been exaggerated ..." (OECD, 1993, pp 21-2).

Liberalisation in Sweden generally was delayed and did not begin until the late 1980s (Notermas, 1993, p 139). Some argue that liberalisation was only undertaken because Swedish companies required less restrictive arrangements for building their business in Sweden and overseas and that without liberalisation at home they would leave because "the strictures of (Swedish) national policy are seen to have become incompatible with profitability" (Bryan and Rafferty, 1999, p 136).

In 1992 the Law requiring permission for entry was abolished along with the legal basis for the foreigners clauses in companies' articles of association. However, foreigners

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[108]For example, it was feared that foreign ownership could lead to restrictions on exports, new technology, etc. or could lead to competitive activities previously sited in Sweden being moved off-shore.

making investments in Sweden are still required to undertake a registration procedure, said to be non-discriminatory.

This informal screening process is undertaken within the economic and industry development bureaucracies, as in Japan, and there is no equivalent of the FIRB. The process lacks published criteria and the procedure is preceded by vigorous and wide-ranging consultation (Safarian, 1993, p 192). The lack of a formal mechanism is also reflected in the fact that agreements for foreign entry "are at least morally binding" but do not carry penalties (ibid, p 193).

A contrast emerges from these comparisons. On the one hand are nations such as Japan and Sweden which have identified development of indigenous firms as important and have set FDI policies with that in mind. Limiting inward FDI has been used as one of a range of means to strengthen local firms and the policy has been adjusted as those firms have become competitive, although, in both cases inward FDI remains limited.

By contrast, Australia and Canada have adopted formal screening procedures primarily aimed not at developing local firms but at eliminating certain cases of FDI which are judged contrary to the national interest. In Australia's case, policies in support of indigenous firms have been weak and sporadic and have not distinguished clearly between indigenous and foreign-owned local firms.

However, for both nations, screening has not kept out FDI and, at least in Australia, screening appears more stringent and exclusionary a test that it is in fact. In addition, neither Australia nor Canada have integrated FDI policies with other arms of economic development (not if by this is meant more than adding criteria, such as the desire to do more raw materials processing or to enhance competition, onto the list by which net national gains are meant to be determined).

The final matter for this section is to note briefly some studies concerning the effectiveness of financial incentives aimed at attracting FDI in general. That is not

precisely our concern which is rather to assess the policy implications which arise with the arrival of FDI. Chapter 2 has said all that is possible about the desirability of more or less in aggregate. In any case, most studies suggest that incentives are not a significant influence on FDI, suggesting that the primary policy concerns lie elsewhere. Nonetheless, some recent research can be reported.

The UNCTAD view is that, despite the major measurement difficulties which " ... have proven to be difficult to unravel, despite decades of research ... the overwhelming evidence ... (is) that incentives are a relatively minor factor .." in determining the spread of FDI (UNCTAD, 1996, p 51).

Indeed, it is said that developed countries do not typically use financial incentives for FDI (UNCTAD, 1996, p 18). This fits with the view of Safarian who concluded similarly from his very large and detailed study that incentives are subject to change in the short term so are "unlikely to attract long term investment" (1993, p 441). An Australian studies has also shown that incentives have been ineffective in determining the intra-national location of FDI (Edgington, 1990, p 233).

In chapters 7 and 8 a number of policy proposals are canvassed in response to specific qualities and instances of Japanese FDI but these are not primarily financial incentives (although, of course, they have pecuniary implications). This study leaves open the question of the effectiveness of various kinds of FDI incentive and concerns itself in subsequent chapters primarily with discerning the principles which decide whether and how government should respond to Japanese FDI.

3.5 Conclusions

This final section summarises what has been said about FDI policy problems and practice. We have shown in section 3.2 that it is not possible to generalise about the

effects of FDI on the host nation. The literature listed there associates FDI with a wide range of effects and often with their opposites as well. For many effects, measuring the net impact of these multivalences requires large amounts of very detailed investigation to provide estimates and, for some effects, meaningful measurement will be simply impossible.

The same analysis highlights particularly for policy the effects which spin off from the FDI activity beyond the investors' control and are therefore available in the host economy. These are particularly difficult to anticipate and measure. Indeed, much of the work which follows centres around the task of clearly conceiving these effects and the policy rationale that extends from them.

More immediately relevant is the proposition that the difficulties in measuring effects occur not just in trying to generalise but in case-by-case assessments too. Detailed examination of each instance, backed by on-going, intimate monitoring would be required in any sophisticated approach and this would need to combine quantitative and qualitative assessments. The resource requirements would be large indeed and the results incomplete and therefore uncertain.

This has led to a critical assessment of Australia's screening apparatus. But before we leave the matter of the FIRB by calling for its removal, it is possible that it offers some benefits not by its formal role of filtering out harmful instances of FDI but by offering a mechanism for informal "pressure on foreign investors to operate in Australia as good corporate citizens" (Brown and Carey, 1999, p 56). The advantages of a more informal approach are also highlighted by the cases of Japan and Sweden.[109]

Firstly, implicit criteria and informal mechanisms allow for flexibility, which might offer advantages given the immeasurables and unsummables involved. Secondly, less formal

[109] To illustrate the subtelty in the Swedes' approach, it is said that "where (performance criteria) are voluntarily undertaken by the foreign firms, they help government to decide on approvals of acquisitions" (Safarian, 1993, p 193).

screening is less likely to be identified as an impediment to liberalisation and less likely to be challenged under the international Agreements. Thirdly, behaviour might change because a merely informal approach would still require that foreign companies explicitly consider the range of impacts they might have on the host, a consideration they might not make otherwise.

However, informal screening procedures could be expensive: because they lack explicit rules, submissions would become more difficult to prepare and the outcomes would be more uncertain. Moreover, if an appeals procedure were in place, the bases upon which it made determinations would quickly become *de facto* criteria. If appeals were not possible, the procedure would lack transparency and likely be subject to claims of arbitrariness.

Whether or not informal screening is likely to be beneficial, the central point made in this chapter remains that there is no economic calculus by which we can reliably and readily answer the policy questions surrounding FDI. FDI policy making is, in some degree, an irreducibly uncertain business, concerning matters which are "complex and subtle" and turn on reasoned judgement (Moran, 1999, p 3).

A broader question is whether these observations about FDI policy lacking an empirical base because it deals with a range of effects with little regularity and plenty of immeasurables, might not be a general observation about policy making. Certainly, there are those who, arguing more generally, conclude that the information requirements of good policy are so great as to make it impossible or at least unlikely (Krugman, 1986; Stiglitz, 1996; Coase, 1960).[110] Whether or not the view is generalisable, the rest of this

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[110] Krugman (1986), who is not intrinsically antagonistic to the notion of strategic intervention, believes that practical problems mean it is not possible to confidently identify strategic sectors (p 15). This alludes also to older debates (particularly involving Hayek, Lerner, *et al*) concerning the feasibility of central planning, especially Hayek's view that "the information problems facing the central planner were overwhelming" (Stiglitz, 1996, p 14). Coase is also of a similar view having written in 1960, in the midst of the post war optimism about big government, that "government regulation will not necessarily give better

study may be conceived as dealing with the question of how FDI policy can proceed rationally when there is no policy calculus.

One reason for thinking that it can is that many current policies lack an empirical base and yet are pursued with vigour. So, for example, a study of industrial incentives offered by US States (Fisher and Peters, 1998) follows a similar logic as here, arguing that the purpose of such policies is in large part to create benefits captured not by the recipient but "by other individual and corporate businesses" (p 3) and that any calculation of net benefit from such incentives "is a dauntingly complex task" (p 4), partly because it is "hard to know what ... would have occurred in [their] absence" (p 14). Nonetheless, as that study shows, such policies are pursued with alacrity and, sometimes, to good effect.

Another example from the current Australian context is the decision to implement Australia's National Competition Policy as part of the market reforms of policy liberalisation. Australia's Industry Commission reviewed the so called Hilmer Reforms on which the policy is based. The review proposed that "major improvements .. are likely to come from greater competition" (p 11) because it will reduce the "opportunities for monopoly 'rents'" (p 15) but, again, there is no means of predicting accurately or of measuring or monitoring the result to ensure that net outcome.

It is true that the IC models the impacts of the policy reforms but they admit that their model "cannot produce an answer to the question of the size of the ... gains" but must rely on "judgements ... about their nature and size" (p 52). Assumptions are also needed about the price impacts of any cost changes. Buried deep in the Commission's report is "the main message to come out of the [modelling] studies ... that there is a lot of uncertainty about the direct impact of micro-economic reforms" (p 494).

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results ... (and) it is my belief that economists have tended to overestimate the advantages which come from governmental regulation" (p 18)

If such a major and widely supported policy reform lacks an empirical base, it suggests that policy making can sometimes proceed without it. A central question for the start of the next chapter is then how?

The final points to be made about FDI policy arise from the international comparisons which have alluded to a raft of additional and equally subtle issues. Prime among them are two. Firstly, that some nations see advantage in promoting indigenous firms despite that the analysis here makes quite clear that if both indigenous and foreign firms can borrow, invest, buy and sell from anywhere, there is little difference between them. Nonetheless, it would be valuable if the understanding on which policy implications for Australia are based were also able to offer an economic explanation for this policy behaviour by other governments.

This seems especially relevant given the shift in Australia's strategy for financing the current account deficit which we reviewed briefly in chapter 2. That shift places greater emphasis on local "firms and managers" (Stopford, 1997, p 65) and less on government and foreigners. It has been associated with the build up in private foreign debt and has probably contributed to the spate of post-liberalisation volatility and corporate imprudence. The point at issue is to interpret this shift in a mix of policies which does not include support for indigenous firms.

The second point is that of integrating FDI policies with industry and economic development policies more generally. Again, while this has some obvious appeal, it lacks a clear policy rationale and raises the question of what opportunities might be lost by the absence of such integration, as in Australia. Again, it would be desirable if the policy implications which arise with Japanese FDI in Australia were based on and therefore consistent with a broader understanding of the development role of government.

There is of course an alternative. If screening is ineffectual and policy making uncertain, why not just follow the lead of liberal reforms and rely on competition among private interests to optimise performance, so doing away with a more direct and specific policy

approach to FDI? As the following chapters show, a reliance only on liberalisation and competition misses some important cues about FDI policy. Chapters 5 and 6 address these questions after Chapter 4 determines the means to proceed.

Chapter 4: A Theoretical Approach

4.1 Introduction

The previous chapters have established that neither official data nor existing studies provide a sufficient basis for FDI policy. Further, the current screening procedures of the FIRB are based on untenable propositions about the ability to measure and sum the effects of FDI. To overcome the policy impasse created by these deficiencies, this chapter looks to theories of FDI to provide and alternative approach.

It begins with a justification for proceeding in this way. It then reviews the development of theory from the policy perspective and focusses particularly on the emergence of Dunning's eclectic, systemic view and the development of his ownership-location-internalisation (OLI) paradigm. Dunning's work is assessed critically from a policy point of view and the analysis of his synthesis leads to a bifurcation, into a malign and a benign view of FDI, associated with the theories which conceive of FDI as anti-competitive and as transaction cost economising respectively.

The central point is that policy cannot rely solely on either theoretical view. Instead, the investigation of theory canvasses possibilities for policy attention so that we address the implications associated with both conceptions of FDI (Stretton, 1969).[111] In short, the investigation finds an ambiguity in theory which should be matched by an ambivalence in policy.

But, firstly, why proceed by means of deductions from the general understanding provided by theory? It is certainly not the only alternative. It would also be possible to proceed by detailed study of a limited number of particular cases of Japanese FDI in

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[111] Professor Stretton states that theory can be used to attempt a range of different tasks and that it can be misused. Its uses include to "warn of dangers, report valuable trends or opportunitites, propose programs, debate strategies .." (ibid, p 398).

Australia and to arrive at policy proposals by induction. There are four reasons for not adopting that course.

Firstly, there is a general problem, long understood, which Hollis and Nell (1975) have called "the riddle of induction" (p 42), i.e. what is true of the part might not be true of the whole. The lack of generalisations about FDI, about Japanese FDI and about the effects of FDI mean that proceeding by induction is fraught with problems of this kind. Of course, equally, particularising from the general is problematic in an analogous way, it risks missing important differences among members of the class. Hence, the crucial reasons for proceeding deductively must lie elsewhere.

The second reason is that the case studies approach would rely heavily on questions put to incumbent investors. Their answers will be prone to obfuscation, especially if it were understood that the purpose was to influence government's spending and taxing behaviours and, even more so, if the investor's intentions were less than benign. It would not be enough to rely on questionnaires. Some additional means would need to be employed to check the veracity of all information. That would be possible but would be resource intensive and might well rely on prior deductive analysis.

Thirdly, the inductive focus on a small number of individual cases might fail to see the importance of relationships among Japanese investors as a whole and the description of Japanese FDI in Chapter 2 suggests that would leave a significant gap. A general approach is more likely to be awake to this possibility, as will be shown in applying these theories in the following chapter.

Finally, proceeding inductively would be to base policy on the study of particular cases of Japanese FDI rather than on an understanding derived from a general conception of FDI. Such policies could be seen as discriminatory. This might be detrimental to the flow of FDI and might also be judged to contravene some of Australia's international obligations.

Each of those difficulties with induction could be partially mitigated and the choice between that course and the more general, theoretical approach adopted remains a matter of weighing pros and cons. The advantages of a deductive approach include firstly, that while there is a dearth of case studies of Japanese FDI in Australia, there is a considerable theoretical literature, albeit not without problems, as we find below, and often with poorly delineated policy implications.

Secondly, the general understanding provided by theory seems better suited to establishing policy which should be based on reasoned principles and not on particular cases. Having established principles, actual policies are then also more predictable than would be those based on a reasoning indeed from a limited sample.

The final reason for favouring deduction is tactical. As we have seen, the dominant liberal policy reforms in Australia, based on privatisation and promotion of competition, have been deduced from economic theory, not derived by induction and measurement. This implies not only that the deductive approach is legitimate but also that, if there are serious weaknesses with the reforms, they are most likely to be revealed by adopting a similarly based approach.

To state the obvious, none of this is to say that policy could rely entirely on theory. If the implications of these theories had no relevance to existing policy questions, then the approach might be judged to have failed. That would be an interesting and somewhat important conclusion in itself. However, the application of this approach in Chapters 5 and 6 and the three illustrative cases examined in Chapters 7 and 8 show its value and give the study empirical support.

And, as intimated above, this is not to say that there are no difficulties in using FDI theory. Perhaps the greatest of these arises from the deep dichotomy we find between the two major views which interpret FDI as malign and benign respectively. There are also a number of other theoretical points of view which need to be understood in terms of the

two broad interpretations and some confusion in the policy implications derived from them. Overcoming these confusions is one of this study's contributions to the literature.

4.2 The Development of Theory to Dunning's Eclectic Approach

Overviews of the history of FDI theory can be found in Ietto-Gilles (1992); Cantwell (1991); and Dunning (1997c, pp 59-62). This exposition begins by examining the views of FDI from the late 19th century, firstly that based on neo-classical theory (a review of earlier theories can be found in Dunning, 1988, pp 120-132).

The neo-classical view was first formulated in the works of Heckscher (1919) and developed further by Ohlin (1933). It pictures competition among sources and uses of capital as leading to a flow from where it is relatively abundant, and therefore has a low marginal product, to where it is relatively scarce. The flow is prompted by differences which develop in the prices for capital in different regions. It is implicit that this is an international not a global flow as it is a reflection of the different factor prices that exist because of different relative scarcities in different national economies. However, beyond that, capital is amorphous and nationless.

Some of the weaknesses of this view are obvious from the definition of FDI: it is not the only form of foreign investment flow which might respond to differences in relative scarcity nor does it necessarily involve a flow of capital, it is essentially a transfer of influence or control. Moreover, the neo-classical view is at odds with the fact that, as the data in Chapter 2 show, the flow of FDI is predominantly among capital rich nations rather than from rich to poor. As Leontieff's elegant paradox shows, it is also a view which is inconsistent with the capital composition of some major trade flows so that neo-classical theory overlaps the motives for FDI and trade (Leontieff, 1956).[112]

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[112] Leontieff showed that, in the post war period, the relatively capital-rich USA was importing goods more capital intensive on average than were its exports.

Similar problems exist with views of FDI as imperialist, views most often formulated from a Marxist base. These have their genesis in the early 20th century in the works of Hobson (1902) and later Marxists like Luxembourg (1913). They conceive of the flow of FDI as being the result of underconsumption, capital accumulation and declining rates of profit in advanced nations. These views have been restated by later Marxists such as Baran and Sweezy (1966); Cohen et al (1979, p 25); and in the later works of Hymer (1970a; 1972a).

Another thread to the imperialist theories is that provided by Lenin and Bukharin whose separate works of 1917 pictured FDI as an inevitable development of capitalism which adds to its productive capacities but which, ultimately, reveals its underlying contradictions and provides an additional, international dimension to its transformation (Jenkins, 1987, p 27). These views too have been restated more recently in the so called world systems theory, as a permanent relationship of subservience and unequal development (Long, 1981, p 26; Murray, 1972; Hymer, 1971a; Girvan, 1976, p 7; Stauffer, 1985, p 23).

While agreeing with Landes that the Marxist notion of imperialism is "not foolish, neither is it empty" (1961, p 497), it suffers from some of the same failings as does the neoclassical approach: it does not distinguish between FDI and other forms of foreign investment, it sees capital as flowing from wealthy exploiters to the poor and exploited. Not only is FDI predominantly among rich nations, as Paul Streeten has said, an imperialist view also fails to acknowledge that "the instrument has been adopted by some ex-colonies." (Streeton, 1986, p 249).

There is another fundamental problem with the neo-classical approach: it is not based on an explicit theory of the firm and this is a particular problem as it is firms which undertake FDI (Hennart, 1982, p 10; Reinicke, 1998, p 7). It is said that, in neo-classical theory, the firm is "just a black box" (Casson, 1987, p 40; Hodgson, 1998, p 217; Ethier, 1998, p 9; Dunning, 1988, p 120). This is because the mechanisms which neo-classical

theory posits as fundamental work on the basis of self-interested competition among individual agents. Economic activity is understood as being organised and governed by prices set by these competitive processes and there is no need for and therefore no theory of organisation within it. To the extent that competition is effective, this view also implies an optimality to economic outcomes, including FDI flows, a point to which we return below.

In response to the failings of grand ideas, theories more specific to FDI have been formulated and "the most widely accepted theoretical framework" is that associated with the prolific writing of J H Dunning (Graham, 1996, p 75). These have been formulated into his eclectic theory, first published in 1977. Dunning's importance is seen in the fact that the number of applied studies in the field which use his OLI framework is so great that it is the commonly used framework. A review of the collection of essays published in his honour in 1992 (Buckley and Casson, 1992) and the eminent authors it attracted also underlines his importance. That work shows that Dunning had published 229 articles and books up until that date and the references to his recent works in the bibliography for this study show how the pace of his publishing and the scope of his influence has not waned since then. The eclectic paradigm, and the internalisation view to which it is closely associated (as we shall describe below), has been described as "the paradigm for which we have been searching" (Rugman, 1982, preface).

Essentially, Dunning saw the need for an eclectic combination of notions from the theory of trade and the theory of MNEs because, in addition to the general problems with previous approaches which have been identified above, as Dunning put it, "the decisions to trade or engage in foreign production are often alternative options to the same firm, (and) any explanation of one must, of necessity, take account of the other" (1977, p 398). This point led Dunning to combine notions from trade theory with those of the theory industrial organisation so that ownership and location endowments became the explanators of the flow of FDI.

In short, the eclectic theory has it that FDI will occur when location endowments at home are best made use of by ownership advantages held by foreign firms. By making use of these dual advantages, foreign firms are able to overcome the higher costs necessarily associated with foreign production.

The location advantages are "of the Ricardian or H/O [Heckscher/Ohlin] type" and ownership advantages such as would lead to FDI can be thought of as "those which any firm may have over another" (Dunning, 1977, p 394) and refer to Bain's notion of barriers to entry (Bain, 1956). As such they might be related to size or exclusive possession of technology or, as Dunning adds, might come from links of the FDI affiliate to the MNE parent (Dunning, 1977, p 401).

This then is the eclectic part of the theory. But Dunning's theory goes beyond the notion that the MNE is simply a vessel for an ownership advantage. It asks also why the ownership advantage is not sold to foreigners. Why must it be exploited by FDI and the control this implies? To address that question, Dunning constructed what he described as a "systemic theory of ownership advantages" (Dunning, 1977, p 406).

The systemic theory combines the notion of monopolistic advantages first associated with Stephen Hymer's view of FDI as a manifestation of oligopoly, with "an idea first formulated by Coase in 1937" that the growth of the firm is a means of economising on the costs of conducting international economic activity at arm's length (Dunning, 1977, pp 401-2). In other words, according to Dunning, the reason the MNE undertakes FDI is not simply because of location advantages in foreign sites, nor because the firm possesses some advantage but also because those advantages can best be made use of by extending control under FDI, rather than by, for example, selling the ownership advantage to host nation residents.

We will expand on the latter notion in the analysis which follows. The point here is that Dunning's approach uses not only "the orthodox type of monopoly advantages" but adds to that view "the advantages which accrue through internalisation" (Dunning, 1977, p

408). The eclecticism is then tripolar: FDI requires ownership (O), locational (L) and internalisation (I) advantages. All three are necessary conditions which determine, simultaneously, which location is best, that the disadvantages of operating overseas can be overcome and that the best way to approach this situation is by extending control.

One of the reasons Dunning's approach has been so long lived and influential is its adaptability. Not only does it marry with the resurrected view from Coase but with the notion of an ownership advantage at its core it is compatible with a large number of views about how such advantages arise and are made use of internationally by FDI (Corley, 1992, p 11). We will develop that idea in section 4.5 below.

Dunning sees his OLI paradigm as focussing on generic notions of market imperfections (Dunning, 1977, p 403). These allow for market power and they also give rise to advantages of internalisation over arm's length sale or licence of ownership advantages. This line of argument has also been repeated by Rugman (1982, 1985) and situates Dunning's view within orthodox market theory which has elaborated a number of aspects of market failure.

There can be no doubt that Dunning's work has systemetised the study of FDI and his influence is widespread (Corley, 1992, *passim*). The adaptable OLI eclecticism has provided an important "descriptive and classificatory device" and a framework for understanding the phenomenon of FDI (Ietto-Gilles, 1992, p 124). However, we are interested in its ability to generate important policy implications and for that it is much less helpful. To see why we must first explain the distinct, self-interested purposes implied by the monopoly and transaction cost economising motives.

Essentially, Dunning's approach has weak policy implications because it combines two incompatible motivations for FDI; monopolising and economising purposes. As to the latter, Dunning's use of internalisation advantages pictures the FDI behaviour as motivated by the fact that it is an organisational arrangement which reduces the costs of undertaking the activity. FDI proceeds when it is more efficient and the savings involved

create a gain which is appropriated by means of the control provided by corporate growth. It is the prospect of this net gain which motivates the behaviour.

The monopolising motivation is very different. This pictures FDI as aimed at the potential which control provides for sharing more greatly in whatever gains are created by the relevant exchanges.[113] The market power provides the ability to capture rents from the economic surpluses created by sales made to customers at prices greater than those of competitive equilibrium and it is this ability to alter the distribution of gains which motivates the behaviour. Monopolising not only changes the distribution of gains, it also restricts output and raises prices, thus altering the allocation of resources from the optimal mix orthodox theory associates with a situation of effective competition. In both economising and monopolising explanations, self interest drives the investment decision but the source of private gain and the impact on total output is different in each.

This eclecticism about motives is more problematic than that associated with Dunning's combining theories of trade with theories of the multinational firm. There are problems from both a policy and a theoretical point of view. We will sketch these here and elaborate upon them below.

As to policy, the problem is easy to grasp: the eclectic, systemic approach does not add the policy implications of one motivation to those of the other. Rather, it implies that the dual nature of FDI means that any costs of monopolising are offset by the benefits of economising in such a way that the net result is "an optimal combination of ownership, locational and internalisation advantages" (Morsink, 1998).[114] Even if it leads to larger and fewer firms, FDI is thought of as being the result of an optimising, market process (Lipsey, 1997).[115]

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113 These arise from different relative prices in the host and source nations.

114 Morsink describes his work as using Dunning's OLI framework (p 10).

115 Lipsey wrote: "if the market leads to the formation of large firms because they are more efficient than small firms, it seems odd to call this a 'market failure'" (p 85).

This is a damaging combination. While it reflects the ignorance of the net benefits of FDI which we have reasoned to in Chapter 3, it undermines our purpose in turning to theory. We want to use theory to alert policy makers to possibilities. Dunning's approach creates a muddle so that instead of following the policy implications of both it runs the danger of addressing neither effectively. As he puts it "[t]he short - but hardly satisfactory - answer [to the policy question] is that it all depends on the kind of FDI .." (Dunning, 1997a, p 218).

This double-sidedness runs through much of Dunning's work so that, for example, he finds a policy paradox in relation to the global operations of MNEs and argues that what is needed is both more and less government (1997a, p 36).[116]

This central point, that there are two sets of coincident and therefore countervailing policy implications, weakens Dunning's policy approach, so that he is often found arguing that good is done by "avoiding inappropriate policies, rather than by taking positive action" (Dunning, 1997d, p 120; see also Dunning, 1997a, *passim*).[117]

The need to find a way around this enervating ambiguity is further heightened by the theoretical weaknesses of Dunning's position. Being so important in current thinking about FDI, Dunning's position has "become the focus of an ongoing debate over what factors constitute a general or integrated theory" (Ensign, 1995, p 19). While Dunning himself has maintained that his theory gives a general view of FDI by itself, other influential writers have rejected that position.

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116 Dunning declares that we have a "sense of bewilderment" about FDI which "arises because many of the events now occuring are paradoxical" (p 358). He adds that the role of government is one such paradox that requires "less, yet more" government (pp 363-365).

117 To further indicate Dunning's policy ambivalence, he maintains simultaneously that "a free market needs strong government", that the role of government is a subject of hot debate and that market failure is not a sufficient condition for intervention to improve welfare (1997a, p 364).

Mark Casson and Peter Buckley particularly, both leaders of the internalisation view, have challenged the systemic approach (Conley, 1992, p 12). Casson argues that Dunning does not appreciate the generality of the internalisation theory (Casson, 1987, pp 33-5) and Buckley has repeatedly pointed out that the apparent importance of any ownership advantage arises only because Dunning's eclectic view is static (Buckley, 1983[118];1988, p 182; 1990, p 661). We will develop these ideas below.

In addition, Dunning's position has been criticised because it uses the term internalisation in such a loose manner. The problem is not just Dunning's. The literature shows a great variety of views about what it is that is being internalised. This conundrum provides the starting point for the following section.

4.3 Foreign Direct Investment as an Economising Behaviour

In Dunning's eclecticism and elsewhere in the literature, it is unclear what is being internalised in the growth of firms via FDI. The debates over this issue are used to develop a view of corporate growth able to explain horizontal integration and diversification in a way consistent with the more straight forward case of vertical integration. This is an important insight, especially for policy, and it is shown to be consistent with the development of Coase's work as elaborated in his second seminal paper (Coase, 1960). It also leads to a repositing of Coase's work as a radical adjunct to neo-classical theory (as he saw it himself), rather than as a refinement of market theory. It provides the basis for much of the policy agenda detailed in Chapter 6 below.

The problem as to what is being internalised was apparent in Dunning's original eclectic formulation which has firms growing to internalise "markets" (p 395); "advantages", "resources", "products" and "activities" (p 402); "operations" (p 405); "rights" (p 406); "assets" (p 406); "technology" and "market imperfections" (p 408). Other notions are

[118]"The firm-specific advantage is a reflection of this cut-off point as a snapshot of a dynamic process" (p 38).

found in the literature; of firms internalising “externalities” (Magee, 1977; Hennart, 1991); “non-rival goods” (Romer, 1993); “market transactions” (Nicholas and Maitland, forthcoming) and, perhaps most opposedly of all, in the debate between Casson and Rugman, of firms internalising “markets” or “missing markets” respectively (Casson, 1987, p37).

The view developed here coincides with none of these but, rather, sees corporate growth as internalising effects which spin off from economic transactions. To sort through the problem, we need to first return to Coase’s original work (Coase, 1937) on which these latter applications are all based and use it to show how a simple transaction cost economising view can approach the matter of vertical integration.

The orthodox theory of markets argues, as we have seen, that prices set competitively must lead to efficiency because when parties to transactions have the ability to change partners, they need not tolerate inefficiency. If it is possible to switch from unsatisfactory partners, the penalties for unsatisfactory behaviour are effective and so too are the rewards for desirable behaviour. There is no need for on-going arrangements among private interests (Casson, 1987).[119] In every instance where utility can be enhanced through exchange, the theory implies that rivalry will ensure that the requisite transactions will be successfully completed. As Putterman (1986, p 7) has put it, efficiency arises from "market relationships [which] are short term and anonymous.."

In essence, Coase’s insight was that it is rarely possible to undertake exchange in this way. Competition is not always effective and efficiency sometimes requires organisation: contractual and institutional arrangements which substitute for the organisational principle of the competitive market. The costs of economic organisation, so called transaction costs, are those incurred in specifying, monitoring and enforcing contractual arrangements. Choices among various modes of organisation are made to economise on these transaction costs. Those choices determine how and if an economic activity will proceed. In other words, in

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[119]"In the neo-classical world, the invisible hand of the market does practically all the managing that is required" (p 40).

instances where competition is ineffective (i.e. to the extent that switching costs are non-trivial), efficiency is pursued by the parties specifying, monitoring and enforcing cost minimising contractual arrangements under which the economic activity can proceed.

In short, Coase's original argument, as set out in his first famous article of 1937, is simply that the costs of undertaking transactions provide the incentives to create arrangements which economise upon those costs. One such set of arrangements are those within firms. Firms exist and grow when transactions are more cheaply organised within them. They are a transaction cost-economising response to difficulties in transacting and reduce but do not eliminate the cost of combining the necessary resources efficiently. [120]

This is the essence of Coasean or transaction cost theory and the propositions involved arise directly from Coase's 1937 paper. The argument has been restated in a similar fashion and popularised by Williamson (see, for example, Williamson, 1985). He explains the position as one of small number trading in which competition is ineffective because of idiosyncratic investments (Williamson, 1986, Table 1-1, p 31).[121]

However, there is a problem here, the solving of which advances our understanding of transaction cost theory and its application to FDI. The usual formulations of transaction cost theory are based on a description of vertical integration by which a firm incorporates suppliers or customers (Williamson, 1986).[122] Corporate growth of this kind can therefore be described as a process of internalising transactions. However, such a description is ungeneralisable and showing how that is so links together Coase's two seminal works: his 1937 "Theory of the Firm" and his 1960 "Problem of Social Cost". This linking allows for a general view of corporate growth but, more significant for present purposes, it also provides access to Coase's most succinct and explicit references to the role of government.

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[120]"It is true that (costly) contracts are not eliminated when there is a firm but they are greatly reduced" (Coase, 1937, p 391).

[121]"If transactions are supported by non-trivial investments in durable transaction-specific assets, then what may have originated as a large-numbers bidding condition at the outset will be transformed into a bilateral exchange relation thereafter..."(p 84).

It is clear that firms may grow by horizontal and diversified as well as by vertical integration. However, these cases cannot be described as the internalisation of transactions. Horizontal integration involves growth of the firm to internalise the activity of a rival. Diversification involves growth into activities related, but in ways neither vertical nor horizontal, to the firm's line of business (Weder and Grubel, 1993).[123] In both cases there is some relation between the firm's current activities and other activities outside the firm but there are no transactions between these parties. It cannot then be true that the firm grows generally by internalising transactions nor is it obvious which transaction costs are being economised upon in the processes of horizontal and diversified growth. It is this confusion that has led to the plethora of views described above as to what is being internalised.

Before showing how to solve this problem, we should note firstly that it is common to side step it by conceiving of transaction cost economising growth as internalising markets (see especially, Casson, 1987; or Cantwell, 1991, p 23; *et al*). By this view, there is no problem: vertical integration is not about internalising transactions, so that an activity previously performed externally is now performed internally. Rather, it is about internalising the up or downstream markets. Similarly, horizontal integration is a matter of internalising markets for intermediate goods.

This is a clumsy exposition. Firstly, the authors do not have in mind that internalisation brings within the firm all the exchanges previously undertaken in the particular market in question but only those exchanges in which the firm was involved. At best this internalises only part of a market.

Secondly, to say that the transaction had been performed in a market but was then internalised implies that it had been subject to some significant level of competition; the implication arises because, as Hayek has put it, economists conceive of markets as “the general context in

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[122]Williamson states that "vertical integration is a paradigm" (p 84).
[123]Diversification is taken here a synonomous with conglomerate growth i.e. "(c)onglomerates consist of firms that by output or input characteristics belong to

which competition takes place" (Hodgson, 1998, p 219). But internalisation sometimes occurs in cases where the alternative is an arm's length contract with a monopsonist, monopolist or oligopolist; none of which are greatly constrained by competition. To describe such a choice as between firm and market is to misrepresent it. Generally, such situations are choices between internalisation within the firm and contractual arrangements with other private interests. Corporate growth is not generally the internalisation of a market.

Finally, this conception implies that the firm creates competitive processes within it by internalising a market. This would be to limit too closely what it is that managers do. While competition is used within firms, intra-mural processes are not merely a replication of market competition within the firm.

Rather than this side-step, the issue can be resolved, as said previously, by following the development of Coase's work from the 1937 view of corporate growth to his 1960 view about the problem social costs pose for maximising the total product. Firstly, however, we should note that, even in 1937, Coase was aware of the sharp difference between vertical and horizontal growth. In that early paper, he considered the case of horizontal integration (which he called a "combination" (pp 397-8)) and, in making a general point about limits to the growth of firms he noted that,

> in most cases (excluding the case of 'combination'), ... there is a market transaction between these two producers ... (p 395, parentheses in the original).

In 1937, the way around this inconsistency was to propose that as two horizontally related firms engaged in the same vertically related transactions (i.e will buy the same inputs and sell the same outputs), horizontal integration might occur if the costs of organising these transactions within one firm were less than with two.[124] However, this gives a quite different emphasis to that which explained the case of vertical integration. The point of comparison is no longer between the costs of organising the transactions within the firm or at arm's length

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different industries" (Weder et al, 1993, p 496).

[124]"(t)here is a combination when transactions which were previously organised by two or more entrepeneurs become organised by one" (Coase, 1937, pp 397-8).

but between the costs of organising the activities in one or two firms, implying an administrative scale economy accounts for the phenomenon, rather than a choice made between organisational modes on the basis of relative transaction costs.

But the inconsistency disappears in the formulation Coase used for his 1960 paper. That second article focussed on the fact that parties to an economic relation are not necessarily engaged in some exchange *per se* but might instead be related through the imposition by one of unwelcome and unrequited damage on the other, damage which is conceived as incidental or at least as secondary to some economic activity and for which the perpetrator is not necessarily required to pay.[125] While such spin off effects (both beneficial and harmful) may exist between parties already engaged in some transactions, their extraneous nature is made more clear in cases where there are no transactions among the parties. However, as Coase put it, the issues raised by spin off effects in the two situations "are really the same" (Coase, 1960, p 39) and we will show that one conception of corporate growth is sufficient to deal with them both.

Before showing how this notion of unsought-after, unrequited and uncontracted effects can be applied to horizontal and diversified integration, we begin by showing how it can be used to explain the paradigm of vertical integration. Consider the purchase of materials. Instead of seeing this as a process of internalising transactions, it can be reformulated as follows: because of idiosyncratic expenses (i.e. which give rise to costs in switching), purchasing from outside exposes our firm to the potential imposition of uncompensated costs or extraction of unpaid for benefits by the material supplier. This potential is expensive to govern at arm's length by specifying, monitoring and enforcing appropriate contractual arrangements. When it is more cheaply governed by growth of the firm, it results in vertical integration.

The same problem can be recast as an incentive problem which growth of the firm can ameliorate. When transactions are costly because important economic effects are not

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[125]Coase described the paper as being "concerned with those actions of business firms which have harmful effects on others. The standard example is that of a factory the smoke from which has harmful effects on those neighbouring

remedied by competitive switching, the link between efficiency and reward is broken (Hennart, 1982).[126] Within the firm, the costs of remedying the broken link may be relatively low and when this is so, transaction cost theorists deduce that corporate growth will occur (Williamson, 1986, p 4). However, of course, even within the firm, the costs of organising a link between behaviour and rewards are not zero and therefore the link is not perfectly re-made (at least compared to the competitive ideal).

This conception therefore links Coase's theory to a considerable literature concerning incentives within firms including, among other things, so called agency costs which are incurred when the operative is not the owner (Jensen et al, 1976; Fama, 1980) and the importance and costliness of monitoring manager and employee behaviour (Alchian et al 1972). These works allude to the broad efficiency problems which arise in a world where incidental effects can be imposed or extracted and show how the firm can contribute to the solution (Putterman, 1986).[127]

The point being made here is that this exact, same conception allows us to address the question of why a firm integrates horizontally: because its activities are interdependent with others doing the same things and this gives rise to the possibility of imposing uncharged for costs or the extraction of unpaid for benefits. Attempting to govern this interdependence at arm's length can become relatively expensive and hence might lead to growth of the firm.

An illustration of horizontal integration helps clarify the situation. Consider an automotive company which invents a new component with broad relevance to other companies' cars as

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properties" (1960, p 1).

[126]Hennart (1982) makes clear the efficiency implications of external effects on an individual's incentives:"(s)ince the level of utility he achieves will depend on (those) activities for which he cannot be enforced to pay (or for which he cannot be remunerated), he will be encouraged to create damage - or not to generate gains.......These damages or foregone gains have been called external effects" (p 32).

[127]"In firms, the incentive structures binding owners, managers, and operatives are crucial because while it is possible to hire 'labour', it is effectively impossible to buy fully predetermined quantities and qualities of labour services ... The coordination problem [within the firm] becomes an incentive problem." (pp 12-

well as its own. To profit from this broader relevance, the company might consider various arrangements at arm's length (eg licensing to rivals) but these will all be costly and will only partially protect the firm from the uncompensated imposition of costs or unpaid for extraction of benefits. Patent protection is often part of such arrangements (Hennart, 1982, pp 109-111). However, the firm might find that dealing with this possibility at arm's length is more costly than internalising the rivals' operations (Casson, 1983, p 11). This would then lead to horizontal integration.

Similarly, diversification can be conceived of as arising when the activities of one firm have spin off effects on another in a different line of business. Firms grow in a diversified manner for the same reason that they grow in other ways: to bring within their governance the external effects of their activities or of other parties' activities on them. For example, consider a chemical company which, through its R&D program comes across an energy saving technology relevant to, say, the cement industry in which the company is not presently engaged. For reasons exactly analogous to the case of horizontal integration, the resulting interdependence might lead to corporate growth by diversification.

In short, growth of the firm is best conceived not as the internalisation of transactions nor as the internalisation of markets, advantages, etc. Instead, it is, more precisely and more generally, the internalisation of effects unpriced by and outside of markets. Many economists have called these effects "externalities" and conceive of them as failures of competition. However, for reasons emphasised below, they are better thought of in relation to the broader notion of transaction costs and as other than a deviation from a perfectly competitive norm.

To be comprehensive, we must finish by explaining why it is that these effects themselves are unpriced by competitive markets. Even if behaviour is not controlled directly by competition and hence there is a need for institutional and contractual arrangements, why is it that competitive markets do not emerge to price the effects which arise in the absence of competition and which could otherwise lead to internalisation? Indeed, Coase (1937) makes

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explicit reference to this possibility of using specialist agents as a partial alternative to the growth of firms.[128]

To give the point more concrete form, consider the case of labour which is prone to shirking. Rather than enhance efficiency by internalising the labour transaction within the firm, it is possible that a market could emerge in which the party who would otherwise be the employer would contract to buy restraint (as a kind of contingency insurance) from one of a number of competing firms who hire, monitor and fire labour. These agents would in turn contract with employees who would sell to them their capacity to shirk (changing a non-pecuniary into a pecuniary gain). If transaction costs are significant so that they can give rise to firms, why do they not provide the incentives for such specialist firms to emerge in enough numbers to cover all contingencies by competitive bidding so that the institution we call the firm would not be required?

The point to be made here is really quite simple: that there is an incomplete set of markets. In particular, there is an incomplete set of contingency markets to price the benefits or costs which might be extracted or imposed by employees, suppliers or others and hence, in some cases at least, the firm itself must seek to govern these effects by growth (Hennart, 1982, p 30).

To be clear, it is not simply the "widely recognised" fact that all contingencies cannot be specified (Williamson, et al, 1975, pp 262-264), nor is it merely that writing and enforcing contracts for all contingencies will be expensive (Klein et al, 1978). Rather, it is that agents do not emerge to price all these effects because the transaction costs involved in the relevant transactions are prohibitive. Transaction costs are central and, in some cases, are so high as to expunge the potential agents' gains. Hence, the relevant firms and competition (markets) do not emerge.

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[128]Regarding the cost of determining available price offers at arm's length Coase writes: "This cost may be reduced but it will not be eliminated by the emergence of specialists who will sell this information ... [This and other instances of specialist intervention may be] devised for minimising these contract costs but they are not eliminated." (p 391).

In terms of the example above, the specialists in hiring, monitoring and firing labour would need to sink resources into each contract such as would expose them to opportunism by the firms or the workers. These parties would be similarly locked into the specialist contractor exposing them too to spin off effects. The proposition is that such interdependencies will be prohibitively expensive to govern by this method in some cases.

As noted above, this conception of corporate growth is often associated with the notion of an externality and there is a considerable literature which conceives of it as such (Hennart, 1982[129]; Zerbe, 1976[130]). However, it is particularly important to our policy deliberations to note that Coase does not use the term anywhere in his 1960 article and yet he conceives of these unrequited, additional effects as alone sufficient to account for corporate growth (Coase, 1960).[131] The so called Coasean Theorem, which occupies only the first third of that article is an exposition set within an unreal world in which "there is a market for externalities or, since this is a contradiction in terms, there are no externalities" (Zerbe, 1976, p 30). The rest of Coase's work of 1960 is situated in the real world where markets are not ubiquitous and corporate growth is sometimes the best way of dealing with divergences of private from total costs and benefits.

To conceive of this most generally, Coase's work points to the phenomenon of transaction costs not externalities. Externalities are adjuncts to the orthodox theory of competitive markets, transactions costs point beyond it to a theory of organisation. This provides a firmer

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[129]As Hennart (1982) has put it: "(i)f the traditional model of competitive markets was always the relevant one, markets would organize all interdependence" (p 25). And, similarly, "(i)n a world where information, enforcement and bargaining costs are nil, all the externalities would vanish"(p 33).

[130]Zerbe refers to conceptual problems in the literature which can be overcome in this way i.e. by recognising that an "externality is defined as synonomous with the non-existence of markets" (p 31).

[131]"It is clear that an alternative form of economic organisation which could achieve the same result [as costless transacting] at less cost than would be incurred by using the market (i.e. in proceeding at arm's length) would enable the value of production to be raised. As I explained many years ago, the firm represents such an alternative.." (p 16).

base for policy, as we shall elucidate below. Ken Arrow has also made the same point, with didactic intent, to a Joint Economic Committee of the US Congress in 1969:

> "[m]arket failure is not absolute; it is better to consider a broader category, that of transaction costs .." (quoted by Williamson 1985, p 8).

This understanding of the fundamentals of transaction cost theory seems to have become lost in much of the literature as transaction cost reasoning has come more into prominence and the orthodoxy has strained to encompass it. It puts one in mind of what Thomas Kuhn has described as the progress of "normal science" (Kuhn, 1968).

Before looking to the policy implications of this view of transaction cost theory, we can note briefly that it also gives a useful perspective on the debate between Casson and Rugman as to whether transaction cost economising corporate growth incorporating externalities is a special case or not (Casson, 1987; Rugman, 1982).[132]

The policy significance of seeing transaction cost theory as an alternative to the orthodox theory of competitive markets can best be appreciated by recounting Coase's incisive attack on the policy implications that arise with Pigou's treatment of externalities (Coase, 1960, pp 39-42). Pigou's broadly accepted argument is that private interests cannot deal with such involuntary, unrequited effects and so government should intervene with a series of taxes and subsidies to create the appropriate ersatz price signals. However, Pigou equivocates over the distinction between cases where the effects are transferred among transacting parties and those where they affect third parties. He considers the

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[132]In the debate between Rugman and Casson (reported in Casson, 1987, pp 35-8), Casson argues that "(t)he internalisation of a market does not, in general, internalise an externality" (p 37). By contrast Rugman's position is that "the multinational enterprise is in the business of by-passing externalities by creating an internal market to replace missing external markets" (Rugman, 1982, p 27). Our view is that corporate growth simply economises on transaction costs that are incurred to control effects which competition is unable to govern. How we conceive of the effects which give rise to transaction costs is secondary to the notion of a transaction cost itself. Moreover, that transaction costs are sometimes prohibitive is important only in the limits it describes to the formation of competitive markets and the implications it has for growth of private organisation

latter to be cases where it is impossible for private solutions to emerge and hence government policy is needed, whereas cases where the parties are already paired together in some transaction can give rise to private solutions which are merely unsatisfactory.[133] Coase, of course, argues cogently that "the two cases are really the same" (i.e. both involve choices among means to solve the problem, each with its own array of transaction costs). But this simple point is lost in Pigou's exposition and Coase says that "not being clear (the Pigovian solution) was never clearly wrong" (1960, p 39).

The point here is that there is a danger in using deviations from the ideal of the market mechanism as the rationale for policy and to conceive of the policy problem as being one of replicating market prices. From the transaction cost perspective, economic processes are not best seen set against a competitive norm and economic problems are not best understood as deviations from the competitive ideal. Coase was quite clear on this point (Coase, 1964).[134] It means that transaction cost economising solutions are best conceived as alternatives to not returns to competition as a governing principle. In short, there is more to Coasean policy than promoting competition. Sometimes, growth of the firm (or of some other private organisation) will be a better alternative than an attempt to replicate markets. But, sometimes, beyond the limits of private organisations, other solutions, such as direct government control might be better still. In short, it is best to see policy as dealing with effects ungoverned by organisation, rather than with effects unpriced by competitive markets.

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and for policy.

[133] Coase quotes Pigou making the distinction between cases where a private solution to the problem of social costs would require "a modification of the contractual relations between .. two contracting parties" and others where a "service or disservice (is) rendered to persons other than the contracting parties" (Coase, 1960, p 38). The former are cases where private solutions are said to be unsatisfactory and the latter are where they are said to be impossible.

[134] Coase wrote: "a comparison with an optimal situation ... is, in most cases, a thoroughly bad approach. ... It has directed economists' attention away from the main question, which is how alternative arrangements will actually work in practice ... Until we realize that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway" (pp 194-5).

In other words, when spin off effects are significant but are unlikely to be controlled by private transaction cost economising, government has a role. Coase goes on to be quite explicit in spelling out the condition required for public sector involvement: public policy is required when these effects are diffuse and "a large number of people are involved" (Coase, 1960, p 18).

In such circumstances private control is unlikely because the costs of specifying, monitoring and enforcing contractual arrangements greatly increases when the effects involved are thinly spread across a large number of private interests. But government can act in such circumstances because, while private interests must focus on capturing and holding a share of gains exclusively, governments' concerns are more simply with gains falling within their geographically-defined areas of jurisdiction. While private interests must specify, monitor and enforce contractual arrangements with others, it is rational for government to act simply by knowing that important, beneficial economic effects will be caught within the region. This means that government faces different and fewer transaction costs. Hence, it can act rationally when the private sector finds the transaction costs prohibitive. This point is central and the study returns to it many times in the chapters which follow.

The final point to note is in regard to the equity considerations which we have seen arise with the monopoly power view. On the distribution of gains, Coase and transaction cost theory are silent. The approach does not consider issue and Coase makes clear that his analysis leaves "questions of equity apart" (1960, p 19).

Hence, his policy agenda is not inconsistent with public action which might control private organisations for other than efficiency reasons. To reiterate, transaction cost theory gives rise to a set of policies which are additional to any that arise because private organisations can be anti-competitive. In general these are policies which ease trading difficulties faced by the private sector, either by improving general conditions for the conduct of economic activity or by addressing particular difficulties.

It is important in what follows to make one more point explicit: that transaction cost theory can be extended to give a rationale for economic organisation beyond the firm *per* se. These alternative organisations represent other private solutions to the problem of transaction costs including arrangements among firms which have been described as forms of "quasi-integration" (Goto, 1982; Casson, 1987).[135] They include joint ventures of various kinds (most of which are consistent with the notion of control and, in the international context, fit with the definition of FDI), long term contractual arrangements, and horizontal associations among firms such as Romer describes as "self-organising industry investment boards" (Romer, 1993).

All these broadenings of the common but narrow view of transaction cost theory both show its radical nature and are consistent with Coases's later attention to the broader implications of transaction costs. In 1991 Coase emphasised this point:

> "it would be wrong to think that the most important consequence for economics of the publication of "The Nature of the Firm" has been to direct attention to the importance of the firm ... [rather it is] the explicit introduction of transaction costs into economic analysis ... the existence of transaction costs leads to ... effects [which] are pervasive in the economy" (Coase, 1991, p 716).

It is not difficult to see how this theory of the firm can be applied to FDI, as was first done systematically by the so called "Reading School" led by Mark Casson and Peter Buckley (Buckley and Casson, 1976; Casson, 1983). Put simply, the transaction cost economising view is that control is extended across national boundaries when the cost of organising economic activity in that way is lower than in others. The essential point, which separates this from the alternative, anti-competitive view is that this conceives of FDI as an arrangement which enhances efficiency. To be comprehensive, we must now look at that alternative.

[135]Casson describes contractual arrangements which are "neither purely firm like nor purely market-like" (p 48). Aoki's views are similar and are related in section 5.2 below.

4.4 Foreign Direct Investment and Monopoly Power

Having provided a general view of corporate growth as transaction cost economising and hence the basis for a transaction cost economising rationale for government, this section returns to the second theoretical debate surrounding Dunning's work, that concerning his use of the imperfect competition theory of FDI.

This section will show that both Dunning's eclecticism and internalisation theory, a variant of transaction cost theory associated with the Reading School, which together account for the vast majority of contemporary thinking about FDI, both attempt to incorporate monopolising objectives in an illegitimate way. The claim that "internalisation theory actually deepens our understanding of monopoly power" (Casson, 1995, p 35) is a misreading of Hymer's major contribution to FDI theory just as is Dunning's proposition that corporate power derived from an ownership advantage cannot be a sufficient reason in itself for FDI.

Again, the prime concern is not with the effect of this misreading on the history of FDI theory. Rather, it is the policy implications which are at issue and these claims, from eclectic and internalisation theory, to generality undermine the policies associated with an understanding of FDI as anti-competitive.

We can begin with an exposition of Hymer's view of FDI as enunciated in his doctoral thesis and which underlies the monopoly power position and, by coincidence, it was submitted in 1960, the same year that Coase's second seminal work was published. This reading shows that Hymer's contribution is best understood as an advance within the orthodoxy, despite his later move outside it.

Hymer's explanation is fundamentally that FDI is a manifestation of imperfect competition i.e. it is both the result of restricted competition and intends to restrict competition (Hymer, 1960, pp 25 and 33; 1970a, p 45). It characterises the multinational

firm "fundamentally as an agent of market power and collusion" (Cantwell, 1991, p 19). Hymer's view is therefore from "a liberal, antitrust orientation" (Cohen et al, 1979, p 15) and looks to what he described as "the darker side of direct foreign investment" (Hymer, 1966, p 173).

This view of FDI as a distributionally-motivated, exploitative corporate strategy addresses characteristics which Hymer saw as fundamental to industries in which what was then predominantly US FDI was concentrated: they were dominated by large companies, were capital intensive and used advanced technology to produce differentiated products (Hymer, 1970a, p 41). In short, they were oligopolistic industries and Hymer took the two to be causally linked and self-reinforcing: FDI is undertaken by oligopolists who undertake FDI to strengthen and extend the reach of their oligopolistic powers. Hence, not only does market failure lead to FDI but FDI leads to more market failure.

Although Hymer's work can be situated as a theory of market failure, in his later writing it took on elements of a more radical Marxist approach. It is said that the progression was prompted by the realisation "that the emphasis ... upon rivalries between capitalist is misplaced" (Cohen et al, 1979, p 19) and it involved him moving away from analysis of the MNE to an analysis of the international division of labour. Of course, we rejected the Marxist view because it takes as "the basic assumption" that capital has no nationality and hence that FDI is the result of "a hierarchy of capitalists not limited by patriotic ties" (Cohen et al, 1979, pp 23 and 25). Such a view empties the notion of FDI having important source nation characteristics. While some see no contradiction between the developed Hymerian and the imperialist modes of thought about FDI (Chesnais, 1988)[136], this thesis focusses primarily on Hymer's original views and uses his later Marxist restatement only to deepen the interpretation of that early work.

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[136] Chesnais states that the only way of understanding monopoly capital and inter-imperialist rivalry is to interpret "firm behaviour in conditions of international oligopoly .." (p 498).

Approached in that way, the key point is that it is unreasonable to set Hymer next to Coase in some synthesis. Hymer placed little store in the benign view of FDI, even though he occasionally commented upon and included economising reasoning. Hence, it is appropriate to treat the policy implications of his work as alternatives to and as additional to those derived from more benign views of FDI.

Hymer's untimely death has meant he could not clarify the relative importance of economising views of FDI against his fundamentally monopolising perspective and it is true that his original work contained some ambiguity. Hymer argued that three features must pertain for FDI to go ahead (1972c, pp 40-1). Firstly, the central point, that there must be barriers to entry which effectively exclude local rivals. The point addresses what Hymer argues is a fundamental fact about foreign production: that it costs more than producing in the home environment and is undertaken at a disadvantage against locals. How then can FDI be profitably undertaken? Hymer's argument is essentially that the multinational oligopolist has some ability to forestall competition.

In other words, and consistent with Dunning's use of it, Hymerian FDI is based on Bain-type advantages (Hymer, 1960, p 47; Dunning and Rugman, 1985) which are unequally distributed among firms. FDI can therefore be understood, as the generic market imperfection view of Dunning and Rugman has it, as a divergence from perfect competition (see also Teece, 1985, p 235).

The second feature essential to Hymer's view of FDI is that it must be more profitable to produce overseas than to export to those markets from home. In other words, as with Dunning's eclecticism, there must be some locational advantage to prompt the FDI.

It is the third element of Hymer's that provides the slight opening for it to be claimed that his work was not inconsistent with the transaction cost economising view point (and therefore could be legitimately synthesised with it). Hymer realised that, even if it were more profitable to produce overseas there must also be reason why FDI is the preferred means by which to proceed rather than, for example, by licensing parties in the foreign nation to

undertake the activity themselves. This is clearly allied to the transaction cost view and Hymer provided a transaction cost-type rationale, even though he was very probably unaware of Coase's work at the time (Horaguchi and Toyne, 1990, pp 488-9; Dunning and Rugman, 1985, p 229). The conundrum is readily resolved: Hymer saw the problem not as one of transaction costs but, consistent with his fundamental point, as a problem of finding "prudent" means to make use of an advantage in a situation of imperfect competition (Hymer, 1960, p 23). It is not about transaction costs but about industry structure.[137]

Another case in point is Hymer's discussion of the scenario where FDI by monopolistic merger might be a more effective response to oligopolistic interdependence than some collusive agreement which it would be expensive to specify, monitor and enforce (Hymer, 1960, pp 25-26). But this does not mean that it is legitimate to see Hymer's as a theory of economising or as anything but a theory of monopoly power. Hymer did not intend that the notion that growth of the MNE could be a "prudent" solution to the problem of oligopolistic interdependence should detract from the underlying oligopolistic nature of the MNE.

In short, we need not concern ourselves too greatly with why Hymer's work contained such a mix of elements. Rather, we focus on what in his own view and in the development of his work was the fundamentally important condition for FDI i.e. that it requires and aims to maintain monopoly power. Hymer's view shows that the theory of imperfect competition can give a stand-alone account of FDI, a point also made by others (Grosse, 1986, *passim*). Hence, its policy implications should be added to, not traded against, those of transaction cost theory.

Against this approach, we have shown that Dunning's eclecticism neuters policy. However, the reluctance to accept that FDI or, at least, that some cases of FDI might

[137] Hymer goes on to point out that the licensing route would be used "if there are many buyers of the advantage" (1960, p 49) ie he was clearly thinking in terms of industry structure.

simply be malign, is also true of internalisation theory, meaning that it too mixes and weakens the policy implications.

This is obvious in the dichotomy Buckley sees in the welfare effects arising from the internalisation view of FDI: there are economising gains but also "losses arise where multinationals maximise monopoly profits by restricting the output of goods and services ..." (Buckley, 1989, p 882). The dual focus of internalisation theory is also seen when, in discussing vertical integration, Casson provides a number of rationale which clearly fit within the transaction cost theory, including economies of internalising long term contracts and the transaction cost savings possible from controlling quality within the firm, but he also makes clear that internalisation might arise to increase the profit available from the exercise of monopoly power (1983, pp 9-11). The same eclectic mix of motives is found elsewhere in Casson's writing (Casson, 1987) and his comments on Hymer make clear that he means internalisation theory to include market power motivations (Casson, 1995, p 35).

Hennart, another leading proponent of the internalisation school, also argues similarly, that both monopolising and economising explanations are "compatible with the model" (Hennart, 1982, p77) but that the monopoly motive is not a necessary condition. In other words, like Dunning's eclecticism, in the quest for generality and additional explanatory power, internalisation theory weakens the usefulness of FDI theory for policy.

We have found that Dunning's eclectic theory and internalisation theory both combine economising and monoplising in single explanations of the FDI decision and so neuter the policy implications, when that was not the intention of the originators of either approach. For the policy purposes of this study, a superior means of proceeding is to maintain the distinction between these motivations and theories and so to see their policy implications as additional to each other.

Support for this reading of FDI theory comes from other senior writers working in the transaction cost approach but outside the field of FDI *per se*. Rather than trying to bring

the two motivations into the one view, Douglass North argues that institutional innovation is fundamentally economising behaviour. However, other motivations can also be sufficient, as when the extension of an economic institution increases private returns “by creating monopolies, by restricting entry and factor mobility, and by political organisations that .... redistribute rather than increase income” (North, 1991, p 110).

Oliver Williamson has it that while transaction cost economising is "the main purpose and effect" of economic organisations, it is possible that "(s)ometimes other purposes, of which monopolising is one, will crowd out the main case" (Williamson, 1993, pp 17-18). So, the theory “always and everywhere (is) followed by an insistence on studying the world of positive transaction costs” (Williamson, 1997, p 5) and “(p)ower is relegated to a secondary role” (1986, p 125). But “main purpose is not ... to be confused with sole purpose” (1985, p 16). In short, "(t)he possibility that economic organisation is designed to promote monopoly purposes, in addition to or instead of economising, is not foreclosed" (ibid, p 31).

Here is the point simply put: that either economising or monopolising motives are sufficient, although both might co-exist. The difference between them are differences over what are “the most important historical driving forces underlying growth of the modern firm” (Cantwell, 1991, p 26). The two simply cannot be rolled into a single view. Both imply matters for policy attention and they cannot, in general, be traded against the other.

4.5 Other Theories of Foreign Direct Investment

This study will develop policies from these dichotomous views of FDI as malign and benign respectively. Given the policy making objectives, these are taken as generic views and, as this section intends to show, they can be used to sketch general policy approaches into which can be fitted the policy implications arising from other theories of FDI.

In other words, while alternative theories emphasise different mechanisms in the FDI decision and might make different predictions about the pattern and development of FDI, as previously stated, the aim here is not to explain the phenomenon but to focus on the policy implications and for this transaction cost and imperfect competition theories stand as generic forms.

To interpret FDI theory generically, the central notion is that of an ownership advantage. In the imperfect competition approach, such advantages provide the basis for oligopolistic competition among MNEs and the cost advantage needed for overseas production and this view carries over to Dunning's systemic theory which, as we have seen, maintains that an ownership advantage is a necessary condition for FDI. As was noted some years ago, it is possible to interpret generally the reasons for FDI and the corporate assets on which it is based as both being "practically identical with the 'barriers to entry of new competition' .." (Lall, 1979, p 313).

Transaction cost theory does not dispute the existence of these advantages but has a different view of their cause and purpose. The transaction cost view is that proprietary assets are owned by the firm and exploited by FDI because this represents the transaction cost minimising method of creating and using them.

So, FDI might be associated with superior management or excess managerial resources (see, for example, Horaguchi and Toyne, 1990 or earlier works by Kindleberger, 1970 and Penrose, 1956). Imperfect competition theory would interpret these as providing some monopoly power because possession of them is the result of imperfect competition in factor markets and allows for monopoly rents to be accumulated.

However, from the transaction cost perspective, the crucial consideration is, of course, transaction cost economising. In this view, managerial resources are accumulated within the firm and not bought-in from outside (or sold to outside if they come to exist in abundance) because this is the transaction cost economising arrangement. Transaction cost economising

also determines if the best means to apply them is by corporate growth rather than by license, joint venture or some other arrangement.

The essential point, which Buckley and others have made repeatedly, is that, the apparent importance of an ownership advantage at the time of the investment decision arises only when the view is static (Buckley, 1983[138]; Buckley, 1988, p 182; Buckley, 1990, p 661; Rugman, 1985, p 571; Casson, 1995, p 34). If we consider FDI as growth of the firm through time then, from a transaction cost perspective, the mix of assets it owns is plastic and the reasons for any FDI it undertakes lie not with the advantages conferred by the assets but with the factors which determined that they would be accumulated within the firm and exploited by corporate growth.

So, both of the generic theories assign particular roles to the concept of an ownership advantage and the notion reveals the fundamental difference between them. We can use this fundamental distinction to interpret some other theories from within the transaction cost or imperfect competition perspectives.

For example, we can examine the product life cycle approach which began with the work of Hirsch (1965) but was developed in a series of models by Vernon (1966, 1979). In essence, these views have it that technical considerations in production mean that, as a product moves from being novel to standard and from domestic to global markets, the optimal capital:labour ratios (including human capital) used in its production will vary and, hence, so will the most profitable production location.

FDI occurs when the owner of the advantage embodied in the product maintains control while the efficient production location shifts away from the nation in which the novelty was first produced. The point is that, from a policy perspective, the key question is why does the FDI occur. If it is because the exploitation of the asset is more expensive to arrange at arm's length, then Vernon's view is consistent with transaction cost theory.

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[138] "The firm-specific advantage is a reflection of this cut-off point as a snapshot of a dynamic process" (p 38).

Alternatively, if it were because control is the best means to defend and extend monopoly rents, the view from imperfect competition seems to apply better (Long, 1981).[139]

Given that our present purpose is to use theory to reveal underlying principles of a policy response, the life cycle approach fits within one, other or both of the generic viewpoints. It might add more to our understanding of the mechanisms behind FDI but that is not the purpose here. In short, it is enough to know that the life-cycle induced FDI should be controlled by policy because it might restrict competition and hurt efficiency or it should be encouraged and its efficiency-raising purposes enhanced by policy because it might have benign, economising purposes.

To extend the argument further, another increasingly significant view is that FDI is best explained in terms of strategies of competitive alliance and rivalry among firms (Teece, et al, 1997, p 511; Nicholas and Maitland, forthcoming). This viewpoint is associated with Knickerbocker's earlier oligopolistic reaction thesis (Knickerbocker, 1973)[140] and with Graham's view of firms' interactions as the exchange of threats (Graham, 1975). More recently it has been associated with the application of game theory to firms' reaction functions and with the work of Cowling and Sudgen (1987) concerning FDI as a countervailing response to concentrations of economic power (e.g. trade unions and governments) in host nations. For our purposes, it is not necessary to follow the detail of each viewpoint but rather to note again that such strategic behaviour can be interpreted as anti-competitive or as efficiency-promoting.

The imperfect competition view is readily applied. As we have seen, it understands international production as "the result of firm's strategies towards competitors and

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139 Under the heading of TNCs as oligopolists, Long interpret's Vernon's theory as implying that FDI is "often undertaken as a defensive strategy to maintain already established market positions" (p 52).

140 "the special technical or organisational capabilities acquired by these firms first invested them with market power at home and, at a later date, invested them with market power abroad" (Kindleberger, 1973, p 20).

markets" (Ietto-Gillies, 1992, p 126). The corporate strategies which are possible can be conceived as the desire to extend and exploit proprietorial advantages.

However, equally, these behaviours can be understood from the transaction cost perspective which, put simply, is that an untransacted interdependence exists among related firms. Business strategies of alliance and rivalry are means of economising on the costs of controlling the effects that can arise with this interdependence.

These two examples of theories based on life-cycles and competitive strategies reinforce the essential points: that monopolising and economising are generic but opposed explanations and so constitute rubrics under which we can group and interpret alternative theoretical viewpoints. The task for the following chapters is to show how the generic theories progress the policy aims of this study.

However, before we do so we need to address the view that if we cannot deduce which of these theories is superior, why not devote the study to testing them and then simply rule out the policy implications of whichever theory is wrong?

Firstly, as a practical matter we should recognise that the dichotomy to which we are pointing has existed in FDI theory since 1960 but no proof of either position has been forthcoming. If we must have proof of theory to have policy for FDI we have already waited long and may have to wait considerably longer still. But, in using theory to alert us to possibilities, we do not need proof, despite that it would be convenient.

The second reason for not resolving the theoretical issues by means of empirical validation is that measurement problems abound. Firstly, theory cannot be proven by showing that a particular case is not inconsistent with a particular theoretical view. It is also necessary to show that the non-existence of other possible outcomes is due to the same cause. Hence, regarding transaction cost theory, we would need to show not just that a given case reduced transaction costs compared to an arm's length alternative but that it was transaction cost minimising compared to all other alternative arrangements

that are possible. It is not just a pairing of at-arm's-length vs within-the-firm but a comparison between FDI and a comprehensive listing of all other arrangements, including the counterfactual case of doing nothing at all and extending to other than economic and other than self-interested motivations.

Similarly, an attempt to refute imperfect competition theory would require measurement of the value of monopolistic motives not just for the FDI arrangement but also for the range of other possible arrangements to which it could be compared. Scientifically valid proof is probably not possible or, at least, would be time and resource-intensive and would constrain the investigation of policy too greatly in a single study such as this. Indeed, as it is likely that the conditions which give rise to FDI change with time and place and pairings of nations, any result might, in any case, be ungeneralisable.

The third reason for choosing not to test theory is more basic. It is that, although both imperfect competition and transaction cost theories assume that behaviour is the result of calculations of economic self interest, they are separated by the different intentions they ascribe to the investors. The one conceives that investors seek gain by redistributing benefits; the other, that gain arises from producing greater benefits. How can we test for intentions which might be mixed and which, by their nature, must remain subjective and largely inscrutable? At least, it is naive to think they can be objectively examined. As Habermas has put it,

> "intentional action can be grasped only by means of understanding, there can be no rigorous, mathematically formulated economic theories" (1989, p 45).

In other words, we use the insight offered by the structured reasoning of alternative theories to side step the problems associated with attempting to test intentions.

Chapter 5: The Policy Implications of Japan's FDI Asymmetry

5.1 Introduction

Chapter 4 has shown how theory can help further the FDI policy reasoning. This chapter expands on the relevance of theory by turning it to the additional task this study set for itself of finding bases for Australian policy which also provide plausible interpretations of Japan's FDI asymmetry. To reiterate, the descriptions from Chapter 2 showed that Japan has a ratio of inward to outward FDI much lower than any other OECD nation. This chapter shows how the theoretical approaches on which it is intended to base policy can interpret that asymmetry. It also brings out the policy implications of these interpretations.

The chapter is simply divided into two sections dealing with the interpretation of Japan's asymmetry as transaction cost economising and as anti-competitive respectively.

5.2 Asymmetry as Transaction Cost Economising

The economising argument is straight forward enough and relies on two, general propositions: firstly, that transaction costs vary among economies so that we can think of a nation's general economic environment as more or less conducive to activity and, secondly, that international exchange tends to have higher transaction costs than does intranational trading (Ghertman, 1998).[141] In short, the argument is that Japan's is a relatively low transaction cost economy for Japanese nationals (for reasons speculated upon below) and, hence, there will be a tendency to restrict inward FDI which might

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[141] As to the first, Ghertman has the notion of macro economic transaction costs which he attempts to measure as transaction costs per capita which are then related to national income levels and give rise to "transaction cost efficiency differentials" (p 5). However, there are measurement problems and Ghertman concludes that his proxies are too unreliable as a basis for policy.

otherwise disrupt that environment and to undertake outward FDI because it can extend efficient trading overseas.

The first task is to look to the evidence that Japan is indeed a relatively low transaction cost environment and, at the end of this section, it is then shown how the argument can be generalised by expressing it in mathematical terms. In short, the reasoning here is that Japanese economic interests look at the rest of the world along what might be called a steep transaction cost gradient. Is there evidence to support that view?

It is important to stress that providing such evidence is not to argue that the transaction cost economising accounts for Japan's success. That might be true (at least in part) but it is not essential to the argument here, which focusses on Japan's FDI position not its economic development more generally.

So as to make clear the advantage of the Japanese environment, the argument begins with the general advantages of intra-national or compatriot transacting. Just as there are well recognised disadvantages in conducting foreign operations (they are central to Hymer's and Dunning's theoretical formulations in Chapter 4) so, conversely, there are advantages in dealing intra-nationally. Compatriots are generally nearby and undertake activity in the same currency, with the same institutions and under the same legal system.

Of course, these advantages apply in all countries including Japan but, in addition, Japan is also a relatively homophilous and homogenous nation (Hayashi, 1988, p 84; Graham, 1996, p 65) and it can be expected that transaction costs within such a national group will be generally lower (Hennart, 1982, p 110; Matsumoto, 1991).[142]

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[142]An ex-MITI officer has made the same point:"in contrast to a nation...(of) people from a variety of racial backgrounds and cultures....a country with a homogenous population will....have less trouble achieving effective communication within the corporation; furthermore, it should be much easier to develop good trusting relationships both within and between companies." (Matsumoto, 1991, p 175).

Further, the advantages of intra-Japanese dealing are also said to be reflected in the unusual degree to which Japanese people seek harmony in their economic and social relations (Yang, 1995; Dore, 1994, p 12; Franko, 1983).[143] The so called cultural "groupism" of Japan can be interpreted as having transaction cost economising effects. Some Japanese authors have been more specific and have drawn forceful connections between traditional Japanese group principles and the practices of modern corporate management and public policy (Murakami, 1989; Hayashi, 1988).[144] Others, such as Fukuyama (1995, *passim*) and Williamson (1985, p 123), have remarked upon the high degree of within-group trust and this is understood to reduce transaction costs, partly because contracting can be less detailed and more open-ended.[145] Williamson traces the genesis of this general notion in the literature back to work by Ken Arrow in the 1960s.[146]

While the cultural trait of 'groupism' can be argued to have a significant impact on transaction costs within the nation, it would not be wise to make too much of it nor to see it as anything other than rational behaviour (Matsumoto, 1991).[147] Indeed, the best evidence that Japan is a low transaction cost environment concerns not unchosen culture, which can have ambivalent effects on efficiency, but the rational selections which have shaped Japan's institutions (especially Japanese firms, inter-firm arrangements and public

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[143] Franko describes the level of voluntary cooperation in Japan as being found "only (in) sports teams in the West" (p 3).

[144] For example, Murakami (1989) sees modern corporate management in Japan as akin to the "indigenous organisational tradition" of *ie* [meaning home group]. He also describes the notion of administrative guidance "as the present-day variant of the mura [literally, village] principle .... " (op cit. p 47).

[145] Fukuyama has written that, in general, "a high degree of trust [is] an additional condition of economic relations [i.e. additional to instititutional and contractual arrangements] ... [which] can increase efficiency by reducing transaction costs .. " (p 152). According to Williamson: "Japanese businessmen place more emphasis on building up a personal relationship than on drafting a detailed contract....lawyers are usually not consulted during the negotiations" (Williamson, 1985, p 123).

[146] He paraphrases Arrow as having said that "[t]he efficacy of alternative modes of contracting will thus vary among cultures because of differences in trust" (Williamson, 1985, p 9).

[147] As Matsumoto notes: "the nature of the groupism argument is .. rather nebulous" and, he adds, that the view that it is essential "is not an opinion originally formulated by the Japanese themselves" (pp 180-1).

policies) and hence her economic environment (Stiglitz, 1996b, p 152). These innovations have a powerful influence on transaction costs and therefore on the "feasibility of engaging in economic activity" (North, 1991, p 97). As Johnson (1990) has put it "(t)he key to what makes Japan so different ...... is its institutional innovation" (p 56).[148][149]

There is a rich vein of literature concerning the innovative features found within and among the institutions of Japanese firms, both by Japanese authors, who tend to stress their economic rationality (Aoki, 1984 and 1992; Odagiri, 1981; Motoshige, 1992) and by non-Japanese writers, who tend to give relatively greater emphasis to the influence of culture on the choices which have been made (e.g. Dore, 1994; Johnson, 1990, *passim*; Fruin, 1992, pp 307-310).

For example, there is no doubt that, in adopting and adapting the joint stock companies in the late 19th century, Japanese innovation has reshaped certain of the internal relations within its firms (Hirschmeier et al, 1975, p 103). The so called *ringi* system of consultation and negotiation is said to provide an alternative to more hierarchical decision making arrangements (JETRO, 1992 b; Dore 1973, *passim*). So too the widespread expectation of lifetime employment among employees of the larger firms and the common instances of corporate investment in generalisable training for employees both reflect an array of rights and obligations not frequently found in Western firms (Franko, 1983, pp 49-53).

In addition, labour is typically organised within each large company into an enterprise union which forms "a substructure of the firm" and helps shape its mode of governance in a way which is unusual (Aoki, 1987, p 265). The peculiarly cooperative principles

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[148]Further, as Murakami (1982) noted "(a) psychological or cultural legacy can be determinant of a major social trend only if it is embodied in some institutional framework or social philosophy" (p 15).
[149]Along similar lines, Odagiri (1981) (whose was a pioneer in the field) wrote that "no model can explain the modern economic growth satisfactorily without introducing the idea of the corporate economy ..." (p 147).

embodied in Japanese organisations are also apparent in some often-lauded operational attributes such as the *kanban* system to govern quality and inventory control (Monden, 1983, pp 14-15).

These features of Japanese firms can be reasoned to arise because they provide benefits to management and workers (Aoki, 1984, p 6) but, while not so very different to some Western views of the firm (as described in Putterman, 1986, *passim*), they are said to be peculiarly influenced by Japanese attitudes and to be "based on some notion of collective interest" (Gerlach, 1997, p 249; Dore, 1994).[150]

The unusual features of Japanese economic organisation extend beyond the inner workings of firms to include innovations aimed to govern the effects which pass among them. Such inter-firm arrangements, referred to in Chapter 4 as forms of quasi-integration, operate extensively in Japan both horizontally and vertically and in formal and less formal ways.

Arrangements between horizontally related firms include trade associations, cartels and specific interest groups (Johnson, 1990, p 520) and these are said to be more common than in the West (Imai and Itami, 1984).[151] Japanese firms linked vertically by transactions are more likely to be controlled separately but to act in concert than would Western firms in comparable circumstances (Imai and Itami, 1984, p 295) and this is said to be "one of the most striking and important peculiarities of Japanese industrial organisation" (Miwa, 1996, p 15).

The arrangements among Japanese firms can involve quite explicit, articulated structures. Such groups of firms, especially the so called *keiretsu*, are based on strong (but not

[150]In contrast to the ruling view in the West, Dore says that "to the average Japanese businessman, a firm is primarily a community of people rather than a piece of property .. " (p 16).
[151]In Japan there are said to be "more organised activities among producers of the same goods, be it legalised cartles, joint R & D efforts, or coordinated behaviuour through governmental administrative guidance ... " (p 294).

exclusive) transactional relations, cross-shareholdings, interlocking directorates and credit provision or guarantees (Gerlach, 1997, p 266-7). They are said to be neither a firm nor a 'market' relation but to represent "a third possibility" (Goto, 1982, p 61).[152]

Other types of business group also exist in Japan.[153] While a number of definitional and other controversies surround them (Takeo, 1994; Miwa, 1996)[154], nonetheless, they point to the predominance in Japan of what has been generically labelled "relational contracting" (Asanuma, 1992)[155], i.e. situations in which economic activity is organised not by competition between unknown rivals nor by simple managerial fiat but by various forms of enduring, quasi-integration.

The point we are driving at is that these developments within among Japanese firms can be interpreted as transaction cost-economising and as an integral part of Japan's "distinctive trading and transacting culture" (Fruin, 1992, p 305). They provide collaboration advantages to Japanese firms and these advantages can provide the means to resist inward FDI (Dunning, 1996, pp 42-3). Not only will foreigners find it hard to compete, Japanese interests will actively oppose entry to preserve these low cost trading conditions (Wakasugi, 1996, p 125).[156] This will maintain the so called "economics of cohesion" (Helou, 1991, p 132). In short, FDI into Japan is restricted by the strengths of

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[152]These groupings have a number of related names in Japanese including *zaibatsu* (literally, financial clique), *keiretsu* (lineage) and *kigyo shudan* (enterprise group). The latter extends the notion of a business group beyond the *keiretsu* and to include what Goto calls B-type groupings, referred to in the footnote which follows.

[153] While the *keiretsu* groupings generally involve a core bank, trading company and manufacturing arm (as well as ancillary firms), a second kind of group (which, following Goto (1982), may be called B-type) centre upon vertical relations and involve a cluster around one large firm, generally a manufacturer (Toyota and Hitachi are important examples).

[154]It is said that "the border of the corporate group is fuzzy" (Takeo, 1994, p290) and that the concept is too often formulated as a "mixture of ill-defined terms and vague argument" (Miwa, 1996, p 2).

[155]"(T)he term *keiretsu* is a misleading tool ...... (t)he concept of relational contracting is far more useful" (p 12).

and because it would threaten the existence of "efficiencies resulting from solidarity" among private interests (Boyd, 1996, p 196).

Like the organisational forms of the private sector, some Japanese government action can be interpreted in transaction cost economising terms as both responses to high transaction costs and as attempts to create an environment of low transaction costs. As Williamson put it, such activity by government is one of the ingredients of a "high performance economy" (Williamson, 1993).[157] Indeed, North, one of the most prominent proponents of the New Institutional Economics sees this role of government as crucial in promoting economic development generally so that it is seen as essential also to the historical process of European growth (North, 1991, p 107; North, 1997, *passim*).

The case of Japan gives another specific illustration of this general point and shows also that the private sector can be highly receptive to good government policy. According to one researcher, this is "the real lesson" from Japan's success in that it shows how appropriate government policy can reduce the impediments to private sector economic activity (Schmieglow, 1989).[158]

This coincidence of public and private purposes can be found in the homogeneity of interests over the low level of inward FDI (Ozawa, 1991, p 60). It is argued that restricting foreign entry "may function as a tool of strategic policy" inside Japan by reserving the domestic market for indigenous firms, thus allowing them to achieve scale economies that would not be possible with a liberal entry policy for FDI (Belderbos, 1997, p 156). This relates to Ozawa's notion of reserved competition which arose in Chapter 3 when discussing Japan's support for indigenous firms in the post war era.

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[156] Wakasugi cites three major instances of "active opposition of managers and employees" to inward FDI i.e. takeover bids for Sankyo Seiki Co, the Miyami Valve Co. and, most famously, the bid for a Board seat on Koito Co. by T. Boon Pickens.
[157]He wrote that "a high performance economy is one in which the community has confidence that public intervention will be made for a good cause" (p 51).
[158]"The real lesson of the Japanese case is that non-coercive, rational, market-oriented public guidance is possible and that dynamic private sectors are in fact receptive to, and frequently in need of, such guidance" (p 185).

Some researchers see a parallel between this role taken by government and the organisational role of Japanese business groups: both provide a framework for and assurances of low transaction cost trading (Imai and Itami, 1984).[159] Hence, the Japanese case stresses similarities in the objectives and methods of the private and public sector, a point of importance in teasing out the policy implications of the benign, economising view of FDI, as shown in section 6.2 below.

So, while it is true that direct Japanese government regulation of inward FDI has been substantially removed, as detailed in Chapter 3, it is also true that the on-going existence of a range of distinctive features of the Japanese economy, which are supported by government in various ways, also continue the purposes of previous regulation. Many such features can be found in the literature including, culture, tradition and "habitual association" (Clark and Chan, 1996, p 99). The distinctive nature of Japan's distribution system in Japan and government's reluctance to liberalise it fully is also cited as a case in point (Weinstein, 1996, p 158).

These private and public institutions and arrangements in Japan alludes to the factors, often cited in surveys of foreign businesses, which contribute to the so called "generic difficulty of operating in Japan" (Weinstein, 1996, pp 154-5). We have linked the exclusion of foreign firms to the desire to build indigenous firms and this way of looking at Japan's FDI asymmetry gives further reason to such a strategy. Domestic firms are favoured for the same reasons that foreign entry is eschewed: their growth maintains the low transaction cost characteristics of the Japanese economy even as it evolves through growth. In other words, while we argued in Chapter 3 that foreign and indigenous firms appear to be little different, there is now reason to think this is not true in Japan at least.

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[159] "The parent firm in the *keiretsu* may exercise authority to decide on each member firm's behaviour for the long run and overall interests of the group .... or the government may influence private lending decisions by the banks as part of its industrial policy" (p 298).

To summarise the transaction cost economising interpretation of Japan's net FDI position, the evidence suggests that, by a combination of means, the Japanese trading environment is particularly attractive to Japanese participants. Compared to dealing with Australians or with other foreigners, dealing with compatriots incurs lower transaction costs and requires less direct control. The situation can be described as one of a steep transaction cost gradient between Japan and the rest of the world, including Australia, and it provides a rationale for both publicly-backed (albeit indirect) impediments and private restrictions on inward FDI to Japan: if foreign entry proceeded unchecked it would reduce efficiency.

In short, transaction cost theory suggests that there are systemic purposes in Japan's FDI asymmetry. Outward Japanese FDI reduces "the uncertainty of doing business in an alien economic environment" (Reid et al, 1996, p 107) while limited inward FDI excludes alien influence. Just as the *sogo shosha* emerged because of Japan's particular difficulties in bridging the considerable gap between home and international environments (Caves, 1982, p 60), so its net FDI position responds to the same problems in interacting with the rest of the world.

As Ozawa (1997) has put it, the psychological distance between Japan and other advanced nations and the sensitivity of some production processes means that FDI embodies Japanese-style management as a "cultural shell" and the distinctly Japanese phenomenon of co-location by other Japanese firms overseas creates a "mini-home community" (ibid, p 183). Put directly, the FDI activities thus provide "an extended location capsule" (ibid, p 184).

To conclude this section we can show how the view that Japan's economic system is distinctive with important implications for its FDI position is further supported by other related FDI literature. For example, an innovative study in this field by Kogut and Singh (1988) focussed explicitly on the observation that Japanese firms tend to establish greenfield investments overseas and to own them wholly and that this tendency is positively related to measures of cultural distance from Japan (based on indexes

developed by Hofstede, 1980).[160] It suggests that the propensity to undertake FDI is a positive function of the transaction cost gradient between nations (as is set out in the mathematical generalisations included below).

A number of other studies have also followed the influence which Japan's cultural and linguistic distance has over the FDI decision (e.g. Dunning, 1990 *passim*; Saelens, 1986, p 91) and over the choice of nation in which to site the FDI activity (Motoshige and Kazuharu, 1986, p 68; Padmanabhan and Cho, 1996) but not always with the same result as Kogut and Singh eg Erramilli comes to the opposite view (Erramilli, 1996; see also Hennart and Larimo, 1998).

Other work has put less emphasis on the cultural causes of FDI and more on the related effect of clustering among Japanese firms operating overseas (Giddy and Young, 1982 was an early example of this; other references have been given in section 2.3 above). This behaviour is also consistent with the view that organisational relationships among Japanese interests are transaction cost economising and offer sufficient advantages to induce co-transplantation to foreign sites. Indeed, work by Head et al (1998) show that clustering is evident in the US and that it occurs not just among Japanese firms within a single industry or linked together by existing corporate or transactional links in Japan; it holds true also for firms in any industry, apparently related only by their being Japanese.

This transaction cost economising view of Japan's FDI position can also be related to the oft-repeated observations (also reported in Chapter 2) that Japanese firms operating overseas tend to "import a high proportion of their parts and components" (Strange, 1993, p 386) and that levels of intra-industry trade are low for Japan (Weinstein, 1996, p 139). This might be because the "dense web of relational contracting" among Japanese interests which tends to exclude FDI also gives a "natural immunity" to imports (Dore, 1986, p 248) and a preference for foreign affiliates to import from Japan. In short, the transaction cost economising view of Japanese economic activity gives reasons for the phenomenon

[160] This index has 4 dimensions: individualism, uncertainty avoidance, power distance, masculinity.

of co-location as well as reasons for the international FDI decision and the aggregate FDI asymmetry.

In making reference to this extended literature we should also emphasise what might be thought of as an emerging observation: that while cultural affinities and other national characteristics can be important in the propensity to undertake FDI (and might, as suggested here, reveal some of its purposes and policy implications), they can decline through time with overseas experience. This is to say that the impediments to international exchange which favour compatriot trading and FDI operate only over a limited time frame (an observation Kogut and Singh made in their original paper) and that psychic distance might decline with experience, not just in the nation where the experience is won but in all foreign locations (Eriksson, Johanson and Majkgard, 1997).

Indeed, this effect might account for the recent decline in Japan's egregiously low ratio of inward to outward FDI. In other words, inward FDI imposes less of an increase in transaction costs at home as Japanese firms gain more overseas experience. While this might be true, nonetheless, the ratio is still far outside the OECD norm and continues to change, as Dore observed in the 1980s, "at a glacial pace" (Dore, 1986, p 249). Japan remains different and its distinctiveness continues to be observable in forms of economic organisation different from other advanced nations (Fajnzybler, 1990, *passim*; Dore, 1990).

The final point to re-emphasis is that made in Chapter 3, that picturing the Japanese economy in this way is not to imply that competition among interests in Japan is eschewed. The view that relations among Japanese interests are simply cooperative and collective would be incorrect. It is better to see the situation in Japan as one where competition and cooperation have been mixed so that both forces provide a productivity boost (Calder, 1993, p 249; Fruin, 1992; p 305; Stigliltz, 1996, pp 163-7). This is important. It is saying that, in the real world, efficiency is promoted by combining the forces that are fundamental to the transaction cost and the market approaches: organisation or anonymous competition. We return to it below.

Before reinterpreting Japan's FDI asymmetry in less benign terms, this transaction cost economising analysis can be generalised as a series of mathematical expressions which address three pertinent questions: where will production be located, whether it will be controlled by FDI and whether a nation will have an asymmetric relationship between inward and outward FDI.

Assume a two nation world i.e. a world in which the cost of undertaking the activity differs between two locations (A & B). The geographic distribution of activities will depend on the total costs of production which will be a combination of production costs and transaction costs associated with that distribution. Both types of cost will vary with location so that sites A or B will have a relative advantage.

To express that mathematically, we begin by conceiving a firm owning some asset, a state of affairs which can be explained from within transaction cost theory or without. We further plausibly assume that the total revenue from sales derived from this asset is independent of the location at which production takes place (i.e. this is a global industry), so that profitability depends on choosing least cost methods and locations.

The first condition for siting an activity in location A is that it be profitable to do so i.e. that

$$TR > Ca.q + TC_a^{\min} \qquad \textbf{1.1}$$

where

TR = revenue from sales

Ca = the per unit production cost incurred if the activity is located in A

q = quantity of output and

$TC_a^{\min}$ = the cost of the transaction cost minimising mode of governance, given that production is sited in A (which, for example, might be by direct investment by the asset's owner or by licensing or joint venture. When the mode is direct and the owners are residents of B, this will give rise to FDI)

A number of points emerge from Equation 1.1.

Firstly, that some activities will be unprofitable solely because the transaction cost minimising arrangement is still so high as to mean they are not viable. In other words, the scope for economic activity is inversely related to the cost of the transaction cost minimising model and a fall in transaction costs increase the number of activities undertaken.

Secondly, *Ca* in equation 1 can be defined as a function of the determinants of prices for inputs to the activity and, in addition, of the location-specific costs of linking the activity into the global network, as described in equation 1.2.

$$Ca = f\{W_a, G_a, T_a\} \qquad \textbf{1.2}$$

where

Wa = the effect on factor prices in A of its stock of wealth, both endowed and reproducible assets i.e. the conditions of supply of inputs

Ga = the input price effects of the policies of government in A and

Ta = the transport and communication costs associated with locating that activity in A as part of a global network of procurement and sale.

Note two points. Firstly, *Ca* is not a function of the market size of the domestic economy in A i.e. it is a global industry. Secondly, linking this to trade theory, *Ca* is primarily a measure of absolute not comparative advantage, ie absolute advantage is a subset of comparative advantage and is the focus for siting decisions.

We should also note a number of points regarding $TC_a^{\min}$ from equation 1.1. It is the mode of governance which minimises transaction costs given that the activity is located in A. $TC_a^{\min}$ will depend on the general ease of trading in A (TC_a^{gen}) which raise or lower transaction costs for all and on the country of residence (*R*) of those who control the activity i.e. whether or not they are locals. This is important because, in general, trading

between residents and non-residents will have higher transaction costs than trading within a single group. Hence,

$$TC_a^{\min} = f\left\{TC_a^{gen}, R\right\} \qquad \textbf{1.3}$$

In general, $TC_a^{\min}$ will be the arrangements which minimise transaction costs of the activity in A.[161]

Not only must it be profitable to locate the activity in A, the second condition for choosing A as the site for the activity is that it must also be relatively cheap i.e.

$$Ca + TC_a^{\min} < Cb + TC_b^{\min} \qquad \textbf{2.1}$$

We can recast the proposition stochastically to describe the probability of locating global activities in A (*La*) as a function of relative production costs and relative transaction costs of that location i.e.

$$La = f\left\{Ca / Cb,\ TC_a^{\min} / TC_b^{\min}\right\} \qquad \textbf{2.2}$$

$$\text{where } \partial La / \partial C_a / Cb < 0 \text{ and } \partial La / \partial TC_a^{\min} / \partial TC_b^{\min} < 0$$

i.e. where the higher the relative production costs in A, the less likely it will be the site chosen and, the greater the transaction costs of siting in A, the less likely it will be chosen.

We can now describe the likelihood that the activity will be undertaken by FDI. The view from internalisation theory is that direct investment will be chosen when it constitutes the transaction cost minimising arrangement. This is the more likely when $TC_a^{gen} > TC_b^{gen}$, i.e. when location A is a relatively difficult trading environment it is more likely that use of

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[161] It might be that $TC_a^{\min}$ is influenced by the fact that the activity in A must fit within the global business strategy (i.e. there might be reasons which reside in the

the asset will be controlled by its owner, wherever they reside. If the asset is owned by residents in B, $TC_a^{gen} > TC_b^{gen}$ will call for FDI.

More generally, the probability that the activity located in A will be controlled by FDI from B (*FDIa*) will be a positive function of the general transaction cost environment in A and a negative function of the TC environment in B for residents of B i.e.

$$FDIa = f\left\{TC_a^{gen}, TC_b^{gen}\right\} \qquad \textbf{3.1}$$

where $\partial FDIa / \partial TCa > 0$ and $\partial FDIa / \partial TCb < 0$

In other words, transaction cost theory has it that, firstly, the higher the cost of doing business in A, the more likely that residents in B will use FDI and, that secondly, the cheaper it is to do business at home, the greater the probability that the activity will be controlled by FDI if a foreign site is most economical. Hence, FDI extends a relatively transaction cost economising home environment overseas because the foreign location is more difficult not just for foreigners (although, probably more so for them) but for everyone.

The final matter we can address with this framework is the likelihood that country B will be a net exporter of FDI and have a FDI asymmetry (*NFDIX*). This will depend on the ratio of general transaction cost in A and B i.e.

$$NFDIXb = f\ \{TCa / TCb\} \qquad \textbf{4.1}$$

where $\partial NFDIXb / \partial TCa / TCb > 0$

i.e. if overseas trading is relatively expensive, it is likely that B will restrict inward FDI.

In short, equation 3 says that a relatively transaction cost efficient home location is likely to lead to outward FDI while equation 4 says such an environment will lead to

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global business strategy for varying the arrangement from that which would minimise TC in A alone) but they are conditions for a more complex world.

restrictions on inward FDI, in both cases because this is transaction cost economising behaviour.

Having generalised the transaction cost analysis of Japan's net FDI position, this chapter now shows how it can equally be interpreted in terms of monopolising behaviour.

5.3 Asymmetry and Barriers to Competition

The transaction cost perspective has offered a persuasive interpretation of Japan's net FDI position. This is not, of course, proof of the theory's validity and the alternative interpretation in terms of monopoly purposes also provides a plausible and consistent view and one which allows for a different perspective on some of the unusual features of Japan's economic and institutional processes.

However, imperfect competition theory does not give a comprehensive account for Japan's asymmetry. Considerable extension of the argument is required and some ways of doing so lead beyond the scope set for this study. Nonetheless, that deficiency does not resolve the ambiguity isolated previously nor the policy ambivalence we concluded is required.

The essential element of the anti-competitive approach is that low levels of inward FDI to Japan in aggregate have the same underlying rationale as the outward FDI decision by individual Japanese firms i.e. they are outcomes of corporate strategies to restrict competition so as to build and exploit monopoly power. The argument is that the entry of foreign companies would dissipate the rents earned by incumbent Japanese oligopolists. However, it is not just foreigners who are excluded: incumbents' consistent exclusion of new entrants would apply to Japanese and non-Japanese alike but excludes especially inward FDI because, for historical reasons, the incumbents are Japanese (Weinstein,

1996, p 141). We can briefly add flesh to the bare bones of this argument by drawing on what others have said of the anti-competitive nature of Japanese economic organisations.

Firstly, the continued existence of unusual Japanese business groups' unusual business practices can be seen to point not to economising but to monopolising purposes. Hence, the private choices which have shaped Japan's business culture, although plausibly attempts to deal with transaction costs can also be interpreted as means to control the distribution of gains.

For example, Japanese *keirestu*, which we interpreted as efficiency-minded structures, might just as well be seen as having monopoly purposes (Helper and Hochfield, 1997, p 209). Similarly, the various forms of quasi-integration can be thought of as having a "predatory nature" allowing for the domination of smaller firms (Chesnais, 1988, p 149). In this view, the monopoly purposes are revealed in the fact that quasi-integration "does not contain [high] levels of voluntarism" (Machado, 1996, p 59).

Secondly, government led institutional innovation in Japan might also be seen as constructing means to exclude entry, rather than to provide efficiency gains and this because the Japanese government has a mercantilist attitude favouring not just domestic firms but insiders in Japan's political economy. It suggests that the Japanese government might have a less than comprehensive commitment to the principles of deregulation and promotion of competition.

While we have seen in Chapter 3 that there are no longer any formal impediments to FDI in Japan, this monopoly view has it that the real restrictions emanate principally through flaws in the application of anti-monoploy legislation in Japan which effectively sanction significant barriers to foreign entry.

It is certainly true that Japan's anti-monopoly legislation is not of Japanese in origin but was written by the Occupation forces after 1945 and is modelled on US legislation (Uchino, 1983, p 22). The legislation itself does not appear to be unusual. As with such

legislation in most nations, it provides a framework for the Fair Trade Commission (*Kosei Torihiki Iinkai*) to address issues such as unreasonable restraints on trade, private monopolisation and unfair business practices, which are said to be the "three pillars" of the legislation (Matsushita and Schoenbaum, 1987, *passim*).

Nonetheless, the fact that the legislation was originally imposed on Japan is consistent with the view that "Japan does not have a long standing anti-trust tradition" (Rotwein, 1964). Indeed, Japan first amended the legislation in 1953, only 15 months after the end of the Occupation (Nakazawe and Weiss, 1989). Moreover, as Johnson points out in his assessment of post-war policy and growth, the MITI and other powerful bureaucracies have, at times vigorously, opposed the application of the legislation (Johnson, 1982, *passim*).

It is an open question as to the degree to which these characteristics continue in the current era of deregulation, given the recent apparent strengthening of the legislation and of the Fair Trade Commission. Evidence for this view comes from Japan's Revised Individual Action Plan for the APEC, which has highlighted "deregulation and active implementation of competition policies" as its "top priority" (APEC website).

Despite this apparent trend in Japanese policy, the view that antimonopoly laws are applied relatively weakly, despite the US pressure, is still extant (Tilton, 1996, *passim*). Some evidence for that view is found in the fact that the Japanese Supreme Court continued to recognise explicitly some agreements between firms which restrict competition (Matsushita and Davis, 1990). In addition, Japanese officials have a long history of sanctioning cartel arrangements under the antimonopoly legislation (Tilton, 1996, *passim*). Many of these arrangements continue despite the comprehensive review undertaken in 1997 by the Japanese government as part of its undertakings to APEC.

Indeed, there is opinion that, as we saw in Chapter 3, some argue that Japan's reluctance to liberalise is revealed by the fact that serious debate concerning cartels and other business structures in Japan did not start until pressure was brought to bear from outside,

particularly by the so called Strategic Impediments Initiative between Japan and the US, starting in 1989.

This all emphasises the point that Japan's commitment to competition reform and strengthening might be less than comprehensive (Shimotami, 1997, p 5). Hence, the view remains that "a liberal interpretation of anti-trust laws" accounts for the low inward FDI (Dunning, 1996, p 45). Certainly any positive effect on inward FDI of the claimed strengthening of anti-trust enforcement in Japan has been small.

This critical view of arrangements in Japan is part of a wider tranche of criticism regarding the closedness of the Japanese economy, not just to FDI but to foreign capital inflows more generally and to visible and invisible imports as well (Stopford, Strange and Henley, 1992, p 234; Drysdale, 1995, *passim*). What we previously saw as transacting advantages that arose with solidarity and a "natural immunity to imports" (Dore, 1986, p 248) among Japanese has equally been interpreted as attempts to exclude foreigners, as we can see in the debate over the trade issue.

There is little dispute that Japan has long had relatively low levels of imports, just as it has low levels of inward FDI (see for example, studies by Lincoln, 1990 and Dornbusch, 1989) and recent IMF trade data used in Chapter 2 confirm the point. Substantial dispute arises only over the motivations for it. The Japanese side argues either that is in some way the result of efficiency-mindedness or that it is the result of peculiar and unavoidable features of the Japanese economy (like its geography and cultural preferences). Either way, it is claimed that low levels of import penetration do not indicate a desire to exclude foreigners from participating in profitable markets in Japan (Goto, 1991).

Of course, the monopolising interpretation is that low imports, low inward FDI and high barriers to entry are all related phenomena. In other words, we can interpret Japan's egregious FDI position as fundamentally the result of excluding inward FDI and can see this as one element in an array of mechanisms of Japanese mercantilism which identifies Japanese interests with those of large Japanese companies and leads to systematic

exclusion of foreigners, foreign products and, especially, foreign control (Belderbos, 1997, p 156).

While there seems to be sufficient evidence and opinion to take seriously the monopoly argument there are, however, problems with it as an explanation in this case. The monopoly argument must be significantly extended to give a plausible view of Japan's net FDI position.

The problem with the monopoly argument is that it is not clear why the exclusionary behaviour would not breakdown through opportunism on the part of some Japanese. As there is no formal impediment to inward FDI and as legislation exists to protect against anti-competitive behaviour, it is hard to see why Japanese interests, possibly insiders themselves or potential entrants facing barriers, would not expect individual benefit in collaborating with potential foreign investors. Nor is it clear why Japanese consumers, who arguably suffer higher prices and more limited choices because of the barriers to entry, would not offer decisive encouragement to new entrants.

There are three possibilities, consistent with but adjuncts to the monopoly argument, which can, separately or in combination, account for the relative stability of the FDI asymmetry in the face of this potential for opportunism. Firstly, it might be that there is a degree of patriotism involved so that the stability of collusion and the acquiescence of consumers is the result of either a willing altruism or of a self interested value being placed upon nationalism. The former prospect would combine the monopolising argument with points of view outside the scope of this study, set as it is by the assumption of self interest. However, either interpretation would be consistent with what has been described as an apparent conspiracy among Japanese interests (von Wolferen, 1989[162]; David et al, 1989[163]) and it is this conspiratorial view, that Japanese interests

[162]"The proliferation in Japan of collusive activities inimical to free market principles naturally makes one wonder whether all these activities might not be part of one gigantic conspiracy" (p 403).

[163]Concluding their study of Japanese FDI (which sees it as the beginning of the "Third Wave" of foreign economic imperilaism in Australia) the authors write

"systematically collude against foreigners" (Weinstein, 1996, p 149), which extends the monopolising argument beyond its simple, firm-centred form.

A second account for the persistence of informal barriers to foreign entry is that incumbent Japanese firms receive high level protection from within government and that this overrides the individual assessments of other Japanese interests which would otherwise prevail to destabilise the arrangements. This might be behaviour which conforms to the precept of bureaucratic capture by rent-seeking private business (Tullock, 1967, *passim*) or to the notion that action by government is the outcome of the self-interest of bureaucrats not the collective interest of the nation (Niskansen, 1971, *passim*) or to other ideas in what is now known as public choice theory (Stretton and Orchard, 1992, *passim*). Or it might simply be a case of patriotic and nationalistic mercantilism practised by government officials, as suggested more than once above. Anyway, it is an extension of the monopolising argument.

Finally, the monopolising argument might hold, despite the likelihood of individuals breaking ranks, because it operates in conjunction with the transaction cost economising, efficiency motive. In other words, it might be that the motivations are self-interested and so within the study scope, but operate in combination so that the arrangement which excludes foreigners has monopoly and economising purposes. In such a view the economising motivation provides the capacity to induce Japanese interests to hold to arrangements which benefit some more than others and foreigners less than residents (Weinstein, 1996).[164] In this way both views together can provide an explanation for the observed relative stability which is otherwise lacking in the monopoly rationale alone.

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that: "[s]uccessful capitalism in Asia [especially in Japan] ... has been a .. more disciplined matter of the integration of polititcal and economic power ... " and that it involves explicit "... coordination, focussing and disciplining ...[which] ... makes nonsense of outdated attitudes to foreign investment." (p 213).

164 The regulations which exclude both foreigners and new local entrants provide benefits which are distributed so as to "give a little something to everyone and each special interest received enough so that no one had an incentive to blow the whistle" (p 141).

This is a persuasive position, even 'though the relative importance of each motivations is not made clear (Boyd, 1996).[165]

In short, the monopolising argument, while superficially appealing, cannot account for the asymmetry by itself. It must be combined with or replaced by notions outside the theory *per se* or outside the assumptions of this study. This combination approach, in any of the three variants, is referred to below as the augmented oligopoly or the augmented imperfect competition view.

The exposition shows that the monopolising motivation can provide an important part of an explanation for Japan's net FDI position, so that the existence of the asymmetry does not resolve the ambiguity between the transaction cost and imperfect competition theories which we have identified in Chapter 4. Rather, this discussion deepens that dichotomy and suggests, again, that the best response is not a synthetic eclecticism but an additive dualism. The next chapter sketches the policy agenda which results from that additive approach.

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[165] Boyd reveals this ambivalence, although he implies that economising purposes predominated. He wrote: "Cohesion in the Japanese inter-corporate system has set up high entry barriers virtually sheltering the home market, but has become a source of superior efficiency" (p 210)

Chapter 6: Implications for Australian Policy

6.1 Introduction

This chapter consolidates and expands on the policy implications derived in Chapter 4 and bridges to the applied work in Chapters 7 and 8. It begins by spelling out the policy implications associated with imperfect competition and transaction cost theories of FDI and then links this to some of the economic development literature. Then, sections 6.2, 6.3 and 6.4 develop the policy implications into an agenda based, respectively, on an understanding of Australia's economic organisations; on the role of FDI in international industrial restructuring; and, on the potential for Japanese FDI to reduce competition.

As to the last, it is clear that the view of FDI as a manifestation of imperfect competition leads to the anti-monopoly policies which conceive of the role of government in orthodox terms so that any undesirable tendencies of Japanese FDI in Australia can be controlled by ensuring adequate contestability in input and output markets.

While it is true that the problem of monopoly powers can be addressed more directly by, for example, nationalisation or regulation, this is not the dominant policy trend which, as we have seen, is to make Australia's a less *dirigiste* economy where efficiency is addressed primarily by the promotion of competition among private interests through anti-monopoly legislation and institutions.

To reiterate, the pro-competition policies have two rationale. Firstly, monopolistic practices restrict output and raise prices relative to the outcomes expected from an alternative, competitive arrangement. This reduces allocative efficiency. Secondly, monopoly pricing and output levels shift the distribution of income from that which it would be under competition. This might be undesirable on equity grounds so that government might have egalitarian or other reasons for intervening. The rationale is heightened in the case of FDI

when the monopolistic control provides gains to foreigners at the expense of residents (Hymer, 1966, p 176).

As noted above, there is some irony here in that, despite the radical elements we have noted in Hymer's work, and which he increasingly emphasised, his view of FDI can be understood in terms of the orthodox model of competitive markets which remains its touchstone and provides its policy implications.

However, the policy agenda from transaction cost theory, based on our understanding of Coase's work, is a radical departure. It is based on a different view of economic organisation and processes and it provides an additional policy agenda. This is the fundamental reason for highlighting and maintaining the bifurcation between theories and the implications of this distinctly non-market view can now be amplified.

Consolidating what we have found from transaction cost theory, it places the stress on spin off effects which are attendant upon economic activity. There are four propositions regarding their control.

Firstly that, in circumstances without significant, idiosyncratic investments, transaction costs will be insignificant and competition alone will govern them. Such conditions are rare. Secondly that, in a world of transaction costs, a private organisation such as the firm (but not just the firm) might emerge to deal with these effects under some set of contractual arrangements (and will likely combine organisation and competition in the attempt). Thirdly, that the government might intervene; directly, to address the effects or, indirectly, to reduce the cost of private governance and so expand the scope of the private sector or to provide its own, additional control. Fourthly, that the effects might go ungoverned and fall as they will, without being priced and with no arrangements to govern them because, as Coase noted, in some cases "it would cost too much to put the matter right" (1960, p 39).

As intimated, the third proposition which provides the rationale for government intervention implies supportive policies of two types. Firstly, government can assist by enhancing the private sector's ability to deal economically with transaction costs. In other words, as we saw in some views about Japan, government has a role in creating a trustful, low transaction cost environment which will promote the spread of economising, institutional growth by the private sector. It can do so by a number of means and these are exemplified, as Coase observed, by the provision of money (Coase, 1991, p 716).

Secondly, government policy can be more targeted and assist particular activities or help to address the same impediments to arm's length trade which the private sector partially addresses by FDI (Dunning, 1993).[166]

At first sight, such policies might appear to reduce the need for private organisation and hence for FDI. But it is better to think of them as extending the scope for private activity.[167] In the context of Australia and Japan, the implications is that government efforts which help address specific difficulties which give rise to FDI will extend the amount of bilateral activity, leading to more of it, including as organised by FDI.

In both cases, the transaction cost rationale for policy is that which we have sketched previously: government is needed when the effects attendant upon the activity are diffuse. And, to reiterate, government is able to act in these circumstances because it need not undertake all the costly tasks of identifying the recipients of these effects and specifying, monitoring and enforcing contractual arrangements with them, as would be the case with

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166 Dunning wrote: "intervention to reduce endemic transaction costs is essentially pro-market and symbiotic with the goals of the firm" (p 64).
167 The total scope for economic activity will be given by all the trades from which gain is possible. This in turn is set by the different marginal rates of substitution of goods and services which pertain to different individuals. Hence, the scope for economic activity is probably enormous. The transaction cost perspective says that the actual amount of activity undertaken is set by the costs of undertakings (cf. the benefits) and is a far smaller amount than the total possible. The proposition above is that policies which reduce transaction costs generally will expand the trading and will not necessarily reduce the amount undertaken by any particular means, including by FDI.

a private organisation. It requires only that the effects fall within its jurisdiction and that the costs of addressing them by policy are more than outweighed by the benefits of doing so. As shown in section 6.3 below, this reasoning has particular relevance to so called industrial structure policy.

To complete this preliminary discussion we can show how the transaction cost view fits with other currents in the economic policy debate, focussing on the role given in explanations of growth to spin-off effects exchanged among activities, especially including parties not engaged in transactions. As noted above, these are commonly conceived by economists as externalities and it is that thread which can be followed through the literature (although we have given good reason to think of them in transaction cost terms).

Firstly, there is a clear link to the so called New Growth Theory. Krugman argues that a role for government exists because "markets" alone cannot coordinate all private activity (Krugman, 1990).[168] The same notion is also part of important early work in development economics by Hirschman (1958) which considered the inclusion of external economies as necessary for effective development policies and his work is relevant particularly to the notion of industrial structure policy.

Some empirical work helps confirm the point, as with the widely reported estimates by DeLong and Summers (1991) that the social rate of return on equipment expenditure is much higher than the return to the private investors, a point taken to "suggest that much of the return is in the form of external effects on production growth in related sectors" (Dowrick, 1992, p 13).

In analysing the economic success of the East Asian nations, Stiglitz isolated the same point much as it has been made here: that "diffuse externalities" are significant and "arise

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[168] In analysing national growth in the Asia-Pacific region he states that "it is impossible to explain such spectacular results without appeal to some kind of externality" (Krugman, 1990, p 37).

when the activities of one firm benefit or confer costs upon many firms, rather than, say, just one upstream firm or one downstream firm." (1996b, p 157). These effects and policies directed to them he sees as central to the East Asian "miracle".

This view, that economic activity is importantly influenced by untransacted effects among parties also gives reason for what has become a hot topic in development studies, alluded to in relation to the co-location of Japanese firms overseas, the notion of clustering and the related idea of networking (Porter, 1991). Why do horizontally and vertically related firms cluster together? Because they are attracted by locational advantages which include, as one point on Porter's diamond, the co-location of related firms. This creates synergies and complementarities which spillover from one private actor to another, but do so in geographically-concentrated ways (Mayer and Mucchielli, 1998, p 133).

The importance attached to these spin off effects among private activities also parallels the line of theoretical reasoning used by Japan's MITI to justify its industry policy (Goto and Irie, 1990), as we shall see below in considering industrial structure policy more comprehensively in section 6.3. However, firstly, we will look to policies which reduce transaction costs as a response to Japanese FDI in Australia.

6.2 Australian Economic Organisations and Policy Making

The understanding of FDI as a means to economise on transaction costs implies to two sorts of similarly minded policies: those aimed to reduce transaction costs within the host nation and those aimed to reduce them between the host and source nation. Both have their rationale in the view that there are significant impediments to economic activity, despite the efforts of private organisation and these impediments can be addressed by policy. This section looks broadly at such impediments and at the general transaction

cost environment in Australia in the context of the bilateral relationship of Australia and Japan.

Dealing firstly with policies to reduce transaction costs at home, we have reasoned that Japan has policies, institutions and a cultural *milieu* which can be conceived as being conducive to economic activity. There are some obvious differences from Australia which mean it might be less well endowed. Not only is Australia's population culturally and linguistically diverse, especially when compared to Japan, but Australia's multiculturalism also generally partakes of Western *mores*, valuing individuality relatively highly and being without the 'groupishness' some see as important in creating a low transaction cost, high trust economic environment in Japan.

As we have also noted, Australia has few indigenous firms and, compared to Japan, there are fewer business groups and other inter-company arrangements. As a result, Australia has been described as "lacking a national corporate identity" (Crough et al, 1982, pp 202-3). Moreover, the business and employer organisations which do exist are said to be subject to "(d)iversity, disarray and disunity ... " (Matthews, 1991, p 201) and their mandate to lead business negotiation with government is "qualified" (Keating and Dixon, 1989, p 64).

It is said to "difficult to identify stable blocs or alliances of capital" in Australia (Tsokhas, 1984, p 151) so that Australia generally lacks what one researcher has called efficient "industry policy relationships" (Stewart, 1994, p 188).

Foreign firms are neither a coherent bloc in themselves nor can it be readily assumed that their interests coincide with the Australia's or that they are easily or well reflected in representative bodies. This all can be interpreted as hampering the organisation of economic activity in Australia by failing to create a transaction cost economising framework.

However, compared to Japan, trade unions are more important in Australia and this offers some additional organisational advantages (Kenwood, 1995) [169], even though Australia's lack of countervailing organisations implies that its political economy is "vulnerable to capture" (Hill and McKern, 1997, p 235). Indeed, Australia's industrial relations system can be interpreted as an institutional innovation aimed to overcome potentially expensive and fractious labour negotiations and to enhance trust by limiting opportunistic and exploitative behaviours (Schere, 1987, p 86; Lansbury et al, 1987, pp 476-7; Buchanan, 1997, p 253).[170] Such an organisational advantage will tend to reduce Australian transaction costs and suggests the value in coopting Australian trade unions into the FDI policy making process.

This raises an important and more general point. One of the strengths identified in Japan's political economy was the close link between government and firms so that its policy making has an unusual degree of inclusiveness. In other words, policy has been critically important in Japan but it would be wrong to conceive of Japanese growth as a matter of central planning by sagacious bureaucrats. It is more a case of cooperative policy development in an economy dominated by private firms and organisations (Stiglitz, 1996b, p 161; Johnson, 1990, p 49). Involving organised stakeholders in the policy development process as the Japanese have done can be seen as reducing the information costs involved and, arguably, as improving the understanding of and compliance with national goals.

In the recent past, Australia too has coopted business and trade unions into the so called tripartite policy development process (Keating and Dixon, 1989, p 69; Capling and Galligan, 1992). However, in the period of liberal reform, these initiatives have been unwound and the emphasis shifted to competition policy. The reasoning here suggests that change in approach might not be optimal. There are grounds for suggesting benefit can be had from reforms which enhance both policy making relationships and trust

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[169]"Trade unions (are) a second principal source of power and influence within the (Australian) economic system" (p 28).

among private interests. This might be especially needed among Australian companies, given that Australian labour is relatively well organised.

Despite the relative advantage Australia has in this regard because of its organised labour, for policy making and in other ways, Australia seems a less coherent economy than Japan. Not only are some elements of economic organisation missing or less well developed but Australia's economy displays a heterogeneity and multinationalism which contrasts sharply with Japan. Australia's economic environment has not been built on distinctive and widely held national traits, for better or ill. In short, while we can sketch a transaction cost economising rationale for Japan to exclude FDI, Australia's long history of inward FDI makes that rationale irrelevant: what might be beneficial for Japan need not work for Australia.

The argument can also be put more positively. It is saying that Australian advantage lies in emphasising its multiculturalism and lack of identification with indigenous firms, so that welcoming FDI is doubly more attractive as an Australian strategy than it would be for Japan: it provides extra organisation from the private sector while not disrupting the existing organisational mix.

Explicitly emphasising this point in Australian policy might encourage total FDI but is especially likely to encourage FDI from Japan and other economies which are culturally or psychically distant from the emerging global norms. For them, the Australian economic environment would likely appear more welcoming and flexible than say Europe or the USA where the mix of national ownership is narrower. In its multinationalism, the Australian economy is more like some of the conceptions of the nationless global economy described in Chapter 1 and is therefore a place to learn to fit within a multinational economy but to do so within a single jurisdictional area where legal and other systems are consistent and so restrain transaction costs.

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[170] Buchanan writes that "Australia's award system provids a very effective reference point for minimising .. transaction costs".

Whether or not Australia's situation can be viewed so optimistically, policies are implied to improve its transaction cost economising characteristics. In particular, policies are implied to build and strengthen the institutions we have referred to as forms of quasi-integration which can aid in negotiating, monitoring and enforcing bargains among private interests. Given the history and heterogeneity of the Australian economy, this kind of institutional building may be more important than developing indigenous firms. Hence, there is argument for government to assist in the development of business organisations and associations among firms and trade union organisations and their peak bodies.

In relation to quasi-integration among firms, this agenda is currently addressed in Australia by the so called networking incentives offerred by State and Federal governments (BIE, 1995, *passim*; The Business Centre, 1998; Worrall, 1993, p 186). Such policies have a strong justification in transaction cost economising terms.

Government assistance to create organisations for policy development and for dealing with interdependence among private parties could provide counterparts to those in Japan, thus creating links between the two nations and forums in which Japanese firms in Australia can interact with other local firms. The following chapters includes some examples of existing and potential industry bodies which fit with this justification and with Romer's related notion of self-organised industry investment boards (Romer, 1993).

More directly relevant to FDI are the second set of transaction cost economising policies which can address the economic environment between Australia and Japan. Many such policies already exist in the web of agreements, treaties and understandings which have been concluded between the two countries on a multilateral or bilateral basis. Most important among these are the Agreement on Commerce of 1957 and the Basic Treaty of Friendship and Cooperation signed in 1976 (McCormack, 1991, pp 27-8).[171] They are

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[171]The 1976 Treaty is said to "locate the Australia/Japan relationship in both bilateral and multilateral contexts as a core element in each country's definition of its external relations" (p 28).

supported by in excess of 20 bilateral treaties dating back to the trade treaty of 1894 and covering a range of economic, environmental, scientific and cultural matters.

At section 3.2 we saw how the agreement over tax matters between Japanese and Australian authorities addressed the important FDI issue of transfer pricing. This too is an example of public initiatives which coordinate regulatory functions and so reduce impediments to international exchange and we will offer specific suggestions for similar cooperative regulation below.

Another important element of the transaction cost economising agenda is government's role in promoting relations between private interests in Australia and Japan. An exemplar of this kind of government assisted initiative is the development of the so called Australia-Japan Business Cooperation Committees (AJBCC). These have been studied by Kamada (1993) and a review of them is instructive. In brief, these twin groups; the Australia-Japan Business Cooperation Committee (formed in Australia in 1962) and the Japan-Australia Business Cooperation Committee (its counterpart on the Japanese side, formed in 1963) were established, with government assistance, in the manoeuvring which followed the Australian government decision to lift the post war embargo on iron ore exports.

Even before the AJBCC, the Japanese side was able to respond to that prospect by forming a cooperative of interested Japanese parties (i.e. *sogo shosha*, steel mills and steel users) to negotiate with the Australian side. However, by contrast, in Australia, neither private interests (which, especially in mining, are not all indigenous Australian interests) nor the relevant government departments could deal collectively with the Japanese side.[172]

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[172]Kamada writes: "(h)eads of Australian mining companies visited Japan one after another, and made competitive offers to the Japanese steel mills" (p 6) and "..within the mining sector there was disunity vis-a-vis the government and foreign business communities" (p 7).

The emerging difficulties led to the Japanese proposal to establish the Committees during a 1961 goodwill mission. They were intended to provide a forum for frank business discussions, for exchanging information and for organising regular, industry-specific conferences. While the Japanese side quickly developed representative organisations to manage their interests at the Committees, in Australia there were problems as various business groups fought for control. These problems carried over to the operations of the Committees.

Despite these early difficulties, the Committees have been long lived and useful, especially in that they have provided a forum for non-Japanese interests in Australia which, to re-emphasise, cannot be thought of simply as Australian interests, to negotiate with Japanese investors and customers (Tsokhas, 1984, p 152). They have established a model upon which other organisations have been built and upon which further initiatives could now be taken.[173]

The final points to bring out of this discussion relate to the relative shift in emphasis in Australia's internationalisation which was detailed in Chapters 2 and 3. There we saw how liberalisation of Australia's external sector was associated with three developments: increased FPI flows; a relative decline in the importance of FDI; and, an absolute decline in the foreign capital raising role of government. This placed increased emphasis on the ability of local firms, indigenous and foreign, to raise the capital required to fund Australia's chronic current account deficit and to do so relatively cheaply.

A number of commentators have questioned whether Australian indigenous firms are capable of playing their part in this shift of strategy. For example, a Parliamentary inquiry linked this FPI inflow to what it described as the "speculative mania" of the late 1980s (House of Representatives, 1991, p 35). Other researchers have argued that the

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[173]For example, the model has ben replicated in establishing the Australia-Japan business forum (and a Japanese equivalent) after the 1984 visit to Tokyo of Prime Minister Hawke.

access to larger pools of foreign lending increased foreign indebtedness and the vulnerability of many Australian businesses so that:

> "Less than a decade after liberalization, many of the country's most prominent business conglomerates had collapsed, and several major banks were in great difficulty" (Hill and McKern, 1997, p 215).

This raises, not for the first time, broader questions about the quality of leading Australians as managers (Stretton, 1985) and particularly about their reputation for creditworthiness in international capital markets.

There are other problems too. We have proposed that Australia is unlikely to support local firms in the same way that Japan did when it too pursued an internationalisation strategy which emphasised the abilities of indigenous managers. Partly this is because the international setting is now somewhat different but partly also it is because Australia policy makers are different.

A controversial study of Australia's top public servants has shown that they are different from those in most advanced countries in the large extent to which they are trained in economics and so see competition, including by imports and potential foreign entrants, as critical to successful reform of the Australian economy (Pusey, 1991, *passim*).[174]

This profile of views is very different from those associated with Japanese officials who are ambivalent about competition and seek to promote efficiency primarily by domestic devices including by support for indigenous firms (Johnson, 1982, p 62; Sheridan, 1996, p 207).

It is not just Australian officials who wish to do little more than liberalise foreign investment and trade. Many leading Australian academics also warn generally against

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[174] Pusey's study has been hotly disputed by Australian economists and policy makers who have variously described it as "sludge" (John Stone, ex head of the

the dangers of bureaucratic capture and argue that government failure is more likely and serious than is market failure (Keating, 1993, p 71; Pincus, 1993, *passim*).

This Australian combination of free market bureaucrats and advisers is unlikely to apply the techniques which Japanese authorities used, in conjunction with controls over inward FDI, to build indigenous firms. And, without such assistance, indigenous firms are unlikely to develop strongly. This means that the large local firms which must do much of the foreign borrowing required by Australia's change in strategy will be more predominantly the subsidiaries of MNCs. In other words, much of the FPI inflow needed to cover the current account deficit will be channelled through MNCs, so increasing FDI (and foreign indebtedness). This study has not argued against such a change *per se* but it is probably not what policy makers had in mind.

Secondly, the strategy can undermine the stability of Australian financial institutions by, in effect, requiring that they act as intermediaries and take on some of the risks associated with international loans to Australian business. We have seen data in Chapter 2 which show the pace with which the foreign indebtedness of Australia financial institutions is increasing and those data underscore this danger. Finally, it is probably true that Australian governments remain the most creditworthy of Australia's economic organisations and to do without their capital raising capacities, as the liberal strategy shift also requires, will likely impose costs on the Australian economy. We return to this matter in concluding in Chapter 9 but can flag already that the policy change looks sub-optimal.

6.3 Industrial Structure Policy

We now consider the second set of policies with a transaction cost economising rationale: those which attend to the structural matters which surround FDI. This section firstly

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Treasury, *Quadrant, 1992*) and as "rubbish" (Professor Richard Blandy, *Australian Quarterly*, 1992). See also essays in King and Lloyd (eds) 1993 eg Pincus, 1993.

clarifies those policies and the link of FDI, trade and the industrial structure. Secondly, it shows how industrial structure policies strike a chord with important Japanese views about FDI and the role of government. Thirdly, it develops the rationale for industrial structure policies with further references to the major currents in thinking about economic development already noted at 6.1 above.

In Chapter 4, we saw that the transaction cost rationale for government is that first laid out by Coase; that policy should address effects which were concentrated geographically within the jurisdiction of government but diffuse among private interests involving, as they do, third parties to transactions. To reiterate, such circumstances involving third parties were seen as particularly important, both in clarifying the general form of transaction cost argument and in differentiating transaction cost economising policy prescriptions from those based on the principle of deviations from competitive pricing.

To clarify further, we can illustrate the case for such structural policies by considering briefly the motor vehicle industry as an exemplar of an activity which generates diffuse benefits and can add coherence to the host economy's industrial structure, i.e. can group together a set of complementary, synergistic activities. That can happen in a number ways but, to further the example with an actual instance we will expand upon in chapter 8, consider that car making has a need for rubber mouldings of a sort very similar to those also used in whitegoods production (air conditioners, washing machines and the like) and which can be produced by a common supplier.

To the extent that local car manufacturing leads to better local rubber mouldings, it can produce benefits to local whitegoods manufacturers. Because those benefits involve third parties and are relatively diffuse, they might be uneconomic to govern by the car maker and, hence, would be excluded from her consideration. But, from the Australian policy makers' point of view, such effects can be important and may justify some targeted assistance to car makers, such as tariff protection, as a means of indirectly assisting the white goods industry. There will be a tendency for private interests to group linked activities like motor vehicle and white goods manufacturing together. The argument here

is that more benefit can be had by a government fillip which creates a more advantageous mix of local activities (Carr, 1979, p 31).[175]

With this type of reasoning in mind, we can consider the structural policy implications of FDI by expanding on the link we previously noted between FDI and trade. The view from the transaction cost economising perspective is that differences in comparative advantage provide potential gains from trade. The trade will go ahead if the means of organising it (FDI or some other contractual arrangement at arm's length) incurs transaction costs sufficiently low as to not expunge the potential gains.

FDI is then one means of providing the investment and organisation required to deal with spin off effects associated with comparative advantage. It is chosen particularly when it provides an economic means of dealing with enduring interdependence, attendant on idiosyncratic investments and the spin off effects this makes possible between residents in different nations.

This view of FDI as an organisational arrangement related to comparative advantage, links it to trade and to the industrial structure in the source and the host nation FDI plays a role in shaping economies as they respond to opportunities for international exchange. We will expand upon that role in Chapter 8 below when discussing the motor vehicle industry (and Appendix 4 provides some generalisations about the relationship) but we can note here that the link between trade, FDI and the industrial structure has been reinforced and clarified in the work of a number of Japanese theorists.

That work links the amount and composition of Japanese FDI to the changing comparative advantage of activities sited in Japan viz-a-viz other nations with which Japan could trade. As such, FDI plays a role in re-shaping the industrial structures of source and host.

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[175] Carr's position which, as far as can be ascertained makes no reference to transaction cost theory, is very similar to that developed here. He wrote that "the normal operations of the profit and market mechanisms can induce such behaviour [of linked growth], but ..... the major program to increase local content in the early 1960s [was also] a cause" (p 31).

Kojima (1978) has put it that FDI flows

> from a comparatively disadvantageous industry in the investing country (which is a potentially comparatively advantaged industry in the host country) .... [and this] .... will promote an upgrading of the industrial structure on both sides and thus accelerate trade between the two countries (Kojima, 1978, p 83).[176]

Ozawa (1979) takes a similar line and, significantly, reveals something of what might be the Japanese public sector's view of FDI by quoting an ex-MITI official's explanation of the link between it and industrial restructuring:

> "the solution [to the problem of declining competitiveness at home]...is to be found in progressively giving away industries to other countries, much as a big brother gives away his out-grown clothes to his younger brother. In this way, a country's own industries become more sophisticated" (Ozawa, 1979, p 205).

In a similar vein Shinohara (1982) reports earlier work (by Akamatsu of Hitotsubashi University) which describes a process of Japanese internationalisation in certain key industries that began firstly with imports, then, once domestic sales had passed some threshold, with domestic production via FDI and, finally with exports from Japan (Shinohara, 1982, p12). Hence, FDI plays a role in upgrading domestic production so that it substitutes for imports and eventually leads on further to exports. Akamatsu called this the "wild geese flying pattern". (We have seen above how this fits the pattern of development of Japan's motor vehicle industry.) The concept has been extended, by Shinohara and Ozawa among others, to explain the role of outward Japanese FDI in Asia and the so called "boomerang effect".[177]

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[176]This conceptualisation refers to Japanese FDI. By contrast, Kojima characterises US FDI much as Hymer has done: as oligopolistic and motivated by the increase in global profits which can be secured by FDI. US-style FDI goes into the industries where firms are strong at home and this means that it is trade substituting and fails to promote beneficial restructuring.

[177]Shinohara argues that this model can be augmented to include the so called Vernon effect whereby domestic production replaces imports and then leads first to exports and then as the product matures, to outward FDI. This gives a pattern

These Japanese views of FDI are part of the broader concern with the industrial structure and the process of structural change which governments have long displayed in Japan (UNCTAD, 1995)[178] and we will look closely at the MITI's stated rationale for industrial structure policies below. But, firstly, the link of the industrial structure to FDI and policies derived from that link rely not solely on these Japanese theorists nor even on transaction cost theory. Key, clarifying elements of the argument can be found in the work of others.

We have already noted the links between the transaction cost view of economic processes and the position of Porter (1991) and the New Growth Theorists, especially Krugman. These links are heightened by consideration of industrial structure policy. Porter's view (in Porter, 1991) is that efficient locational decisions are determined in part by the presence of supporting industries i.e. that external effects are traded among activities within an economy are important and important for policy makers.[179]

The structure of the local economy is also important in the New Growth Theory conception of clustering as being dependent on local external economies (Krugman, 1995, pp 49-50) [180] and this alludes to a wider literature on regional growth and the economics of agglomeration

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of "import - domestic production - export - overseas investment" (Shinohara, 1982, p 12). Shinohara also makes reference to what he calls the "boomerang effect" which is a further step in this process whereby the foreign production base begins to export back to Japan (or to other countries previously supplied from Japan) thus creating a situation of "reversed imports" (ibid, p 15).

[178]A recent report by the UN notes: "Japan's success in becoming a highly competitive economy owes much to its ability to restructure its manufacturing sector continuously from labour-intensive through resource-based heavy industries and assembly-oriented industries towards high technology industries. Outward FDI in manufacturing was important at each stage of the restructuring process." (UNCTD, 1995, pxxxvi).

[179] Porter writes that "(e)xternal economies within a nation .... are a central feature of competition, and their role is more pervasive than generally supposed" (p 144). Similarly, that "(g)overnment policy must recognize the interconnectedness of industries in creating competitive advantage" (p 656).

[180]He writes: "(i)n the....absence of any scale economies we would not even see a world of small villages - we would see one of self-sufficient farms." (1995, p 36).

which goes back to the classical economists (Marshall, 1961, pp 268-273; David and Rosenbluth, 1990, *passim*) and has been much developed more recently (Knox, 1994, *passim*). The literature refers to localised scale effects, including the concept of critical mass by which some minimum presence of effects from supporting industries, infrastructure and firms provide the basis for a cluster to emerge. It includes other spin offs as well as external scale economies such as demonstration, contagion and reputation effects which also tend to concentrate geographically.

The notion that policy should be designed to influence the structure of the economy aligns especially closely with the views of Hirschman who, in his classic study of economic development policies, isolated two kinds of relatedness among activities: some activities are net generators of positive external effects and induce further investment while some are net users (Hirschman, 1957).[181] The former are targets because of the growth they induce, the latter are targets because assistance to them conforms to locational advantages and therefore growth promoted via them is most readily encouraged. Translating this to Australian policies for Japanese FDI, some would target Japanese FDI because it can create spin offs (the motor vehicle industry is the exemplar) and others target Japanese FDI activities which make use of spin offs (as would subsequent policies to attract white goods manufacturers).

This all relates to the notion that FDI can play a role in creating an efficient composition of activities which fit together within an economy. This notion of fit in turn leads to the proposition that public assistance, like growth of private organisation, must be selective so that policy is a question of which activities should be encouraged at home just as corporate growth is a matter of which activities to undertake internally. The right mix of activities will have a coherence which results from their relatedness, both to each other and to the region's immobile assets. These together make up an economy's locational advantages and the exploitation of strategic complementarities among them can add to the probability of virtuous, self-reinforcing cycles in regional development (Krugman, 1995, p 46).

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[181]Hirschman defines these as projects which are "net beneficiaries of external economies" (p 71). We also find, in the same passage, reference to those activities which create net external benefits. In Hirschman's words, the latter are industries

The key observation is that competitive industries do not operate in isolation. The efficiency of any particular activity in any particular place depends in part on how well it fits with other, co-located activities, i.e. on the extent to which an activity creates beneficial external effects for other local activities or makes use of such effects which are created by other local activities. This study has contributed to the literature on this matter by providing a transaction cost economising rationale for government policy which attends to these effects.

Before concluding this general description of industrial structure policy it is instructive to consider the Japanese view of it in more detail. This deepens the appreciation of Japanese business' view regarding the potential role an Australian government could play in influencing FDI to shape the industrial structure.

Industrial structure policy (*sangyo kozo seisaku*) is one of the two components of industry policy in Japan, the other being industrial rationalisation policy (*sangyo gorika seisaku*). The latter deals with competitiveness of particular activities while the former obviously deals with the matter at hand, the structure or composition of the economy as a whole (Johnson, 1982, *passim*; JETRO, 1985, p1).

Industrial structure policy operated most vigorously in Japan after the creation of the Industrial Structure Investigation Council in 1961 (Johnson 1982, p 253) and has since been advanced through a series of MITI Vision Statements (Sheridan, 1995, pp 164-171). While there is dispute as to whether any of these policies were effective, the present objective is simply to follow the MITI's rationale for them.[182]

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with "a large 'input' of external economies and a much smaller 'output'" (ibid).

[182] Some, such as Johnson (1982) argue that the "shift of the industrial structure was the operative mechanism of the economic miracle" (p 31) and others such as Trevise et al (1976) argue that "economic growth spread across the industrial spectrum as could be expected" (p 794) i.e. as the authors anticipated would have been the case without industrial structure policy.

This can be found in the MITI's first and only significant attempt to describe, in English, the basis for Japan's industry policy (Goto and Irie, 1990).[183] It focusses on effects of one firm's action which "spillover to other firms" and justifies government policy by reference to the difficulty which the private sector has in dealing with "the linkages within and among industries" (p 27).

Interestingly, the authors perform an often-missing step in that they point out that if a benefit is potentially produced by governing some spillover effect then, in principle at least, private firms could raise the finance required to undertake that governance.[184] In other words they begin by following the same logical progression as here: that government action is justified when "it is not possible for the benefits .... [of an investment] ... to be exclusively enjoyed by the firm" (p 27) which creates them and they realise the need to show, if this is to be a matter for policy, why it is not possible for the private sector to provide the organisation required.

Their illustration which then follows, of a firm considering investment in a large scale steel mill, elucidates the close parallels and contrasts between the MITI and transaction cost economising rationale. Goto and Irie describe the situation as one in which the investment will decrease average costs markedly but, because the fixed costs involved are high, it will need a large increase in the demand for steel if the investment is to be profitable. It is likely but not assured that if the investment goes ahead there will be cost decreases for users of steel and increased demand for steel from them, partly because their products will be cheaper and more in demand. As the authors put it

> (i)f the steel company correctly grasps these general equilibrium effects in advance, this will act as an incentive for it to build the blast furnace, but in order

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[183]One prior work is JETRO (1985), entitled "Japan's Postwar Industrial Policy". This publication differs, however, in being a description of the evolution of programs rather than an attempt to reveal the underlying rationale.

[184] The argument is that if "the discounted present value of future social benefits to be derived from protection and promotion .. exceed(s) the current social cost .... firms can achieve self-reliance through thier own efforts by raising money from financial institutions." (pp 26-7).

to compute this it will require an immense quantity of information, which is not possible for a single firm (p 28).

It is this significant information problem which, somehow, the public sector can more readily solve, that is the MITI's central justification for industry policy.

Again, this is clearly allied to the reasoning employed here: "general equilibrium effects" ripple out and become diffuse; it therefore becomes expensive to identify beneficiaries and negotiate and enforce an agreement with them; hence there is a need for government. Indeed, the two views would be very nearly the same but for the fact the MITI sees the problem as one of information costs rather than of transaction costs. In this regard, it can be seen that the view developed here is superior for two reasons.

Firstly, the difficulties facing private interests are not just those of identifying gains and gainers and monitoring compliance (which could conceivably be thought of as information problems) but also include the costs of negotiating and enforcing agreements over shares of the benefits which the investment produces. These fit only within a very elastic definition of information costs. As Stiglitz has put it: “Information costs are but one form of transaction costs ...” (1996b, p 176).

Secondly, the MITI view implies that government is somehow more able to collect and disseminate information, although it gives no reasons why this might be so. By comparison, the transaction cost approach developed here has provided a clear distinction between public and private sector economic organisation, noting that government has an advantage in that it can act so long as it expects net benefits within its region.

All this has provided general arguments for government to have a role in shaping the industrial structure and it leads to a set of proposals for targeted (i.e. selective) industry assistance to help shape the industrial structure. However, these are general arguments and apply to all kinds of investment. But there are two ways in which they have an additional relevance to Japanese FDI.

The first is allied to the Japanese notions of FDI considered above. Japanese FDI will restructure the Australian economy in a way related to the trade opportunities which exist bilaterally between the two. In particular, the mix of economic activities undertaken in Japan will change through time with changes at home and abroad. This will change both the pattern of trade and of FDI and, to the extent these changes are relevant to Australia they will determine the effect on bilateral trade and FDI.

It implies that, if Australian policy makers understand the effects which spin off into the local economy from these changes in trade and FDI and can isolate among them those effects which it is unlikely the private sector will control, they then have targets for attracting Japanese FDI, either because it will make use of spin off effects from existing activities (and so is relatively cheaply encouraged) or because it will give rise to spin off effects which lead to growth of other activities. In short, Australia's policy with respect to Japanese FDI should respond to the implications for the Australian economy of changes in bilateral advantage and should be based on an assessment as to which of these implications will be beyond the organisational capacities of private interests.

The second implication arises from the proposition expressed in section 5.2, that Japanese firms have an economically rational, systematic tendency, based on self-interested, efficiency-minded motivations, to deal with compatriots.

But, because it is compatriot-favouring, Japanese FDI might then be less likely to create to make use of tendencies which exist in Australia for synergistic, self-reinforcing growth and so will not maximise host nation gains. In short, that the attractions among Japanese interests might bias the development process.

Hence, Australian government action to promote beneficial restructuring is needed not just because the industrial structure is shaped by diffuse external effects (i.e. not just for the usual reasons to intervene on behalf of the industrial structure) but also because these

effects tend to be dissipated away from the host under FDI, especially when the investment comes from Japan.

The cost of not acting would be felt over time in a mix of local activities whose tendency to coherence is limited by the presence of Japanese FDI. Coherence will be increasingly manifest not in the effects among local activities but in their relation to Japanese-controlled activities in foreign lands, especially in Japan.

And this can be reasoned to be the result not of conscious attempts to exclude foreigners but because the Japanese economic environment and intra-Japanese trading offers such strong attractions. As such, it means evidence that Japanese FDI is exclusionary is not necessarily evidence that it has less-than-benign motives. The appropriate Australian response is to make more than usual efforts to build coherence into the Australian industrial structure.

6.4 Competition Policy

We now turn to the last of the three elements in the policy agenda and the only implication deduced from imperfect competition theory: the application of anti-monopoly legislation to FDI. Assessing it as a response to Japanese FDI is especially important given the high priority assigned to competition policy in the current era of deregulation in Australia.

The view of FDI as anti-competitive leads to the anti-monopoly policies which conceive of the role of government in orthodox terms i.e. that any exploitative tendencies of Japanese FDI in Australia should be controlled primarily by ensuring adequate contestability in input and output markets. We have sketched the efficiency and equity rationale for this set of policies at 6.1 above. They lead to action under what in Australia is known as Trade Practices legislation which, like Japan's anti-monopoly legislation, aims to promote competition.

In Australia, the recently formed Australian Competition and Consumer Commission (ACCC) has replaced the older Trade Practices Commission (TPC) in implementing the Australian Trade Practices Act. As in Japan, Australia's legislation contains wide ranging clauses which prohibit anti-competitive agreements, the misuse of substantial market power, exclusive dealing, resale price maintenance and mergers and acquisitions which would substantially lessen competition (ACCC, 1995 and 1999). These provisions are backed by laws for access and principles of neutrality in the operation of public business enterprises and government policy more generally.

The relevance of all this to Japanese FDI in Australia is two fold. Firstly, like all business operating in Australia, activities of Japanese FDI organisations will be scrutinised under the legislation in the normal way on the basis that "a foreign monopolist is a bad as a local one" (Stopford, Strange and Henley, 1992, p 249).

However, secondly, the FIRB is required to inform the ACCC of all new FDI proposals or of changes abroad which can substantially reduce competition in Australia. While investigations of both types have been undertaken with respect to Japanese FDI[185], the ACCC has not taken action to oppose or unwind any Japanese FDI on the grounds of its having significant anti-competitive impacts. So while anti-monopoly legislation applies to FDI, a case to oppose Japanese FDI because of its anti-competitive impacts has yet to be made.

The lack of direct action under Australia's Trade Practices Act need not be taken to imply that there are no anti-competitive concerns associated with Japanese FDI, although the contrary view is sometimes expressed (Kasper, 1984; Howe, 1994).[186] Rather, it might

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[185] In recent times, Shinagawa Thermal Ceramics was involved in a merger within Australia with UK firm Morgan Crucible Company which was investigated by the ACCC in March 1998 but not opposed. A case of changes abroad with possible implications for competition in Australia occurred in December 1999 when the Asahi and the Tokai banks were merged in Japan. This had relevance to Australia because both banks operated there but no action was taken by the ACCC.

[186] Howe wrote that "problems in this area [of Trade Practices Legislation] ..... do not appear to have been very systematic ..." but offers no evidence or analysis (p 138).

indicate that such issues are worked out in the consultative phase which precedes formal FIRB screening.

But perhaps more significantly, it might also reveal a lack of monitoring and awareness by Australian authorities. In particular, it is unlikely that Australian authorities maintain a sufficiently detailed information base to be aware of all developments overseas which might impact on the level of competition fostered by Japanese FDI affiliates in Australia. Therefore it is possible that anti-monopoly legislation is not applied stringently enough to Japanese FDI.

To put it bluntly, if the arcane, even inscrutable, arrangements among Japanese interests in Japan can be typified as anti-competitive, despite the existence of Japan's FTC, then it is likely that Japanese FDI can be interpreted in the same way, despite that it has not been challenged by Australia's ACCC. However, this might go unrealised because, to be seen it will require detailed knowledge of dynamic arrangements in Japan and it is not likely that the ACCC is in possession of that knowledge. The point is reinforced by the detail and complexity involved in interpreting the Japanese arrangements described in chapter 5. It is clinched by the illustrations in chapters 7 and 8 which show that, to address policy issues adequately, very considerably more detail and greater complexity must be included.

As with the screening function itself, the overwhelming numbers are not primarily in the large scale of new investments but in the vast number of past investments. To avoid a significant diminution of competition as a result of Japanese FDI requires that Australian authorities have at hand sophisticated means to understand Japanese ownership and transactional links which involve all Japanese firms operating in Australia.

This difficulty for Australian policy is acute: without detailed knowledge of business dealings in Japan, such as might be held by Japan's Fair Trade Commission but as would be difficult for the ACCC to maintain accurately, how can Australia apply its anti-monopoly legislation to Japanese FDI?[187] In short, because activities overseas can have important implications for

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[187] The point applies more broadly than to just anti-monopoly legislation. Australia's Tax Commissioner Carmody noted in a speech in 1998 that it is not

competition at home, the control of the anti-competitive potentials of FDI requires coordination and cooperation between regulatory authorities in the host and the source nations over issues such as information gathering and enforcement (Belderbos, 1997).[188] The point is emphasised further by Hymer's conception that the relevant locus of competition among MNEs is not a single nation state but the international economy.

One of the difficulties in applying anti-monopoly legislation is that there is no multilateral arrangement to facilitate the information flows and monitoring functions (Reinicke, 1998, p 49). However, there are a number of mechanisms by which some bilateral contact between Australia and Japan proceeds currently. These appear to need strengthening and extension.

Firstly, there is a 1986 multilateral agreement among OECD nations regarding broad cooperation on restrictive trade practices and a similar multilateral system of conferences on the application of competition policies among Asian and Oceanic countries which has been operating since 1979 and which, on occasion, Australia and Japan have hosted. In addition, Australia's ACCC also makes efforts to develop what they describe as the "..'culture' of cooperation" with regulatory authorities in Australia's export markets (ACCC web site). Such efforts might better be directed to source nations of FDI (rather than export markets) and include explicitly provisions to deal with issues surrounding FDI.

Another existing mechanism for cooperation and coordination over anti-monopoly legislation is the series of annual bilateral meetings which Japan holds with some APEC members (the US, Canada and the Republic of Korea) but not currently with Australia. Similarly, Australia has a number of bilateral agreements concerning anti-monopoly legislation (with Chinese Taipei, PNG, the US and NZ) but not with Japan. There is an obvious opportunity to establish a bilateral agreement which would build on the "informal" links which are said to exist already between Australia and Japan (Grimwade, 1996, p 23).

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possible to monitor the activities of MNEs in Australia by Australian means alone (Bryan and Rafferty, 1999, p xxii).

A way forward would be to replicate between Australia and Japan the agreement which exists between Australia and NZ. That agreement covers issues of enforcement, adjudication, education, etc. and extends especially to the crucial issue here: the exchange of information (TPC, 1994). The agreement allows one nation to conduct interviews, obtain documents and data on behalf of the other and this aids and coordinates enforcement. It is a useful model for extending cooperation between Australia and Japan.

A third element to upgrade contact arises as part of Japan's Action Plan for implementing APEC's competition principles. Japan is moving to ensure its anti-monopoly legislation is harmonised "with international standards" (Japanese Government, 1997, APEC website). To the extent that harmonised standards would mean consistent interpretations by governments and courts in Australia and Japan, it offers the potential to codify the policy principles which would then apply to both the parent company and its FDI affiliates. Such a broad approach could greatly enhance the use of anti-monopoly legislation in relation to FDI.

These considerations raise the question of whether, in response to the anti-competitive potential of Japanese FDI, Australian anti-monopoly legislation should include an explicit international dimension which would clarify the legal basis for the ACCC to consider matters outside of the Australian economy *per se*. Such a move would parallel the current US approach which is to enact legislation that removes any domestic impediments to their Fair Trade Commission investigating outside the US (TPC, 1995, p 22) and it would be consistent with the provision which existed in the Japanese legislation until June 1997 which had required that all international contracts were to be filed with the FTC within 30 days so that it could consider any possible anti-competitive implications (Matsushita and Schoenbaum, 1989, pp 168-171). Such contracts included agreements between Japanese companies operating abroad and foreign companies and so covered instances of FDI. There are cases where the Japanese legislation has been useful in preventing anti-competitive behaviours

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[188] Belderbos wrote: "The solution .... must be found in coordination and harmonisation of antitrust rules and enforcement" (p 364).

because it has allowed for action to be taken over trade related issues when no other basis existed.[189]

There are two major considerations in assessing the potential for an explicit international dimension to be added to Australia's anti-monopoly legislation. Firstly, such a move would be outside the prevailing policy trend. For Australia to replace FDI screening (which the logic and momentum of liberalisation is pressing it to do) by adding an international dimension to its anti-monopoly legislation would seem anomalous and could also lead to international challenge and possibly retaliation.

Secondly, while the notion that a country has power over foreigners within its territory is well accepted, as is the application of a nation's laws to its people or companies wherever they are, the extension to operations of the foreign investor elsewhere, under the so called "effects doctrine" (i.e. that a nation's laws have force if the effects of an action are felt within its territory) is resisted by most nations, although not by the US (Utton, 1995, pp 308-14). In the past application of the old Japanese legal provisions, a pragmatic view was taken; that the FTC powers applied "in those cases where a Japanese company and that company's foreign subsidiary are functionally one economic unit" (Utton, 1995, p170). However, this is a doubtful legal position.

This suggests that bilateral coordination rather than explicit extension of national anti-monopoly legislation is the most appropriate step in strengthening its application to FDI. Although, the initiative should be bilateral, a good deal of the monitoring will need to be done by the source nation governments (Hirst and Thompson, 1996, p 139).

The net result of this is to argue for coordination, cooperation and harmonisation between Australia and Japan over their anti-monopoly legislation by means which upgrade the current informal basis but avoid explicit extra-territoriality provisions. Instead, the policy reform

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[189] This was the case in the so called Chemical Fiber Cases when, in 1974, Japanese and European textile producers agreed not to export to each others' markets. The FTC took action successfully against the Japanese firms.

calls for formal, bilateral contact between competition regulators and the explicit inclusion of FDI into the ambit of their coordination. As we shall find in the case studies which follow, establishing such a link would help fill the gap in Australian understanding of Japanese business groups and other forms of cooperation. These appear to be crucial lacunae at present.

Chapter 7 : Policy Responses in the Beef and Coal Industries

7.1 Introduction

This chapter illustrates how the policy implications deduced from theory apply to two instances of Japanese FDI in Australian primary industries. To reiterate, the closer study of these particular instances is not aimed to test theories but, rather, to illustrate the relevance of both the malign view that FDI is a device to protect super-normal profits and the benign view that it is an economic means of dealing with impediments. We will also show how the deductions from Chapter 5 and the policy agenda mapped out in Chapter 6 fit with and provide the basis for an improved and consistent response to many of the existing policy issues.

In the cases of beef and coal, the underlying reasons for siting operations in Australia are obviously to do with the absolute advantage Australia has relative to Japan and many other nations in the production of these raw materials so that Australia is a major producer and, even more so, a significant exporter to Japan of both the commodities concerned. Both instances can then be thought of as cases of vertical integration of primary production in Australia by Japanese FDI (although, as we shall see, any particular Japanese investor might be pursuing vertical, horizontal or diversified integration).

An understanding of these instances and the relevant policy considerations bring organisational matters to the fore. The peculiar array of Japanese organisations at home and abroad which surround the FDI activities in Australia allude to the prospect of Australian institutional innovation, based on government's roles in promoting both transaction cost economising and competition. These cover the first and last of the three elements of the Australian policy response mapped out in Chapter 6. The second, that of industrial structure policy, although it applies in all cases, is illustrated with reference to the automotive industry considered in the next chapter.

Each of the following sections details Japanese FDI involvement as closely as possible and describes the processes of production and trade in Australia and Japan, including the role of institutions. Then the extant policy issues are reported and interpreted. Finally, in section 6.4, the commonalities and differences apparent in these two cases are drawn together and the policy response is generalised.

7.2 Policy Implications of Japanese Participation in the Australian Beef Industry

The instance of the beef industry has been chosen partly because it is so controversial, both in trade and FDI, having been described as "easily the most politicised" (George, 1984, p 1) area of Japan's international negotiation where discussions have been "often heated and tense" (Mori and Ling, 1990, p 176).

In particular, the US has long demanded improved access to the Japanese beef market and has reached a series of agreements to achieve this progressively (George, 1984; Takahashi, 1990), including agreements initially negotiated bilaterally between the US and Japan and then extended to become also agreements between Australia and Japan (Nakase, 1990, p 135). These have stipulated the tariffication of Japan's beef quota and the progressive winding back of the extensive domestic support schemes previously operated by Japanese government agencies as well as compliance with the new WTO arrangements regarding agriculture (George, 1997, *passim*). Importantly, Japan was reluctant to conclude each of these agreements and one, in 1988, was negotiated only after and the US and Australia began the process of challenging Japan's system of beef protection under the GATT rules.

Just as the beef trade with Japan is controversial, so too is Japanese FDI in Australian beef activities. A recent government inquiry (IC, 1994) recorded the concerns of many participants. The Cattle Council of Australia has called for closer monitoring (Morison, 1995, p 203) and concerns have been expressed that Japanese FDI in Australian beef is

extensive and amounts to “hegemonic integration” (David and Wheelwright, 1991, p 71).[190] However, overall, most Australian analyses of the beef situation reach the conclusion that Japanese FDI is beneficial on balance (the NSW Meat Industry Authority, quoted in Morison, 1995, p 204; AMLIPC, 1988; IC, 1994; p 230; *et al*) although, in line with the discussion of previous chapters, there has been no attempt to quantify this net benefit (Young and Sheales, 1991, p 74). Despite this overall conclusion, the Japanese side appears to have little sympathy for any Australian concerns and a senior figure has described Australian calls for tighter control on Japanese beef FDI as “an emotional reaction” (Nakase, 1990, p 143).[191]

To show how the theoretical interpretations and their policy implications apply in this case, this section begins by describing the situation in some detail, starting with trade data and a description of Australia’s locational advantages before detailing Japanese participation in the Australian industry. Then the beef production and marketing regimes in Australia and Japan are examined so as to identify more closely the Japanese companies involved. Next, we interpret these descriptions in terms of the theoretical analysis before showing how the existing policy issues can be usefully addressed.

Firstly, a few basic statistics.[192] Australia is the world's largest exporter of beef and beef is Australia's fourth largest export. Exports account for 65% of local production, an increasing proportion amounting to 180 Kt on a total turnover (through meat processing) valued at more than A$5bn. Japan is also a beef producer with nearly 3 million head of cattle (cf. 26.2 million in Australia) and is a large consumer with imports making up more than half of total supply, so that Japan is the world's second largest importer of beef (after the US).

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[190]The authors claim, without offerring good evidence, of Japanese investors "buying up ... cattle stations, feedlots, abattoirs, meatworks and cold stores, resulting in domination of a whole chain of production from beef on the hoof in the Australian outback, to the desired Japanese cut in the supermarket. This control of the sequential processes of production .... is becoming known as 'hegemonic integration'" (p 71).

[191]At the time Nakase was Vice President of the LIPC.

[192]Data for this section come from IC (1994) and AMLC (1995).

In recent years, the import share of the Japanese import market has been expanding with the removal of quota and reductions in tariffs. Australia has been Japan's major foreign source of beef and the US has been second. However, while Australia's exports to Japan have recently increased, it has been a matter of some controversy that Australia's share of the Japanese market fell at the same time that of the US increased (Harris et al, 1990, p 12; George, 1984, pp 6-12).[193]

Australian suppliers provide Japan predominantly with grass-fed beef and have dominated that part of the market and, while Australia's share of the more highly valued, higher quality grain-fed market in Japan was only 12% in 1989-90, its grain-fed beef exports to Japan are said to be rising quickly.[194] This shift is reflected in the sharp growth of Australian feedlot production, especially in the latter half of the 1980's. Feedlot production accounts for 10% of Australia's beef livestock (compared with some 80% in the US) and it is expected to continue rising quickly.

The locational advantage which in part accounts for the FDI centres primarily in the cost of meat production rather than in processing or transport (Booz et al, 1993).[195] Its source

[193]In 1980, nearly two-thirds of Japan's imports were from Australia but in the early 1990's it has fallen to some 40% while, over the same period, the US share has risen from 27.5% to 57.2% (IC, 1994, Table D6). The reasons for this are controversial with claims that, despite Japan stating that it applies quota globally, the increased imports arising from liberalisation agreements has been purposefully directed to the US so as to reduce trade tensions. Others, especially Japanese sources, argue that other issues apply, including that US beef is of higher quality and that the US makes available special cuts while only full set carcasses are available from Australia.

[194]Grain-fed beef rose from only 4% of the total in 1988 to 37% in 1994, although some of these data include grain-finished rather than fully grain-fed beef (AMLC, 1995, p 42).

[195]Data provided for the Meat Research Council are summarised in the following table:

Table A: International Comparisons of Beef Costs (A $).

Country	Net Animal Cost	Processing Cost	Total Cost
Ireland	6.43	0.86	7.44
US	3.84	0.41	4.35
Australia	2.84	1.13	4.34

is obviously related to Australia's greater supply of clean space, which is needed not just for cattle stations and feedlots but for the linked activities of grain and seed production and waste disposal.[196] Australia also conceivably has locational advantages which arise because of the health of its herds and its reputation for First World hygiene and other standards (Reithmuller, 1990, p 9).

FDI in the beef industry has a relatively long history and investments in production and processing provide some of the earliest Australian examples of vertical integration undertaken by FDI (Morison, 1995, p 196). However, Japanese investment in this activity is of relatively recent origin, as shown in the following Table 7.2.1 which provides the most comprehensive listing of Japanese involvement currently available. The companies have been grouped by activity along the chain of value added from feed trading through production and slaughtering to processing.

Table 7.2.1: Japanese Participation in Australian Beef Activities

Activity/ Company	**Capital $m**	**Turnover $m**	**Year of est.**[197]	**Employ-ees**	**Japanese equity**	**No. of Japanese cos.**
GRAIN						
Mt Tyson Seeds P/L	0.1	10.0	u/a	9	25%	1
Riverina Stockfeeds P/L[198]	2.4	107	1965	60	50%	1
FEEDLOTS/STATIONS						
Hannan Australia P/L	22.5	u/a	1988	4	100%	1
Killara P/L (1992 data)	2.3	17.0	1973	30	100%	2
Mirrabrook Cattle Co. P/L	6.5	10.0	1988	13	46.2%	3
Rangers Valley Cattle Station P/L	22.0	u/a	1988	38	100%	2

Argentina	2.28	1.05	3.84

Source: Booz et al (1993, p iv-4).
Note: Total cost = columns 1 + 2 + transport costs.

[196]This proximity of feedlots and grain production is fundamental so that, even within Australia it is said that there is no feedlot production in the Northern Territory because of the high cost of feed there (Australian grain production is undertaken in the more temparate south) (IC, 1994, p 10).
[197]This is not necessarily the year of Japanese investment.
[198] Also engaged in feed and other agricultural product trading with Japan.

Tasmanian Feedlots P/L	4.8	10.0	1957	14	100%	2
Teys Feedlots P/L	5.0	u/a	1988	11	49%	2
ABATTOIR						
R J Gilbertson P/L	9.9	325.0	1928	1644	40%	1
Lachley Meats P/L	10.0	100.0	1988	300	100%	2
Oakey Abattoir P/L	0.03	204.0	1956	562	100%	1
The Mid Coast Meat Co P/L	10.0	120.0	1987	380	75%	1
PROCESSORS[199]						
Hans Continental Sm'goods	3.5	38	1967	200	100%	1
MQF P/L	27.0	u/a	1989	900	100%	1
Tibaldi Small Goods P/L	6.0	u/a	1934	92	97.5%	2
TRADERS[200]						
Itoham Foods (Aust) P/L	23.5	146.0	1988	5	100%	1
Kamei Aust P/L	0.06	22.0	1987	4	100%	1
Marubeni Aust P/L	16.0	2390	1960	90	100%	1
Mitsubishi Aust P/L	25.0	5200	1958	119	100%	1
Nichirei Aust P/L	1.0	35.0	1984	8	100%	1
Nitchiku Aust P/L	2.0	u/a	1973	4	100%	1
Nozaki & Co (Aust) P/L	0.6	50.0	1979	5	100%	1
Unicoop Japan (Aust) P/L	0.05	40.0	1975	5	99.8%	1
Zenchiku	0.95	u/a	1972	1	100%	1
TOTAL of reporting companies (trading companies not included)	**198.69**	**924**		**4257**		

Sources:

1. AJEI, 1996
2. Morison, 1995
3. Johnson, 1988
4. Rothacher, 1989

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[199] Includes processors of other meats as well as beef and companies which make local sales as well as exports to Japan.

[200] Some of these trading companies deal in food other than beef and there are other Japanese trading companies which trade in beef without listing it as a major activity in Australia. All Japanese trading companies previously designated as official beef importers and operating in Australian are included in Table 7.2.2 below.

From the Table, it is clear that Japanese FDI to control the procurement of Australian beef is spread widely along the chain of value adding. Japanese activities stop before integrating the highly diverse seed and grain production activities but extend from grain trading, through feedlot and pasture-based production, to slaughtering (including packing), trading and processing (into portions and smallgoods). As detailed further in Table 7.2.2 below, a large number of Japanese trading companies also engage in Australian FDI.

The Table shows that, of the 15 companies (excluding traders) with Japanese participation, nine were established after 1987 (and so the picture is consistent with the observation from section 2.5 of recent growth of Japanese FDI in food related activities). Particularly in beef production and slaughtering, Japanese investors have been active in recent times and this adds substance to the view that the Japanese investments have been fundamentally a response to liberalisation in Japan and, in particular, have been timed to provide product as the market opens i.e. they have led the opportunity.[201]

Another important point emerges from the employment and turnover data reported in Table 7.2.1 which suggest that Japanese companies operating in the Australian beef industry have a multi-functionality but are not fully vertically-integrated operation. For example, large companies, like Mitsubishi are strongly represented in most sectors.[202] However, the mismatches in the scale of their operations suggest that they are not tightly vertically integrated. The turnover and employment data suggest that companies with Mitsubishi participation in processing source their beef from other companies as well as from Mitsubishi's own cattle operations. Similarly, although complete data are

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[201] Further evidence for this may be gleaned by comparing the AJEI Directory for 1992 with that for 1996. This shows a substantial increase in the value of Japanese investment in Australian abattoirs which is a further development in the Japanese response to liberalisation.

[202] Mitsubishi has beef subsidiaries in The Mid Coast Meat Company and Mid Coast Protein and joint ventures in Australian Chilled Beef P/L, Riverina Wholesale Meat P/L, Lachley Meats, Riverina Stockfeeds P/L and Rockdale Beef Partnership. In addition, Mitsubishi-related companies operate in Australia including Japan's second largest meat processor, Nippon Meat Packers.

unavailable, Mitsubishi's export operation quite clearly buys meat and cattle from companies other than Mitsubishi subsidiaries.[203] A senior Australian beef industry figure has confirmed that this is so in the case of Mitsubishi and is likely to be the case with other large Japanese investors.[204]

The point is reinforced by the scale of Japanese abattoirs and that of Japanese grain traders who are unlikely to provide all the feed needed by Japanese beef producers in Australia (they also export some of their turnover directly to Japan). So too, if we look at Japanese traders, it would appear that some of them are engaged predominantly in procuring Australian beef rather than in producing or processing it themselves and rely on Japanese and non-Japanese sources in Australia.

This observation replicates the view developed in Morison's study (1995, p 110): whatever its motivation, Japanese FDI in the beef industry does not seem to require complete control of the production process. Of course, we do not know the extent to which Japanese companies operating in Australia buy from and sell to other Japanese companies outside their group. Nonetheless, it is likely that such integration is incomplete among Japanese interests, even though, when it comes to control of the beef trade itself (i.e. the actual transaction between Australia and Japan), Japanese interests are said to control the vast majority (Young and Sheales, 1991, p 68; IC, 1994, p 230). The role of Japanese FDI in beef production and further upstream appears to provide a strong presence in many sectors but does not comprehensively exclude non-Japanese interests.

This behaviour, of course, intersects with many matters raised in previous chapters. It links to the high level of Japanese control over own-nation exports from Australia and to the phenomenon of co-location by related Japanese companies and to questions of local embeddedness. The available data on Japanese participation in the Australian beef

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[203]Mitsubishi trades in large quantities of beef, although the AJEI data does not tell how much of its $5.2 billion in annual turnover is beef. Nonetheless, we can be confident it exceeds the $120 million of turnover from its abattoir operations.
[204] Personal communication with Mr John Penn, Australian Marketing Manager of the AMLC.

industry offer no general conclusions in regard to these matters. Nonetheless, it appears that Japanese FDI focusses on opportunities related to Japan and does so in peculiarly Japanese ways. In other words, it appears to have a bilateral character, shaped by conditions in Japan relative to Australia. Importantly, this study has given some economic reasons for that while others often seem to assume it is naturally so.[205]

The peculiarly Japanese nature of the FDI behaviour in this industry is emphasised by describing it in more detail. Returning to Table 7.2.1, it also shows that, although Japanese interests do not control all the beef production chain, they opt for effective or outright control of those companies in which they do invest. Japanese equity participation in Australian beef companies is 100% in 7 of the 15 cases and is less that 40% in only 2. In many cases, more than one Japanese company has invested in a single FDI affiliate, particularly in beef production activities where investments are relatively recent and paid-up capital is relatively significant. This implies a degree of quasi-integration among Japanese beef interests in Australia, although the inter-company arrangements are not immediately clear (we will identify the *keiretsu* and other ties of the companies more closely below). Morison (1995, p 100) claims there is evidence that the Japanese equity share tends to increase overtime although it does not appear to be true that the predominance of 100% equity is greater among longer established firms.

Turning now to the production, marketing and consumption relations in Japan, a range of special considerations are said to exist which have long made them a somewhat "murky affair" (Rothacher, 1989) and have long been the source of "a great deal of confusion" (Longworth, 1983, p 189). The peculiarities exist in a number of dimensions and are described in some detail, partly to indicate some of the themes from the previous descriptions of Japanese business relations and liberalisation in Japanese policy but mainly to help identify the Japanese interests which have invested in Australia.

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205 The IC, for example, writes that "clearly, foreign-owned subsidiaries in Australia will focus upon supplying their home market" (p230) as if there were no doubt concerning the global nature of FDI and without offerring any reason.

Firstly, from the historical perspective, religious and cultural prohibitions have meant that beef and other land mammals comprised only a minor part of the Japanese diet, which has been correspondingly rich in fish and vegetable protein (Simpson et al, 1996). Organised beef production developed only relatively recently and centred around distinctive Japanese breeds, especially the so called *wagyu* cattle developed variously in a number of prefectures by cross breeding domestic beasts with foreign cattle (Namikawa, 1990, p 8). These cattle are traditionally raised in small herds on small farms.

In the modern era after 1950, there has been a shift towards fattening feeder calves from the dairy industry in larger establishments. However, even in this sector, farms are small by international standards and, while herd sizes are increasing, Japanese production remains less than competitive in scale and cost (Morison, 1995, p 35; Booz, et al, 1993). Since the period of high speed growth, Japanese beef consumption has increased markedly, despite that Japanese prices and beef farm incomes have remained relatively high (Morison, 1995, p 33).

There are other peculiarities to the Japanese beef trade. Traditionally, the tasks of slaughtering, leather production and processing have been thought of as undesirable and have fallen to a group of Japanese known as the *burakumin* or, especially in the modern era since the Emancipation Edict of 1871 ended the formal caste system, as *dowa*. These *dowa* constitute a butchers' guild and, while their predominance is waning, they continue to hold significant influence in beef processing and wholesaling. There have been instances of corrupt practices undertaken by *dowa* groups and claims by foreigners that they have run an Osaka-based "meat mafia" (Johnson and Fisher, 1988, p 34; Rothacher, 1989, p 146). There is evidence of *dowa* influence also among consumer groups, especially the so called Kansai Housewives' Association, and of *dowa*-controlled FDI (Johnson and Fisher, 1988, p 33), although none of these groups can be identified as having undertaken FDI in Australia.

The peculiar considerations in the Japanese beef industry have also included an extensive and somewhat arcane range of private organisations and public institutions and policies.

The purpose of these arrangements have been variously interpreted as collective, in that they enhance food self sufficiency and therefore security.[206] In addition, they preserve the rural community in accordance with the Japanese notion of *nohonshugi* or "agricultural fundamentalism" (Rothacher, 1989, pp 19-21). Such collective purposes have also been enhanced by the political power provided to rural interests in Japan by the close links with the LDP and the gerrymandered electoral system (Longworth, 1987, p 63; Sato and Curran, 1983, p 127).

In addition, like most agricultural industries in Japan, beef has a large number of cooperative organisations which fit broadly within the concept of quasi-integration i.e. they undertake some of the functions associated with firms (mediating conflicting interests, undertaking complex, multi-people tasks, etc.) which we can understand as transaction cost economising (although, again, they might also have other motives).

First among these are the agricultural cooperatives or *Nokyo*. They date back to the 18th century but, since the Agricultural Basic Law of 1961, have played increasingly prominent roles, including in government policy development and delivery. *Nokyo* has a range of affiliated organisations, including a political arm (*Zenchu*) and a number of beef-related bodies including *Zenchikuen, Zenrakuen* and, the biggest, *Zennoh* (Sato and Curran, 1987, p 127). In addition, there are a number of *dowa* groups including *Zendoren, Zenyura, Shindowa* and, most important of all, *Zennikuren* (Johnson and Fisher, 1988, p 33).

The Japanese beef industry is also subject to considerable amounts of intervention by the Ministry of Agriculture, Forestry and Fisheries (MAFF) into processing, wholesaling and retailing operations, dating back to the 1920s and developed during the 1950s, in conjunction with the MITI, to include a range of infrastructure facilities for slaughtering

[206] According to Ministry of Agriculture, Forestry and Fisheries, data, Japanese food self sufficiency has fallen from 73% in 1963 to 37% in 1993 (Simpson et al, 1996, p 5).

and processing meat (so called "meat centers") and designated wholesale markets (Morison, 1995, pp 40-43; Longworth, 1983, *passim*).

Foremost among the *dirigiste* devices have been the functions of the Livestock Industry Promotion Council (LIPC) formed in 1961 (and reformed in 1996 into the Agriculture and Livestock Industries Corporation after merging with the Silk and Sugar Price Stabilization Corporation; see George, 1997, p 3.8). The LIPC undertakes a range of activities including cooperative promotion and R & D, the provision of low interest capital loans, the operation of price support and stabilisation schemes for various livestock inputs and outputs (such as feed and dairy calves) and other activities to modernise the industry. Since 1967, the LIPC has also played a key role in regulating beef imports and it is to this issue we now turn.

Japanese produced beef is expensive compared to imports and the Japanese government has employed a wide range of practices, including tariffs and quota to maintain this price differential and hence local profitability in production and processing. These devices have been at the heart of the trade tensions which have preceded beef liberalisation in Japan. The system has clearly meant higher prices for domestic consumers and, in addition, there "are endless stories of how the system has been abused since its very inception" (Longworth, 1983, p 188).[207]

Up until the 1991 Market Access Agreements, imported beef was subject to quota, most of which were controlled by the LIPC[208] which allocated them to designated importers who then sold imported beef to the LIPC which then on-sold only to registered users (Takahasi, 1990, *passim*). The LIPC could vary quota and use buffer stocks to help maintain and stabilise high domestic prices. The LIPC has also imported beef on its own and has profited directly by price arbitrage between imported and domestic production

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[207] In particular, the LIPC has established price bands for sale of imported beef but higher prices than the upper limit are frequently charged.

[208] In addition 10% of the general quota was controlled by another Japanese quango, the Japanese Meat Conference, and 10% were special quota allocated for food promotion fairs, some schools, chandlers, etc.

and by various modes of operation in the Japanese market. In particular, the LIPC has operated a competitive tender system for the sale of imported frozen beef to Japanese wholesalers and set price tenders for the sale of chilled beef to various retailers and cooperative associations. The proceeds from these have been substantial and constitute the major source of funds used by the Council for industry modernisation and structural adjustment (Longworth, 1983, *passim*; George, 1984, p 127).

In general, imported beef is considered inferior to beef produced domestically (Takahashi, 1990).[209] Japanese consumers clearly prefer traditionally produced, long-grain-fed beef which is very different to the short-fed US style beef or to the pasture fed beef typical of Australia which Japanese consumers perceive as having an "offensive smell" and an undesirable rind of yellow fat so that an Australian industry expert has commented that "few Australian carcasses exceed B yield grade" in Japan's convoluted and complex classification system (Dunlop, 1990).[210]

A number of Japanese economists have estimated the elasticities of substitution between local and imported beef (Takahashi (1990) and Mori et al (1990)) and have confirmed that the market is heavily segmented between the two so that "there is no significant substitutive relationship between (them)" (Takahashi, 1990, p 32). Even more so, the demand response for traditionally produced, domestic beef to falls in import prices is highly inelastic and these investigations show consistently that (as surprising as it may sound) "imported beef ought to be treated as a different commodity from home produced beef" (ibid, p 34). The predominant view in Japan, held by the so called "old-style people" (*kyujinrui*) who are the majority, is that local beef is clearly distinguished in quality (Namiki, 1990, p 83) and the market remains divided into "the three categories of *wagyu*, dairy and imported beeves [sic]" (Namiki, 1990, p 57).

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[209]Takahashi reports that "even imported 'high quality' beef only corresponds to the 'third grade' of home production .... " (p 29).

[210] Dunlop describes the Japanese grading system as a matrix of 5 quality grades and 3 yield grades. The latter are determined by "complex formulae" including characteristics of eye muscle area, rib thickness, subcutaneous fat thickness and

The new, liberalised arrangements have created what is called a system of Simultaneous Buying and Selling (known widely as the SBS system). Under the old system, designated importers sold only to registered users, with the LIPC standing between them and actually purchasing and then reselling the product. Under the SBS system, the LIPC has created a so called criss-cross or *tasukigake* formula in which designated importers can sell to anyone and registered users can buy from anyone (Nakase, 1990, p 141). This creates a situation in which there is "as little intervention as possible by the LIPC" (ibid), whatever that means exactly. Certainly, the *tasukigake* formula has allowed many new importers and users to enter the market: it is claimed 19 of the former and 142 of the latter after the first few years (Nakase, 1990, p 141).

However, contrary to the claims of some analysts that the liberalisation meant the LIPC had no role (Morison, 1995, p 1; Johnson and Fisher, 1988, p 5), according to Japanese insiders the LIPC continued to occupy a central position and still took possession of the actual goods sold between importers and users (see Nakase's diagram and discussion of the flow of goods under the SBS system, 1990, p 139).

In addition, under the agreements and the provisions of the WTO Agreement on Agriculture, the LIPC can also institute emergency measures for beef if needed and, under the so called 'green box exemptions', the LIPC is still able to pursue a range of activities to enhance the local industry and domestic food security (ABARE, 1997, pp 10-11). Hence, consistent with our previous overview of liberalisation in Japan, it is doubtful whether, with all the exemptions, reservations and continuities, we can describe the Japanese beef system as liberalised. As recently noted, progress on derregulation in Japanese agriculture generally has been "slower and harder to achieve than political rhetoric" (George, 1997, p 3.7).

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so called correction factors. Quality depends on marbling, colour, texture, firmness and fat colour (ibid).

In any case, foreigners remain restricted in their ability to invest in Japanese agriculture (OECD, 1997, pp 99-100) and no foreign based interests currently do so in the beef industry, although it is reported that an Australian group operating under the acronym IBP did try to operate in the Japanese processing sector but has since pulled out (AMLC, pers. comm.).

Before examining the Australian industry in some detail, we can now use the understanding of the Japanese industry to identify the investors in the Australian beef industry. The following Table 7.2.2 lists the Japanese parent companies involved and indicates how they fit into the Japanese beef system. It re-arranges what is known about Japanese beef FDI in Australia on the basis of the Japanese firms which undertake the investment and augments that with data for Japanese trading firms which deal in beef. Identities are established according to two characteristics: membership of the group of previously designated beef importers (now partially liberalised); membership of the *keiretsu* and other business groups in Japan. Checks have also been made against membership of known *dowa* organisations but none have been identified.

Membership of these groups clearly provides corporate tie-ups and links to the Japanese regulatory system which are important in the beef industry back in Japan and the propensity to undertake FDI in Australian beef activities is, for some firms at least, positively correlated with the likelihood of being integrated in Japan (Morison, 1993, p 108). The key point is that we can identify most of the Japanese investors as insiders in the Japanese beef system. Of the 27 listed, only six cannot be surely identified, only three of these are of significant size and we can be reasonably confident that even they fit the profile of being insiders in the Japanese beef system.[211]

Table 7.2.2 Japanese FDI Companies in the Australian Beef Industry

Parent Company in Japan	**Design-ated**	**Keiretsu**	**Comment**

[211] Hannan and Kamei are two of the unidentified large firms. They are big beef specialists from Osaka and Sendai respectively and appear to be related to the Central Wholesale Meat Market Companies in those two cities. Inter-City Mills P/L is understood to have some relation to the Marubeni group of Japanese retailers.

	Importer	Member	
Asahi Chemical Industry Co Ltd		Sumitomo	
Hannan Corporations			Osaka-based beef specialist; abattoir
Inter-City Mills P/L			
Itochu Corporation		Daiichi Kangyo	feedlot operations
ItoHam Foods Inc		Sanwa	Japan's largest meat processor
Jusco Co Ltd			long term, small investor
Kamei Corporation			Sendai-based beef specialist
Kanematsu Corporation	*		sogo shosha
Kyodo Shiryo			Morison, 1995
Manno Corporation			Morison, 1995
Marubeni Corporation	*	Fuyo	sogo shosha; beef production
Mitsubishi Corporation	*	Mitsubishi	sogo shosha; 5 beef subsidiaries[212]
Mitsui Corporation	*	Mitsui	sogo shosha
Nichimen Corporation	*		sogo shosha; smallgoods
Nichirei Corporation	*		food trading (= Nippon Reizo Co Ltd, part of Fuyo?)
Nihon Sugar Refining Co.			smallgoods
Nippon Ham			Morison, 1995
Nippon Meat Packers Inc		Mitsubishi	Japan's 2nd largest meat processor
Nissho Iwai Corporation	*		trading
Nitchiku Ltd	*		beef specialist trader
Nomura & Co Ltd	*		sogo shosha
Nozaki & Co Ltd	*		sogo shosha, feedlot
Okura & Co Ltd	*		sogo shosha
Prima Meat Packers Ltd		Dai ichi Kyogo/ C. Itoh	feedlot
Sakai & Co Ltd			feedlot, small company
Snow Brand Trading P/L			food trading, Nokyo affiliated
Sumikin Bussa Kaisha			unidentified
Sumitomo Corporation	*		sogo shosha
Takku Corporation			Morison, 1995
Tokyo Meat Service Co Ltd			feedlot, small company
Tokyu Foods			major food retailer in Japan
Toshoku Ltd	*		food trading company
Unicoopjapan	*		Zennoh-affiliated
Zenchiku Co Ltd	*	Mitsui	trading company
Zennoh			information gathering

Sources: Same as for Table 7.2.1

[212] Subsidiaries are: The Mid Coast Meat Co.; Mid Coast Protein; Austrailan Chilled Beef P/L; Riverina Wholesale Meats P/L; Rockdale Beef Partnership.

Table 7.2.2 also makes clear that there are a range of corporate strategies involved. In the Australian beef industry we have not only vertical integration but also a range of other forms of corporate growth. For example, Tokyo Meat Service's participation in the Mirrabrook Cattle Co. is a case of vertical integration. Similarly, Nippon Meat Packers' investment in the Oakey Abattoir is a case of horizontal integration and Asahi Chemicals' investment in Hans Continental Smallgoods is, for reasons which are not self-evident, a case of diversification.

Turning now to the Australian industry, a number of points of contrast and similarity emerge with respect to Japan. We have already noted that Australian beef is produced on a larger scale than in Japan and comes from grass-fed, range cattle. Australian beef production has low levels of corporate involvement and high levels of competition (Morison, 1995, p 25).

Australian beef processing is also undertaken under competitive conditions with the largest four companies accounting for only one-quarter of production and the 20 largest only 58% (IC, 1994, p 21). Most abattoirs are export accredited and oriented and of the 87 major operators, two of the largest four have some Japanese involvement (ibid, p 24).

As in Japan, the Australian institutional framework in beef is relatively dense and includes a number of public and private organisations ranging from producer groups such as the Australian Meat Exporters Federal Council and trade unions such as the Meat and Allied Trades Federation, to major quangos such as the Meat Research Council and, until the end of Australia's foray into cooperative, tripartite policy development, the Australian Meat and Livestock Industry Policy Council. However, the most important has been the Australian Meat and Livestock Corporation (AMLC), recently reformed as Meat and Livestock Australia (MLA).

The AMLC was established by government in 1977 with the general objective to increase the profitability of the industry and its funding of more than $100 million has been

provided almost entirely by compulsory levees.[213] The Corporation oversees the licensing of exporters (there were 381 in 1993), it undertakes marketing and promotional activities and it controls the AUS-MEAT description codes.

Having now described both the Australian and Japanese industries and Japanese FDI, we can show how this instance can be understood by means of the various interpretations previously developed.

Firstly, the view from imperfect competition theory would have it that the FDI is part of the oligopolistic rivalry among firms. Japanese firms invest in Australian beef to maintain and extend the proprietary advantages which are primarily those associated with Japan's "murky" beef arrangements. The key to this oligopolistic rivalry is to have become an insider so as to possess "cultural, historical and political (advantages) in markets and distribution in Japan" (Morison, 1995, p 115). This view is repeated by the Australian beef industry's Peak Council (IC, 1994, p 229).

In short, an explanation for Japanese beef FDI is that it is undertaken to make use of the advantages some Japanese firms have developed as insiders in the Japanese system, especially in its pre-liberalised form. First mover advantages and on-going access to information regarding liberalisation and market developments continue to provide such monopolistic powers post-liberalisation.

The fact that these arrangements are relatively long-lived suggests that they are supported or at least not proscribed by government. Indeed, the Japanese government has consistently defended the underlying arrangements, as the negotiations with the American and Australian parties reveal. This all points to the augmented imperfect competition approach which we canvassed in Chapter 5 to explain Japan's FDI asymmetry.

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[213]A beef transactions levy on producers and a production levee on processors contributed roughly equal portions to the AMLC budget.

The transaction cost interpretation of the same facts is very different. It highlights issues of quality control in linking Australia as a production location to Japan as a market. In this view Japanese consumers are seen as seeking assurances of quality, provided by reputable and recognised incumbent Japanese firms who invest in and then control foreign production. Hence, Japanese FDI can be interpreted as a transaction cost economising means to offer assurances of quality. Similarly, this perspective proposes also that Japanese FDI provides other transaction cost economising both through vertical integration and through the quasi-integration which exists within the business groups and economic environment found in Japan.

In other words, being able to offer quality assurances in the highly quality-conscious Japanese beef trade provides putative advantages which economically ease the difficulties in selling Australian-produced beef to Japanese concsumers. In addition, being able to operate economically in Japan's business environment offers further transaction cost economising advantages. From this viewpoint, the FDI is cost-economising and activity-extending because it enhances the Japanese demand for Australian beef whereas the view from imperfect competition theory sees it as exploitative and restrictive.

Both views are consistent with different interpretations of the facts assembled here and, without choosing between them, both offer policy insights. From the perspective of imperfect competition theory, the important point is to respond to the possibility that the FDI has an anti-competitive nature. This is not because integration among Japanese interests is "hegemonic", as claimed by David and Wheelwright (1991, p 71). It is likely that Japanese interests are not so monolithic. Rather it is, because the systematic exclusion of foreigners is also an exclusion of new entrants and this, in turn, raises equity issues and means that a spur to efficiency and therefore to growth in the Japanese beef market in unavailable.

Of course, this reading does not claim that Japanese FDI can exert monopoly power in relation to Australian beef production which, as described above, is highly competitive. Rather, on the presumption that Japanese interests stand between Australian producers

and Japanese users (as investors, traders, distributors or regulators), it focusses on the potentially anti-competitive nature of downstream activities in Japan. Indeed, the suggestion by some (Young and Sheales, 1991, p 7; IC, 1994, p 230) that any monopoly powers of Japanese investors which could depress Australian cattle prices can be addressed by applying section 46 of the TPA, is too simple a view.

The point is more one of whether Australian interests share fairly in the surplus available because of the price premium between Australia and Japan, a price premium which exists downstream of Australian interests precisely because of the insularity of the Japanese market. Pressure in Australia which isolated and addressed the local effects of limited competition in the Japanese beef market would raise the share available to Australian interests.

However, doing this will require detailed knowledge of competition and institutional and other arrangements among Japanese interests. This section has gone some of the way by explaining the system in Japan and identifying the investors in Australia. But more detail and on-going monitoring are required. As we argued above, this is best progressed not by insisting that provisions of Australia's Trade Practices Act apply to beef arrangements in Japan but by means of cooperation with the Japanese Fair Trade Commission to coordinate monitoring and information gathering functions, with each nation using its own poers at home.

Pursuing this proposal in the case of beef requires also an appreciation that Japanese authorities (especially at the MAFF) will continue to engage strongly in debate over this issue and will be likely to resist any action which implies that the Japanese system is anti-competitive. In addition, account would need to be taken of the likelihood that some Japanese consumer groups would also resist liberalisation (Tabusa, 1997, *passim*) and, of course, the beef institutions previously mentioned would also be likely to oppose the process.

Of course, allies could also be found in Japan, especially from organisations such as the FTC, the Economic Planning Agency and the Management Coordination Agency in the Prime Minister's Office. Exerting pressure through these channels will require high level contact and formal and informal information sharing.

The broad Japanese support for current arrangements, including FDI in Australia, might be motivated by a combination of motives which enhances efficiency somewhat but benefits particularly incumbent Japanese interests as well. There is evidence that some of the peculiar arrangements intend to control the accumulation of producer surplus which arise from access to cheaper imported product and to feed the rents back into the Japanese beef system. This can then ease and limit the process of structural adjustment concomitant on the liberalisation. Structural adjustment assistance can be particularly important in maintaining the viability of rural communities and there is said to be a widespread sense among Japanese consumers that foregoing some gains from liberalisation might be needed "for the sake of food security and for sponsoring their beloved needy country folk" (Rothacher, 1989, pp 179-180).

In other words, the FDI and Japan's beef production, marketing and distribution arrangements are to be understood in terms of the controlled internationalisation of the Japanese economy, a process supported broadly by Japanese consumers and by government's industrial structure policy in particular.

Turning now to the policy implications of the transaction cost economising perspective, they centre upon the proposition that government recognises that, although the FDI provides transaction cost economising assurances of quality, it does so only partially and, hence, similarly intentioned public support can further improve the trading environment. Hence, government should seek to assist the development of the bilateral beef trade by easing trading difficulties in general and by helping to assure the quality of Australian beef in particular. This can be done in a myriad of ways (e.g. export inspections, promotion, standards harmonisation, joint marketing body, etc) including those we review below from the existing policy debate.

The theory of transaction costs suggests also that institutional innovation would assist in providing these assurances and in dealing with the general bilateral impediments. It implies the value in forming what might be called a Joint Australia-Japan Beef Industry Council to explore the bilateral trading difficulties which give rise to the FDI and the difficulties in Japan which, by the transaction cost economising reasoning, have given rise to the peculiar arrangements used there. The Council could be formed from sub-committees of existing organisations in Australia and Japan such as the MLA and the reformed LIPC and would parallel the general bilateral Business Councils described in chapter 5 above. A similar policy advisory body, albeit made up only of indigenous interests operates to assist US beef trade negotiations (Sato and Curran, 1983). Clearly, such an initiative would overlap with any joint Australian and Japanese approach to apply competition policy to the beef industry so that the institutional response could be double edged.

These policy responses are derived deductively but we can also show how they are relevant to the existing policy debate. Australian interests have been advised to respond to the FDI asymmetry in the beef industry by undertaking FDI in Japan to create a marketing company specifically for Australian beef (Young and Sheales, 1991, p 73). It is not hard to see the rationale if the situation is interpreted as one of augmented imperfect competition. Nothing has come of that advice, perhaps because of Japanese resistance, although, more recently, the MLA has appointed an Australian Marketing Manager to Japan (MLA Press Release, 18.02.00). This responds to the implications from the transaction cost perspective but it does not respond to the market power issue.

Policy issues related to transaction cost economising also exist in initiatives the Australian government has taken to enhance the quality assurances offered by Australian beef production. One such role is in its provision of export regulations and here it is instructive to note the rationale provided further by the IC.

The IC argues that public export inspection services are justified because of the negative reputation effects all Australian beef interests would suffer from poor quality control by just one supplier (1994, p 80). This is consistent with the notion deduced from transaction cost theory regarding spin-off effects, although the IC understands it simply as a case of market failure and without reference to transaction costs.

The problem such a conception causes is that it offers no clear rationale for the government to be involved. Hence, the Commission recommends that, unless foreign governments require AQIS inspection of export beef, it could be performed by private interests (IC, 1994, recommendation 8). By contrast, having followed the transaction cost economising reasoning, this study would question whether a private inspection service could profitably identify beneficiaries and specify, monitor and enforce agreements with them over the reputation effects involved. As argued above, government faces different and fewer transaction costs in intervening. At the very least, the IC's would be a high cost approach and would under-supply export inspection.

The lack of a clear rationale for a public sector role is further illustrated elsewhere the Report where the IC spells out the importance of limits to self-interested private decision making but, again, does not develop an economising rationale for government.[214]

The same issues also arise with regard to what is known as generic promotion i.e. the promotion of all beef exports from Australia regardless of ownership or exact production locale. It is a matter in hot dispute.

The debate is about whether generic promotion should be undertaken in Japan and there has been considerable discussion of the AMLC's expensive "Aussie Beef" promotion in

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[214] The IC write that "situations can arise where markets based solely on the incentives facing individual participants (are there other kinds of markets?) fail to produce satisfactory outcomes. Instances where this can occur in the meat industry include: protecting public health, satisfying overseas government inspection requirements, supporting research efforts, and some marketing activities." (p 149, parentheses added)

Japan.[215] As might be expected, some industry participants would prefer to run their own, private campaigns instead of paying higher levees to fund the generic campaign under institutional arrangements of the new MLA. However, if private interests were to act singularly or even in small groups rather than collectively through their organisation they would find that their campaign created diffuse benefits to others, such as in the form of enhanced reputation of Australia as a beef production location.

It is highly likely that it would be uneconomic to write and enforce contracts to govern these benefits and so, without some organisational means to provide a quasi-integrated fillip, too little promotion would be undertaken. Again, this illustrates the central importance to policy of spin offs, such as reputation effects, which fall outside the likely capture of the private interests involved and yet are of net benefit.

This policy issue also highlights that our reasoning does not provide a means to determine precisely the size of the levee as an optimal amount, nor to determine the optimal expenditure on generic promotion. However, generic promotion addresses what transaction cost interpretations see as the central impediment to further bilateral activity in this multi-billion dollar industry. Hence, by comparison of scale, only a very considerable promotional effort could be too much.

The matter of the role of government in initiating and supporting quasi-integration among private interests arises often. For example, it has been recommended that the operation of the Meat Research Council be amended to move it away from exclusively generic research towards collaborative R&D with private firms (IC, 1994, pxxvi). This is also subject to the same arguments as for generic promotion, suggesting that moves to reduce the collaborative efforts might create sub-optimal amounts of beef R & D.

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[215]The campaign aimed to promote Australian beef as "a natural, wholesome, healthy and inexpensive product" (IC, 1994, p105). The 'Aussie Beef' logo is widely used but it is not compulsory and is not universally used. The total advertising budget in Japan in 1992-3 was A$12.1 million, more than 10% of annual AMLC income. There is no minimum standard for beef using the logo and evidence tha it has been abused by Japanese retailers (AMLC, pers. comm.).

The situation in beef also illustrates how over-extended the liberalisation argument becomes. Some of those seeking reform do not simply want to shift the relative emphasis. Rather, they argue that the MLA should move "significantly further in the direction of financing individual projects by way of direct charges to the beneficiaries, with concomitant reductions in general levees" (IC, 1994, pxxxi). In other words, it is proposed that the MLA could be taken out of the public sphere and remade it as a profit-seeking (i.e. a profit-requiring) organisation.

Instead of operating on the rationale that their activities produce benefits for the industry and the nation, the MLA would, if this recommendation were implemented, be obliged to identify beneficiaries, negotiate with them over funding, monitor outcomes and enforce agreements. If this were costless, the change would simply mean that the MLA shifted from the public to the private spheres and became another specialist, private organisation. That it is not costless will mean that fewer activities would be undertaken and the reform would create a 'dead-weight' loss which can lead to further so called dynamic inefficiencies. In short, such reform proposals show how important it is to include transaction cost reasoning in the policy debate.

Hence, in summary, it would seem that our policy framework does address some of the key elements already in the public arena. If this is true for beef, is it also true for coal?

7.3 Policy Implications of Japanese Participation in the Australian Coal Industry

Japanese involvement in the Australian coal industry is another under the rubric of vertical-relatedness so that in coal, as in the beef industry, Japanese FDI is one means of organising procurement in Australia for shipment to users in Japan.

The major question for Australian policy makers is whether FDI plays a key role in a Japanese strategy to depress prices for Australian export coal, thereby conforming to what we have called an augmented imperfect competition motivation i.e. an anti-competitive purpose, supported by the Japanese government and advanced by intra-Japanese cooperation? Alternatively, do the arrangements serve an economic purpose and overcome some difficulty more economically than at arm's length? The Japanese desire for security of supply appears to raise such difficulty and, as with the case of beef, it is a matter of interpreting some very unusual and particularly Japanese arrangements found in this industry.

The focus on the relation of FDI and prices for Australian coal reflects a long expressed concern, held even at the highest level, over the prices paid by Japanese buyers of Australian coal.[216] This concern is reflected in the Australian government's long held (but recently rescinded) powers to intervene over coal export prices[217] and it has been a major issue at a recent government inquiry (IC, 1991, *passim*).

We begin by describing the coal industries in Australia and Japan and Japanese FDI in Australia and its links to Japanese producers and users. Next, we examine the Australia-Japan price negotiations in the context of the pricing regime in the international coal market before considering the security of supply issue. Having shown how the theoretical positions apply, we then use this instance to again illustrate the policy agenda.

Firstly, some facts about the coal industries in Australia and Japan. Australia's coal industry is large by world standards (although it is dwarfed by the giant US and PRC

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[216]In 1978 the then Minister for Trade stated that "Australian companies face buyers who are coordinated or who have a high degree of consultation and who as a result......play one seller off against another." (IC, 1991, p 156). Similarly, in 1975, the then Minister for Natural Resources Rex Connor, led a delegation to Japan to renegote what were taken to be unfair prices (Gaskin, 1983a, p 53).

[217]While the Federal government was adamant that it would " not become involved in commercial negotiations," (DPIE, 1995, p 14), it had the power (by means of its control over international trade) to overview all coal export contracts, although it would only exercise these powers "where clear and compelling national interest considerations are involved" (ibid).

undertakings) and is considered to be relatively efficient, with a wide range of coal types and qualities. Extraction of Australian coal is cheap relative to Japan and elsewhere and Australia is the world's largest exporter, having been so since 1984, with total production of 230 Mt and exports of 131 Mt (DPIE, 1995, p1).[218] Australia has very large reserves (some 50 billion tonnes of economically recoverable ore) and has the supporting infrastructure to process and ship coal. As in the beef industry, Australian coal activities operate at close to world's best practice.[219]

Australian exports are almost equally divided between coking (also called metallurgical) and steaming (or thermal) coal. The major export markets for Australian coal are in Japan and other north-east Asian nations which together make up 70% of the total with the remainder going to Europe, India and north Africa (DPIE, 1995, p 3).

There is a high degree of complementarity between the positions of Australia and Japan: Australia is the largest exporter and Japan is the largest importer. Japan is highly import-dependent for many of its energy sources and especially for coal (Gaskin, 1983b, p 7). It does have a small, high cost domestic industry which has had a colourful and often less than desirable past including the use of forced and foreign labour and of *yakuza*-like operations (Allen, 1994). However, the industry has been in decline for many years, falling from a peak production of 57.5 Mt in 1960 to 6.3 Mt in 1996, and having been the subject of a number of restructuring plans (most recently the New Coal Plan of 1992). The Japanese government has been concerned to manage the decline of the industry (Culter, 1999, *passim*) and continues to require that power utilities buy coal from the two remaining Japanese mines at some three times the world price as a condition of their

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[218]In 1992 Australia accounted for nearly 40% of coking coal traded internationally and 25.0% of the steaming coal trade (ABARE, 1994, Tables 267-270).

[219]An Australian government study of this matter makes the point that there are significant problems with any international comparisons in coal mining, including data deficiencies and conceptual problems. However, on a saleable coal production per employee basis, the Australian industry average is comparable to that of the US. Data also suggest that Australian mines are safe by worlds standards (DPIE, 1994).

continuing to import coal (IEA, 1997, p 64). Again, as in beef, the benefits of access to cheaper foreign supplies creates a rent which is channelled into structural adjustment.

Australia is by far the largest source of Japanese coal imports with a share of more than two-thirds of steaming coal imports and half of coking coal. These shares have been relatively constant for more than a decade.[220]

Turning now to the matter of Japanese FDI, Table 7.3.1 below lists coal mining companies in Australia with Japanese participation, including some basic information on their operation. Table 7.3.2 which follows then lists the Japanese companies which participate in the Australian industry and shows the number of Australian coal companies with which they are involved and the predominant activity in which they take part. The two are connected in that the last column of 7.3.1 lists numbers in italics which correspond to the company names in 7.3.2.

Table 7.3.1: Australian Coal Mining Companies with Japanese Participation

Company	**Capital $m**	**Turnover $m**	**Year of establ't**	**Employ-ees**	**Japanese equity**	**Japanese cos.***
Apollo Resources	20.5	135.5	1989	15	100%	*2*
Australian Char P/L	0.3	u/a	1969	100	17.0%	*11*
Aust. Mining Invest't	9.4	40.0	1963	123	47.9%	*18*
BHP Aust Coal P/L[221]	u/a	2000.0	1984	5080	13.3%	*7*
BHP Mitsui Coal P/L	246.0	u/a	1962	5100	20.0%	*8*
Blair Athol Coal Project[222]	13.2	395.0	1965	u/a	11.4%	*1, 2*
Blight Coal Ltd	5.4	u/a	1980	u/a	100%	2
Camberwell Coal J V	u/a	u/a	c1991	162	50.0%	*7, 19*
Clermont Coal Mines Ltd	u/a	u/a	1983	u/a	45%	*7*
Coal & Allied Ind Ltd	64.4	553.5	1960	1251	19%	*11, 20*

[220]The US and Canada dominate the Atlantic trade supplying to Europe where the US share is more than 20% cf. Australia's share of 10.8% (ABARE, 1994).
[221]Operators of the Central Queensland Coal Associates Joint Venture.
[222]Includes Dalrymple Bay Coal Terminal.

Curragh Qld Mining	u/a	u/a	1981	437	13.0%	*8*
Dalrymple Bay Coal Terminal (1992 data)	25.0	u/a	1981	160	8%	*1, 2, 8*
Denehurst Ltd	71.1	u/a	1981	437	13%	*8*
Dia Coal Mining (Aust)	8.0	u/a	1989	3	100%	*7*
Drayton Coal P/L	0	165.0	1983	414	6.8%	*8*
Ensham J V	0.1	u/a	1990	72	47.5%	*2*
Howick J V	u/a	170.0	1990	300	40.0%	*7*
Macquarie Coal J V	u/a	u/a	1992	714	27%	*5, 6, 17*
Maitland Main Collieries	0.55	0.1	1929	4	40%	*10, 18*
Muswellbrook Coal Co	u/a	u/a	1907	210	100.0%	*2*
New Hope Corporation	9.4	u/a	1952	300	19.2%	*7, 17*
Oakbridge P/L	175.6	515.0	1958	1800	50.8%	*4, 10, 18*
Peldeen P/L[223]	3.0	u/a	1989	2	100%	*6*
Pt Waratah Coal Services[224]	132.6	128.8	1976	293	29.6%	*18, 8, 7*[225]
Savage Resources	13.7	31.0	1985	225	14.0%	*1*
Sumisho Coal Develop't	79.9	46.9	1974	3	100%	*16*
Ulan Coal Mining Ltd	2.0	250.0	1975	440	49.0%	*7*
Wambo Mining Corp	34.0	100.0	1969	380	88.0%	*1*
Warkworth Mining	u/a	u/a	1981	440	36.25%	*3*
TOTAL	914.2	4530.8		19365		
number reporting	21	14		26		

Source: A-JEI 1992.

Table 7.3.2: Japanese Companies Participating in the Australian Coal Mining Industry

Parent Company	**Mining**	**Mining & other**	**Trading**	**Office**	**Other**
1. Electric Power Dvpt Co.*	1			1	

[223]This company is in a number of joint ventures including Jellingbah East, Bowen Basin Coal, Macquarie Coal, German Creek East and Hail Creek.
[224]Includes the Koorang Coal Loader Ltd and Newcastle Shippers P/L.
[225]In addition to the 3 Japanese companies to which reference is made in the Table, the Port Waratah Coal Services Ltd has 24 Japanese equity holders (and 4 others). These include 7 large steel and 3 large cement companies.

2. Idemitsu Kosan Co Ltd.	5	1		1	1
3. Japan Coal Dvpt Co.**	1				
4. Kawasho Corporation			1		
5. Marubeni Corporation	3	1		1	
6. Mitsubishi Corporation	8	2	2	3	2
7. Mitsui and Co Ltd.	4	1	2	4	1
8. Nichimen Corporation			1		
9. Nippon Oil	2				1
10. Nissho Iwai Corp		1	1		1
11. Nittetsu Shoji Co.			1		
12. Nomura Trading Co.			1		
13. Okura and Co.			1		
14. Showa Coal	2			1	
15. Sumitomo Corporation	1		1	1	1
16. Taiheiyo Kohatsu Inc.					1
17. Tomen Corporation	1		1	1	2
18. Toyota Tsusho Corp'tion	1		1	1	
19. UBE Industries			1		

Source: A-JEI 1992.

* A Japanese public power company.

** A consortium of 9 private electric power companies.

Note: We are able to use the employment data from the Table to infer that some very large operations have not been included in the capital or turnover data.[226]

Excluding four operations known to be no more than offices, there are only three cases in the coal industry of total Japanese FDI equity at 100%, two more at greater than 50%, the next six at more than 40% (therefore fitting the definition of FDI on a combined basis), seven more at greater than 15% (3 of which constitute cases of FDI) and the remaining seven are equity holdings of less than 15%. Thus an obvious difference between beef and

[226]For example, the giant BHP Mitsui operation employs 5100 people and is therefore likely to have turnover comparable to the BHP Aust Coal P/L's $2 billion.

coal is that Japanese interests are far more likely to take up minority equity positions in this instance.

As to the timing, the Table suggests that Japanese participation in Australian coal activities has been of recent origin, with 16 of the 29 Australian companies in which Japanese interests participate being established since 1980. However, some of the biggest examples, such as the BHP Mitsui operation and CQCA, began in the 1960s during the period of high speed Japanese growth.

As stated above, Japanese participation in Australian coal activities can be characterised as a case of vertical relations, with supplies being exported primarily to Japan (Parker, 1990, p 3). And, as was the case in beef activities, this fundamentally vertical, bilateral relatedness is developed through the full range of corporate growth strategies. This is made clear by Table 7.3.2 which shows data for the 19 Japanese companies that can be identified as participating closely in the Australian coal mining industry. Most companies undertake multiple activities and most can be identified as members of *keiretsu* or of coal user or producer groups in Japan. Moreover, in many instances (nine out of 29), including some of the biggest, Japanese firms participate via joint ventures with other Japanese firms.

Japanese involvement is by means of five groups: the *sogo shosha*, participating sometimes as traders, more often as part of more fully integrated *keiretsu* operations; the Japanese steel mills (as, for example, Nittetsu Shoji Co Ltd, associated with Nippon Steel); electricity companies (as with the Electric Power Development Co. and the Japan Coal Development Co.[227]); mining companies (especially as the mining arms of the *sogo shosha*); and, even, oil companies (Parker, 1990, p 1).

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[227]The JCDC was developed in the early 1980's to coordinate the global investment and purchasing activities of major Japanese electric power companies (Gaskin, 1983 b, p 6).

The identities of these companies and groups confirm that the corporate strategies being pursued cover the range of vertical, horizontal and diversified growth: the involvement of Japanese power companies and steel mills are clear cases of vertical integration; that of Mitsubishi Mining and the investment in mining by Idemitsu Kosan are cases of corporate growth by horizontal integration; and, the case of Japanese oil companies such as Nippon Oil Company's investment in the Maitland Main Colleries P/L represent instances of diversification within the energy industry.

As can be seen from the Table, most of the companies which invest in Australian coal undertake a number of operations, not just mining. Some, such as Nomura Trading, undertake no activity but trading and some, often those participating only as single joint venture partners, operate no more than a local office for managerial staff. Other companies, especially those with *sogo shosha* and *keiretsu* links, undertake a wide range of operations: Mitsubishi had 17 and Mitsui 12 coal projects in Australia.

These multiple undertakings appear to be vertically integrated. However, as with the beef industry, the relative size of each entity in the chain of vertical integration are often mismatched, strongly indicating that transactions are not all undertaken within the group. The non-exclusivity in business relations in Japan, reported in Chapter 5, is a feature which is repeated in Japanese FDI operating in Australia, indicating, again, that the pattern of investment and trade is shaped, in part at least, by corporate and institutional links in Japan but that there is no simple one-to-one correspondence and the relations may include close ties between otherwise competing entities.[228]

To appreciate the role which this FDI might play in pricing the Australia-Japan coal trade we need briefly to describe price setting in the international coal market (this description relies predominantly on IEA, 1997).

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[228]Examples of inter-*keiretsu* and other Japanese inter-company FDI include the Mitsubishi-Toyota Tsusho Corporation investment in the Camberwell Coal Joint Venture, the Mitsui-Showa Shell Sekiyu KK investment in Redbank Plains Resources P/L and the Tomen-Sumitomo collaboration in The Wallerwang Colleries Ltd.

Australian producers and Japanese users negotiate directly, albeit within a negotiating environment set internationally. Traditionally, contracts have been long term and have specified prices, quantities, qualities, duration and adjustment provisions (Joskow, 1988, p 49).

For steaming coal, initial global price parameters are set by Italian tenderers who bid at the beginning of the financial year. South African suppliers, who can sell to Europe or to the Asia-Pacific markets, act as a conduit from these tenders to the Japanese-Australia negotiations which occur in the lead up to the start of the Japanese financial year in April. The negotiations are conducted primarily by Japanese electric companies and, while separate, are related to the deliberations over coking coal prices.

Coking coal price negotiations are conducted traditionally between the Japan steel mills and large, traditionally Australian-owned producer, BHP. These establish the so called benchmark price as a reference for all other bilateral negotiations. The benchmark is commonly regarded as including a small premium paid by the Japanese buyers to secure supply from Australian producers and it sets a standard not just for other bilateral negotiations but one also automatically followed by South Korean and Taiwanese negotiators.

It should be noted that this marketing structure is said to be changing with Japanese negotiators relying increasingly on the evolving spot market. A crucial juncture came in 1997 when Chubu Electric used spot market prices as a reference point to negotiate reduced prices for Australian steaming coal. This success has established Chubu Electric as a lead negotiator on the Japanese side in subsequent years. However, despite the growing importance of the spot market, the essence of the pricing regime remains the benchmark (partly because technical considerations limit competitive switching, as explained below).[229]

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229 At the time of writing, it has been reported that BHP is preparing to negotiate with individual companies in Japan and that this might lead to the end of

These arrangements can be understood in terms of the anti-competitive view of FDI in that they aim to coordinate and exploit the monopoly powers of Japanese users' to extract rents from Australian suppliers by squeezing profit margins. This view also understands the FDI in the same way so that the investment, the use of negotiating leaders, the trading and investing activity of the *sogo shosha* and the "more consistent government backing than is the case for other importing countries" (Gaskin, 1983a, p38) all point to the augmented imperfect competition interpretation. In short, the FDI can be interpreted as part of a concerted, manipulative and exclusionary strategy by Japanese interests.

That view is consistent with data which show that prices for Australian coal exports to Japan have lagged those of the US by some 10% (ABARE, 1994).[230] Further empirical work on the prices for coking coal reported in and augmented by Koerner (1996) uses the so called hedonic approach to establish a relationship between price and quality (based on supposedly objective, technical considerations) and then tests, using regression analysis, for any price distortions. The empirical results show "persistently lower acquisition costs for Australian coals" (cf. US and Canada) (p 10) by Japanese steel mills.

While the evidence seems clear, there is some dispute. A number of industry submissions to government inquiries argue that price levels for Australian coals are internationally competitive (e.g. Utah Development Co, 1982; Australian Coal Association, in IC, 1991, p 11), albeit, again, by companies and organisations which are not exclusively Australian based and have international perspectives.

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benchmarking (AFR 23.01.01). It remains to be seen if Japanese buyers see advantage in fragmenting negotiations and whether any changes in strategy leads to an increase in prices for Australian coal.

[230]The ratio of Australian to US prices for export coal are:

Year	Steaming Coal		Coking Coal	
	toJapan	to all nations	toJapan	to all nations
1985	78.4%	67.7%	81.4%	82.4%
1990	95.6%	93.9%	95.8%	94.1%
1993	90.1%	86.4%	91.3%	90.1%

Further, international and historical trends belie the conclusion that that this is a clear case of price distortion. As the table in footnote number 40 shows, the low Australian price is evident in the average prices for sales of Australian coal to all destinations not just to Japan and, indeed, the price gap is more pronounced for all countries on average than for trade to Japan. Further, the gap was narrower in the mid 1990's than in the early 1980's, suggesting that the growth in Japanese FDI in Australian coal mining has not been associated with a worsening but with an improvement in the relative price paid.

Thus, at best, the evidence on the matter of prices is ambiguous. It is complicated not just by difficulties in measurement and trends. In addition, because Japanese interests are part owners of Australian mines, depressing prices has a negative impact on the Japanese FDI affiliates' profits in Australia. In that way the FDI can reduce the incentive Japanese negotiators-cum-investors have to force prices down.

In a similar vein, as argued in the case of the beef industry, the apparent non-exclusivity in dealings by Japanese FDI companies and coal traders suggests that Japanese interests are not monolithic, despite that they are coordinated. This too increases the complexity of any manipulative strategy and reduces the force of the augmented anti-competitive rationale.

There is evidence too for the alternative transaction cost economising interpretation. Firstly, the preponderance of small equity holdings in coal compared with beef suggests that other motives might also be important. As others have observed, minority equity positions of this kind, while too small to control prices, might be sufficient to provide a position on the Board of the relevant companies and so give regular access to company-specific information through the reporting requirements to shareholders, thus establishing listening posts to improve economically the amount and reliability of information (Gaskin, 1983b, p 7; McKern, 1996, pp 336-7).

Source: ABARE, 1994, Table 276.

As noted above, Japan's lack of energy independence gives particular reason for Japanese interests to seek access to such information (Koerner, 1996, pp 9-10). There is some interesting historical and international evidence to suggest that this interpretation might lie at the heart of the FDI behaviour. Firstly, it has long been recognised that the security of coal supplies has been a key issue for successive Japanese governments and has led them to encourage FDI by Japanese coal producers and users (Ozawa, 1979, *passim*; IEA, 1997, p 17).

Secondly, since the 1960's Japanese steel makers, although once heavily dependent on the US, have diversified into cheaper Canadian and Australian sources. But, as Koerner (1996) points out, in this they did not run-down the US mines, preferring instead to maintain them as higher cost sources in order to enhance supply security. Furthermore, in the 1980's, when the prices of Australian coals were declining relative to Canadian, the steel mills actually expanded their Canadian operations. In fact, economic modelling shows that Australia's relative position as a supplier to Japanese steel mills has not increased, despite its being the lowest cost coking coal producer (Koerner, 1996, p 10).

A similar picture emerges from the study by Parker (1990) in which he recounts the development of the Central Queensland Coal Associates deposit. It was initially a joint venture of Utah International (a subsidiary of the US company, General Electric) and Mitsubishi (which held a minority share of 15%). During the early 1980's, in expectation of lower prices, the US firm sold out to Australian interests (led by BHP and the AMP Society). Despite the poor profit forecasts, Mitsubishi stayed. Parker reports the same process in Canada where the US firms sold out to local interests while the Japanese groups stayed. As he notes, the US and Japanese interests were faced the same situation but reacted differently: "(t)he contrasts between short term profit and long term security motives ..... is well illustrated" (Parker, 1990, p 4).

The transaction cost-economising understanding of this motivation is that it is likely to be expensive to achieve security of supply by relying on arm's length transactions alone. Of course, we might expect that security can be achieved without FDI and simply through

diversification (geographic and transactional), so that competition between firms and between source nations limits the imposition of costs (or extraction of benefits) which might occur because of the opportunism of trading partners (Abbeglen et al, 1985, p 245).

However, promoting efficiency by disciplinary switching of partners for the supply of coal can be costly and over-reliance upon it might upset the incentives needed to encourage new exploration and development. Similarly, competition might be a weak restraint on suppliers' acting opportunistically in ways which compromise security of supply (by, for example, economising on inventories or the frequency of shipments). In addition, the problem of security cannot be satisfactorily addressed by reliance on improved information flows (Gaskin, 1983a, p 64). This is because there are uncertainties as to the veracity of the information, uncertainties which it is costly to govern by contract.

Nonetheless, it could be argued that security of supply would be best achieved by greater reliance on paying premia in spot markets, rather than on a strategy involving FDI. In this view, competition among users will award coal to those most willing to pay and, so long as these prices are sufficient to induce supply (a minimum requirement for all arrangements), it might be a cheaper means of obtaining long term access.

However, there are problems with this approach. As we have seen, there is not one kind of coal but many and a switch of coal partners likely means a switch of coal type and quality. This will require a prolonged process of trail shipments and test firing before significant quantities can be used. In other words, there is a degree of assets specificity and a "need to tailor downstream facilities to the quality of upstream output" (Casson, 1995, p 25). These considerations limit the ability to make spot market purchases and the development of a secondary market in coal futures. Both suggest that security of supply cannot be left to a market mechanism.

The result of all this ambiguous evidence serves to reinforce the proposition from Chapter 4: that we cannot objectively interpret the motivation of economic agents and,

hence, that the ambiguity in our understanding should be met with an ambivalence in policy. In this instance, the policy agenda would apply as follows.

Firstly, to respond to the anti-competitive interpretation, policy makers need to consider anti-monopoly behaviour, both by and among Japanese coal trading and investing firms. While in beef, the compliance of consumers and their organisations seemed to be implied, in coal, the augmented imperfect competition view might better explain the situation as an amalgam of monopoly and mercantilism and this appears to be the position of Koerner (1996). As a consequence, he proposes that Australia's options include policies to form a seller's cartel to coordinate the negotiations conducted by Australian and some Canadian suppliers to Japan and so countervail on anti-competitive Japanese organisation, although it is not clear how this would work with Japanese companies being well represented in Australia and Canada and therefore having a major presence in any sellers' cartel.

Koerner also suggests that Australian governments limit companies' abilities to settle on reduced prices for Australian export coal. At the least, it seems reasonable to suggest that some involvement by the Australian government seems warranted to strengthen the exporters' negotiations. In this context, the recent rescinding of explicit export controls by the Federal government appears to have been a misplaced reform but, in any case, those powers would need to be augmented by alliances formed with Japanese interests. In this case, such groups would include those who have supported the current process of energy sector liberalisation in Japan (Lesbirel, 1997, *passim*)

The transaction cost economising agenda would be to support further Japanese FDI which it interprets as efficiency-promoting and which, as we have seen, can operate as a means to limit price manipulation. Further, from the same perspective, government policy could focus upon enhancing the factors which would create trust and promote long term commitments and contracts, thereby helping to address the security of supply issue directly.

Hence, the agenda would include institutional innovations such as establishing a bilateral negotiating committee which would include government as well as commercial interests. The committee would plan for future Japanese demand and Australian supply. It would include investigation over issues such as coal specification and testing and R & D. Again, as in the beef industry, it could be combined with bilateral initiatives aimed at monitoring and controlling any anti-competitive tendencies arising with Japanese FDI.

7.4 Summary and Conclusions

This chapter has found significant commonalities and a number of key differences in the role and type of Japanese FDI in Australian beef and coal. As to the commonalities, both cases demonstrate the asymmetry of Japanese FDI: there is no equivalent flow of FDI from Australia or anywhere else to Japan. In both cases too we have found that the Japanese investors are insiders within esoteric, arcane and sometimes colourful arrangements found within Japan.

Further, in both cases the industry in Japan is in decline relative to imports (in the case of coal it is also in absolute decline) and there is a publicly sponsored process of structural adjustment in train of which outward FDI appears as one part but which includes assistance to industry in Japan and which is funded by the proceeds arising from maintaining the price difference between local and foreign locations.

The Japanese investors have significant influence at a number of points over the chain of value added in Australia. However, no single company nor single Japanese business group has complete or hegemonic integration. While we cannot be sure if integration among Japanese interests outside a single group is complete, that too seems unlikely, despite that we have some instances of clear cooperation among *keiretsu* and companies from other Japanese business groupings.

As to differences: firstly, it appears that beef FDI has led the opening up of the Japanese industry whereas in coal it followed the trade opportunity. Secondly, the prevalence of outright ownership and control is more significant in beef, and we have found a transaction cost economising rationale for this in the different impediments which can be interpreted as the major cause of the FDI. Thirdly, while FDI is relatively high in coal and supply from Australia is relatively concentrated, FDI is relatively low in beef production and supply is relatively competitive.

None of this descriptive work allows a choice to be made between the two theoretical perspective. The arrangements surrounding FDI and the motivation for FDI are not resolved and the policy agenda should be ambivalent.

In large measure the policy responses are organisational and concern Australian institutional innovation. In line with the transaction cost economising reading of the situation, Australian beef organisations should focus on offering credible quality assurances to Japanese users. Similarly, Australian coal organisations should seek to promote security of supply. Both initiatives would extend and support the economising purposes of the FDI, leading to more activity overall so that, even as they reduce the intensity of the motivation for the FDI, such responses expand the total amount of it.

In line with the alternative reasoning, Australian organisations should be formed to promote entry into the Japanese market or, where Japanese interests object to entry on the basis of credible transaction cost economising rationale, Australian authorities should concern themselves with the development of Australian organisations which could countervail against any anti-competitive behaviour which might arise. These activities should parallel links with Japan's FTC and other groups.

There is more that can be drawn from these illustration but that is left to summing up at the end of the next chapter.

Chapter 8: Policy Responses in the Motor Vehicle Industry

8.1 Introduction

The case of the automotive industry is very different from that of the primary industries examined in Chapter 6. Firstly, in car making, production in Australia is not advantaged over Japan, quite the contrary, and the primary reason for siting the activity in Australia is the government's long term commitment to tariff protection not some natural and immutable advantage. That commitment is waning and the local industry is in a process of restructuring associated with substantial tariff reduction, much as are beef and coal in Japan, and this raises the major policy issue: should the Australian government continue to support Japanese motor vehicle manufacturers?

A second difference is that cars are more elaborate, manufactured goods and production in Australia under Japanese control raises a raft of issues in transferring technology and work organisation. Finally, as noted previously, the automotive industry case brings issues of industrial structure sharply into focus and this, in turn, illustrates the links among trade, FDI and the industrial structure and the case of the motor vehicle industry is used to exemplify related policies.

Although the differences are striking, some similarities also emerge. Firstly, as we described in Chapter 3, the history of the Japanese motor vehicle industry shows the capacity, peculiarly well developed in Japan, to respond to the pressures and opportunities of internationalisation by flexible and innovative, albeit not always successful, public and private initiatives. Secondly, we find here as in beef and coal, that Japanese investors are linked to a range of business groups and other peculiarly Japanese relations but, thirdly, that Japanese interests lack complete vertical integration.

The Chapter is structured as follows. Section 8.2 describes the industry in Australia and Japan. Section 8.3 describes Japanese FDI in the Australian industry and interprets it in

terms of our two theoretical points of view. Then 8.4 deals with policy. It takes the Australian State of South Australia where the motor vehicle industry is well represented to illustrate some of the ways in which the presence of that activity can benefit the local industrial structure in ways important to policy. Section 8.4 also expands on the notion raised in section 6.4, that while the co-location of Japanese assemblers and parts makers extends the Japanese FDI activity, it can also limit the flow on effects emanating from the industry, even if it has efficiency purposes. A summary section 8.5 concludes this and the previous chapter.

8.2 The Automotive Industry in Australia and Japan

Motor vehicle production and consumption are both large activities in Japan. While the world's largest motor vehicle firms are the US companies Ford and General Motors, Japanese companies Toyota and Nissan are third and fourth largest and Japan also has a clutch of other significant players in car, truck and motorcycle production (Shimokawa, 1994). The global scene also includes significant European producers and, in recent years, new motor vehicle companies have emerged in east and south-east Asia, often with Japanese connections.[231]

Japanese motor vehicle interests exhibit the full range of inter-company organisational characteristics described as importantly Japanese in chapter 5. These are said contribute greatly to the economic environment in which the industry operates and to be a key factor in the success of Japanese companies (Shimokawa, 1994, p 24). We can identify a wide

[231]For example, Mitsubishi Motors has been a large parts supplier to Hyundai from the Republic of Korea and has also supplied parts also for production of the Proton in Malaysia. Similarly, Daihatsu has joint venture arrangements in India and Taiwan while Suzuki also has arrangements on the sub-continent. Mazda, which is linked to the Republic of Korea's second largest car firm, Kia, is 25% owned by Ford Motor Company with whom it (Mazda) also has extensive supplier and marketing links.

range of corporate groups in this industry, including *keiretsu* groups and ties with large banks (Ozawa, 1997) and quasi-integration, both horizontal and vertical (Takeo, 1994).[232]

One consequence of these forms of quasi-integration, including the higher rate of sub-contracting (Odaka et al, 1988, p 53), is that average firm size tends to be smaller in Japanese motor vehicle manufacturers but that the ratio of turnover per employee tends to be higher (Fukuyama, 1995; Miwa, 1996).[233]

Despite the reliance on sub-contracting, including some less formal networking methods (Goto, 1982, pp 55-6), the Japanese industry is said not to be burdened with contract-laden relationships. The relevant contracts are said to be "open-ended" (Smitka, 1991, p 5) and based on "mutual trust, obligation and loyalty" (Yang, 1995, p 17). These can be interpreted as transaction cost-economising forms of organisation.

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[232] Ozawa creates the following table (p 171)

Carmakers	**Keiretsu**	**Banks**
Toyota	Mitsui	Mitsui Bank
Nissan	Fuyo	Fuji Bank
Isuzu	Dai-Ichi Kangyo	Dai-Ichi Kangyo Bank
Mitsubishi	Mitsubishi	Mitsubishi Bank
Toyo Kogyo	Sumitomo	Sumitomo Bank
Daihatsu	Sanwa (Toyota affiliate)	Sanwa Bank
Honda	Mitsubishi	Mistubishi Bank

Takeo discernes three kinds of relations. Firstly, there are *keiretsu* with a high degree of intra-group cross-ownership and transactional relations (as with Mitsubishi Motors, or Nissan (part of the Fuyo Group), or Mazda (part of the Sumitomo Group but with Mitsubishi and Mitsui involvement)). Secondly, there are many forms of quasi-vertical integration, most fully developed in the case of Toyota which has a close financial and transactional connection to a large number of parts suppliers such that they are described as being "an organic part of the (Toyota) corporation" (ibid, pp 67-8, quoting directly from Toyota's 1939 procurement policy document). Thirdly, Toyota also exemplifies a number of relationships which may be called quasi-horizontal integration. Examples include its relationship with Daihatsu Motors (which joined the Toyota ensemble in 1967) and Hino Motors (which joined in 1966).

[233]For example, Toyota produces approximately 4.5 million cars per annum with 65,000 employees. By contrast, GM produces 8 million cars with 750,000 workers (Fukuyama, 1995, p 163). In fact, the combined employment of Mitsubishi, Mitsui and Sumitomo groups was only 637,000 (Miwa, 1996, p 12).

In addition, it is said that Japan's transaction cost economising traits and institutional forms are particularly well suited to the automotive industry, where product complexity is high and lead times are long (Casson, 1995, p 16). Combined with the high quality expectations of Japanese consumers (Dunning, 1997a, p 126), this has meant that, in succeeding, Japanese firms have needed to develop many of the proprietary assets needed in this industry.

However, these arrangements could equally be interpreted as anti-competitive. Accordingly, the arrangements between manufacturers and parts suppliers within the Japanese auto industry might be better understood not as efficient but as a means to exploit the buying power of the car maker over the far smaller and more numerous parts makers (Clark, 1979; Odagiri, 1992, pp 151-2).[234] As explained in Chapter 5, these arrangements can be motivated by the corporate gains that might be made by exploiting the advantages of monopoly and monopsony enjoyed by the large, core companies.

The case of Japan's car industry therefore only returns us to the dichotomy we have previously highlighted. However, it also indicates the possible resolution we have previously sketched by giving us a real world example of efficiency being promoted by a combination of transaction cost economising organisation and competition among parts suppliers (Smitka, 1991).[235]

This interpretation is further evidenced by the fact that even close business relationships in Japan's automotive sector tend to be non-exclusive (Miwa, 1996). While the situation involves such enduring and important interdependencies that parties must "commit themselves to offering a kind of monopolistic position to their partners" (Miwa, 1996, p

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[234] Odagiri is not of this view and describes it as a "myth, stressed by Marxists" (p 152)

[235]Contracts are said to be based on "historic costs and comparisons with one or at most two other firms" (p 4) so that competition is made "credible without having to be cutthroat" (p 6).

59), competition (or the threat of it) is used as one, further spur to efficiency and as a guard against and discouragement to opportunism.

Parts makers too can blend organisation with competition among buyers so that they often supply more than one manufacturer just as manufacturers often source from more than one parts maker (Odaka, 1988).[236] To extend the phrase of Imai and Itami (1984), efficiency is determined by the efficacy with which all these modes of organisation "interpenetrate" each other. So, Japan's motor vehicle industry is instructive as an illustration of relations among Japanese firms and between firms and the Japanese.

Turning now to the Australian industry, firstly, it is small by world standards.[237] Annual production of passenger motor vehicle is some 325 000 units, spread over five models, giving plant production runs below international benchmarks.[238] Imports were 233 000 in 1996, and Japan is by far the largest source, accounting for 42% of the total. Component production in Australia is undertaken by almost 200 firms, with turnover of $3.4 billion. Total employment was over 47,000 in 1994-5 (23 000 in motor vehicle manufacture, 24 000 in parts).

There are four passenger vehicle manufacturers, all foreign owned: Ford, GM, Toyota and Mitsubishi. Local content of Australian vehicles is relatively high at some 80%, despite the end of formal local content requirements in 1989 (AIA, 1994). In addition, major motor vehicle companies also operate importing and distribution operations. Over the period 1985-1996 (i.e. during the period of rapid tariff reductions), the real value of passenger motor vehicle exports has increased by an average of 30.6% p.a. to more than $0.83 bn. However, given the rising import penetration (up by 7.7% pa or $1.7bn) to $2.95 bn, this has not added significantly to the scale of operation.

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[236]For example, 45 of the 162 first tier suppliers to Nissan also supply Toyota (Miwa, 1996, p 15). The case of Nippondenso is instructive. Originally formed from Toyota, it has grown large and now, while still associated with Toyota, supplies also Mitsubishi, Mazda and others (Odaka, et al, 1988, pp 154 - 169).
[237]Data in this section comes mainly from IC (1997).

As previously stated, the manufacturers operate in Australia primarily because of the tariff on vehicles and parts. However, there are also some other reasons (IC, 1997, p 315). Local production plays a role in creating positive brand image and assists in marketing efforts by promoting cars which are designed and built for local conditions. In addition, an Australian location gives access to some relatively cheap inputs which provides a further basis for the siting decision. For example, in the production of some motor vehicle parts from basic products, products such as aluminium castings, batteries and plastic mouldings, access to relatively cheap mineral products and low energy costs are significant elements in the siting decision and in these areas the motor vehicle industry's activities in Australia are not dependent on tariff protection or government assistance.

The contrast between Australia and Japan is also evident in the history of the Australian automotive industry (Commonwealth, 1981, pp 5-10; IC, 1997, App K; Manning, 1993). While Australia developed an indigenous assembly and chassis building capability in the period before 1930, domestically designed and produced motor vehicles relied on large scale FDI by US, European and, later, Japanese firms. The strategy was to use FDI and tariffs to site activity in Australia rather than to develop locally owned car makers which could have used foreign proprietary assets under licence.

The reasons given for this strategy were most often to do with the small domestic market which, it was argued, could not support car makers in competition with bigger overseas rivals because of the economies of scale operating in this industry (Commonwealth, 1984, p 8). However, that reasoning might not have been sound. Firstly, if the protected market were large enough for plants of multinational companies in the 1950s and 1960s, it was conceivably large enough to provide a base for local firms. Secondly, the case of Sweden reviewed in Chapter 3 shows that a market even smaller than Australia's could provide such a base for the automotive industry, if protected not just from imports but

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[238] Optimal scale is said to be between 200 000 and 400 000 units per annum (Jomo, 1995, p 274).

from FDI as well and if sufficiently export competitive. The reasoning employed in this study suggests that the critical issues were more to do with whether Australian managers could fulfil their role (including raising the capital required) and whether the foreign technology could be economically licensed.

By the early 1980s, the policy framework began to change with the first schedule of major tariff cuts and the establishment of the Automotive Industry Association. Government also sought a major restructuring of the industry, including cooperation among manufacturers to create only three automotive groups. In the process, government wanted to see

> greater Australian equity in, and participation in, the management of foreign-owned companies, as well as increased autonomy of local operation (Commonwealth, 1984, p 5).

While that might have been an aim, tariff cuts would hardly induce local investment and the objective has not been pursued subsequently by Australian governments. Again, this illustrated that Australian governments have been less than consistent and comprehensive in their support for indigenous firms.

8.3 Japanese FDI in the Australian Automotive Industry

Japanese involvement in motor vehicle manufacturing, importing and distributing in Australia is detailed in the following Table 8.3.[239] Many of the investments are of relatively recent origin. Despite that, as noted in section 2.5, the major Japanese motor vehicle companies have had a presence in Australia since the 1960s, significant

[239] A feature of this division is that the large FDI enterprises shown as motor vehicle assembly operations also undertake their own importing and distributing activities.

investment did not begin until the late 1970s with the exit of some European and US firms and many important investments were not made until the 1980's.[240]

Table 8.3: Japanese Participation in the Australian Motor Vehicle Industry.

(a) Manufacturing:

Australian Company	Capital $m	Turn-over $m	Date of estab.	No. of emp'ees	Japan-ese equity	Japanese parent
motor vehicle assembly:						
Mitsubishi Motors Aust Ltd	59.4	2039.0	1980	4600	99.6%	Mitsubishi & Mits. Mtrs Corp
Toyota Motor Corporation Aust. Ltd	392.6	1790.0	1957	4000	100%	Toyota Motor Corporation
auto parts:						
Flexidrive Industries Ltd	7.1	48.3	1953	300	100%	Nippondenso Co, Nippon Cable System
Nippondenso (Aust) P/L	4.0	208.3	1972	367	100%	Nippondenso Co, Toyota Mtr Corp &AMI/Toyota
Nissan Mtr Co Aust P/L	u/a	u/a	1966	439	100%	Nissan Mtr Co.
Unidrive P/L	5.0	67.0	1987	430	20%	NTN Corp.
VDO Instruments Aust	5.9	83.0	1957	429	25%	Yazaki Corp.
Yazaki Aust P/L	5.2	120.0	1973	614	100%	Yazaki Corp.
other mfg:						
Bridgestone Aust Ltd.	12.9	380.0	1980	2500	56.8%	Bridgestone Corp.
Century Yuasa Batteries P/L	u/a	u/a	1928	285	u/a	Yuasa Japan
Totals of Reporting Firms	**533.9**	**4687.3**		**13964**		
No. of Reporting Firms	**8**	**8**		**10**		

(b) Importers/distributors*

Australian Company	Capital $m	Turn-over $m	Date of establ.	No. of emp'ees	Japan-ese equity	Japanese parent
of motor vehicles:						
Daihatsu Aust P/L	2.0	250.0	1975	120	100%	Daihatsu Mtr Co, Nichimen Corp. & Toyota Mtr Co.
Honda Aust. P/L	22.5	380.0	1991	173	100%	Honda Mtr Co Ltd
Honda M/cycle & Power Equipment P/L	10.0	u/a	1987	80	100%	Honda Motor Co.
Isuzu General Motors Aust. Ltd.	20.0	400.0	1989	100	60%	Isuzu Motors
Kawasaki Motors P/L	2.0	45.0	1975	48	100%	Kawasaki Heavy Industries

[240]Volkswagen withdrew from Australia in 1967, British Leyland ceased assembly operations in Australia in 1974 and Chrysler sold out to Mitsubishi in 1980.

Mazda Aust P/l	31.0	u/a	1967	245	100%	Mazda Mtrs & T. Chatani Co Ltd.
Nichimen Aust Mtrs P/L	2.3	15.4	1989	30	100%	Nichimen Corp.
Yamaha Motor Aust P/L	12.5	u/a	1983	98	100%	Yamaha Mtr Co.
of auto parts:						
Fujitsu Ten (Aust) P/L	u/a	u/a	1990	6	u/a	Fujistsu Corp.
Koyo Aust P/L	1.3	15.9	1964	19	100%	Koyo Seiko Co Ltd
NGK Spark Plug (Aust) P/L	0	12.5	1980	25	100%	NGK Spark Plug Co.
NOK Singapore Trading	u/a	u/a	1979	3	100%	NOK Corp.
NTN-CBC (Aust) Ltd	0.6	u/a	1971	15	100%	NTN Toyo Bearings
Sumitomo Rubber Ind Ltd	u/a	u/a	1976	2	100%	Sumitomo Rubber Ind Ltd
Toyo Tyre Aust Ltd	10.0	62.6	1975	190	100%	Toyo Tyre & Rubber and Mitsubishi Corp
Unicla Aust P/L	u/a	u/a	1972	25	60%	Unicla Co. Ltd.
Totals of Reporting Firms	**113.9**	**1181.4**		**1179**		
No. of reporting firms	**12**	**8**		**16**		
Totals of Reporting Firms in **(a), (b) & (c)**	**968.7**	**5424.4**		**18885**		
No. of Reporting Firms	**20**	**16**		**26**		

*Includes wholesaling operations.

Source: AJEI 1996

Since the exit of Nissan from motor vehicle assembly in 1992 and the end of the Isuzu-GM truck assembly joint venture, there are two Japanese motor vehicle assemblers, both of which assemble passenger motor vehicles (up until 1997, Mitsubishi Motors Australia Limited also operated a small truck assembly plant). There are eight Japanese component producers which produce motor vehicle parts, ranging from aluminium castings (for items such as wheels and engine components) to more elaborate electrical componentry.

For reasons which will be highlighted below, it is significant that these Japanese FDI enterprises generally specialise in supplying motor vehicles parts and there are only two, recorded in the Table in the 'other manufacturing' segment, who state in the AJEI compendium that their products enter other industries as well. This fits with the view from other studies which show that Japanese FDI operations have a tightly focussed product range (Hutchinson et al, 1994).[241]

[241] It has been estimated that Japanese MNE's in Australia make significantly greater use of the so called U-form (i.e. unitary-form) than do other MNE's and

These instances of Japanese FDI in the motor vehicle manufacturing industry are all apparent cases of horizontal integration in that all of the firms operating in Australia undertake similar activities in Japan. By contrast, Japanese FDI in importing and wholesaling is primarily undertaken as a strategy of downstream vertical integration, to control from the source nation the shipping and initial distribution of goods. As Table 8.4 (b) shows, these enterprises are much smaller than those involved in manufacturing. They are also more likely to be fully owned by the Japanese parent.

Table 8.4 also shows some of the influence of Japanese automotive companies' inter-corporate ties. For example, the international connections are reflected in the local tie-ups between Toyota and GM or in the relationship of Mitsubishi and Chrysler in the formation of Mitsubishi Motors Australia.

Similarly, the corporate ties established between Japanese companies in Japan also have an influence in Australia and, as we have seen of Japanese FDI elsewhere, the Japanese parts makers' and parts importers' decisions to invest in Australia are influenced by the decisions of the larger assemblers. For example, the move of Nippondenso to Australia is linked to the establishment of Toyota's car plant in that the two have extensive and long-lived ties in Japan.

The Table also shows that, Japanese involvement concentrates in manufacturing and wholesaling but is relatively low in retailing. Whatever its purposes, Japanese automotive FDI does not focus on the interface with the Australian consumer.

A further important inference can be made from Table 8.4 (a): that the automotive industry, like beef and coal, is not subject to what was described as hegemonic integration. Local firms supply considerable amounts of componentry to the Japanese manufacturers. This inference arises from information the Table provides as to the number of Japanese component producers in Australia, the scale of their operations and the breadth of their output range which are all such that, given the high local content, they

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that this "reflects the greater product specialisation of Japanese MNE's" (p 11).

can be supplying only a small part of Japanese motor vehicle manufacturers' requirements in Australia, even if none of their output were exported.

We now turn to the question of the motivation for Japanese involvement and particularly the motivation behind the large motor vehicle manufacturing-cum-assembly operations. In applying transaction cost theory the issue is to determine the key transactional difficulties that impede the production of Japanese cars (by which is meant Japanese designs built with Japanese techniques to Japanese standards) under licence to Australian producers which are sufficiently significant as to lead to FDI as the transaction cost minimising alternative?

A relevant study is that by Hutchinson et al (1994) (which we have seen previously at 2.5), used two data sources to examine the transfer of Japanese technology to Australian manufacturing, both within Japanese FDI enterprises and without, and found evidence that many Japanese firms (35%) initially experienced considerable "psychic [sic] distance" from Australia whereas the vast majority of US and UK firms (80%) found this not to be the case (p 14). Further, that compared to the UK and the US MNE's, Japanese FDI which involved the transfer of proprietary knowledge to Australia, concentrated in the relatively straightforward activities of product and process technologies. These general concerns fit with other studies of Japanese FDI which emphasise cultural distance as being important and to which we have referred in chapter 4 above.

The importance of these observations is that they suggest that when complex manufacturing technologies, cultural distance and technological gaps are involved, the activity is generally kept in Japan. This is especially true, as has been seen, of Japanese R & D. Less complex activities (such as manufacturing-cum-assembly) which still involve proprietary technologies, might move off-shore but do so under FDI and do so within wholly or nearly wholly-owned subsidiaries. In the automotive industry (as in electronic products) where complex, multi-plant operations are involved in design and supply of parts and manufactured vehicles, the FDI behaviour is also associated with co-location of sub-contractors from Japan (Machado, 1994, p 299).

The study by Hutchinson *et al* also found that, in addition to it being difficult to transfer Japanese technologies to Australian control, also, "(t)here was no disproportionate transfer of skilled personnel or work organisation by Japanese firms.."(p15). This suggests that the broadly admired Japanese human resource management skills are culturally attuned and are of little advantage in direct dealings with psychologically distant Australian employees.

A further study of Japanese FDI in Australian manufacturing reached a similar conclusion: that, under Japanese FDI, successful human resource management techniques from Japan were not systematically substituted for those typical of Australian firms (Dedoussis, 1994 and 1996).[242] This fits with the observation that key managerial staff in Japanese FDI affiliates in Australia are often Japanese nationals and with the results of other research about Japanese FDI globally which concludes that Japanese human resource practices are transplanted selectively (Enderwick, 1996, p 232).

In short, if the FDI is interpreted in transaction cost economising terms, the emphasis would be placed on the difficulties of transferring Japanese technology and techniques to Australian managers and workers. It is better done with Japanese control and input from some top level Japanese managers. In this view, Japanese parts makers co-locate with assemblers also to ease the problems which would otherwise be involved in dealing with some aspects of Japanese technology and production techniques such as inventory and quality control.

In this reading, an attempt to build an Australian-owned and controlled automotive industry would have likely excluded access to Japanese technology. At least, it would have been significantly more expensive and probably less successful to attempt to build "Japanese" cars in Australia without Japanese FDI.

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[242]The author argues that Australian manufacturing firms under Japanese control have little decision making autonomy and, while some human resource practices are transferred to the Australian operation (e.g. internal promotion), they are not

Overall, the evidence on whether the successful transferring of Japanese techniques is "culture-specific" is ambiguous (Chen, 1996, p 185) and it might be that the transaction cost interpretation simply provides a rationale which covers more important, anti-competitive purposes. In other words, that the proprietary assets involved are the source of monopolistic advantage and their exploitation and extension account for the FDI by assemblers and parts makers. It is a point of view referenced in the literature, especially in the US context (e.g. Helper and Hochfelder, 1997, p 209; Chapman, et al, 1995, p 75). In addition, we have already considered (in section 2.5) Kreinin's comparative study of US, UK and Japanese operations in Australian manufacturing, especially motor vehicle manufacturing, which concluded that Japanese purchasing arrangements were anti-competitive (Kreinin, 1988, pp 529-530) although, as we also saw, that is not an undisputed view.

However, while referenced in the literature, the view that Japanese FDI in car making is anti-competitive is not readily evidenced in Australia. The relevant Australian authorities have never opposed automotive FDI on these grounds. Further, competition from large US MNEs reduces, although by no means eliminates, the chance that monopolistic practices by Japanese car firms can seriously damage Australian interests. However, the use of anti-monopoly powers in this case must be guided by an understanding of relations among Japanese motor vehicle interests and of the increasingly complicated and convoluted relationships among major motor vehicle MNEs.

8.4 Policy Implications of Japanese FDI in the Australian Automotive Industry

We described industrial structure policy in Chapter 6. Here we illustrate its relevance to FDI by considering the beneficial structural impacts associated with Japanese participation in Australia's automotive industry. We then consider some of the limits the Japanese character places on the spread of those benefits. Next, we discuss other policy

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extensively or sytematically applied.

responses to the peculiar character of Japanese FDI in this industry. Finally, we return to Pigou's policy recommendation and illustrate the relevance of Coase's criticism.

Industrial structure policy is best explained by firstly describing the policy development technique involved. This amplifies the link of FDI, trade and the industrial structure described in section 6.4 above. In particular, a key aid in devising industrial structure policy is the use of input-output tables. Essentially, these are maps of transactions among sectors in the domestic economy. Because they are transactions among sectors, the tables are not comprehensive in that they do not map intra-industry exchange. However, leaving that difficulty aside, we can imagine combining input-output tables as a map of domestic transactions with trade data showing foreign transactions to give a map of all transactions, domestic and foreign.

Industrial structure policy making can be conceived most simply as a matter of laying over the map of transactions, a map of corporations (to show which transactions are brought within firms) and of other forms of private organisation (to show transactions governed by quasi-integration), so as to isolate lacunae which might be filled by policy initiatives.

To reiterate, the argument for industrial structure policy is that while FDI addresses costs of governing some effects which arise with bilateral interdependence and other forms of inter-corporate organisation help govern other difficulties, the total product can be increased by government assistance targeted to those FDI activities which create spin-off benefits that are ungoverned by private interests because they are diffuse, involving third parties. In this way, industrial structure policy is analogous to corporate growth but operates by following the effects into the local economy, beyond the limit of private organisation.

That is the simple view and it is easy to see how input-output tables plus trade data are then useful for tracing possible paths of vertical integration by FDI. But, just as a general transaction cost view of corporate growth needed extension of the argument beyond the

vertical integration paradigm, so conceiving of the industrial structure policy related to horizontal and diversified interdependence must be conceived more broadly.

We can get some indication of the potential for horizontal growth by FDI by overlaying the map of private organisations in the host nation and in its trading partners, on each single industry classifications within the input-output tables. This will identify firms and other organisations in the same line of business. The foreign firms so included might invest directly in the domestic economy.

Diversification by FDI cannot be easily traced using input-output tables because the only connection among the agents is that of external interdependencies. Nonetheless, as shown in Chapter 4, diversified corporate growth can be conceived in the same general way. Policy, like diversified corporate growth, must be guided here by knowledge of interrelatedness which does not follow transactions.

Conceiving of FDI in this way has provided insight into industrial structure policy. It deals with some of the effects which might lead to growth of private firms or other forms of private organisation but do not because the transaction costs associated with them are prohibitive. In some of these cases, targeted government assistance can help. This conception of FDI has also given a general description of the connections among FDI, trade and linkages in the industrial structure and some further clarification of it is given in Appendix 4.

As to industrial structure policy, as argued in Chapter 6, the objective is to enhance the complementarities within the local economy and therefore its tendency to self-reinforcing growth. To do so policy makers need to ask if the Japanese motor vehicle FDI is likely to create spin off effects which are significant, beneficial and local and yet diffuse and expensive to govern privately. We can review some of the evidence.

It has been suggested that the external effects associated with motor vehicle manufacturing are particularly powerful and that the motor vehicle industry is special in

this regard (Womack, et al, 1990; Yang, 1995, p 13; Sachwald, 1995b).[243] There are, for example, the external effects associated with the industry's scale, which can be followed as an exemplar (there are also technology and R & D externalities, demonstration, reputation and contagion effects, etc).

Given the strength of demand for cars, the automotive industry is big and, given its technologies, it operates with large scale establishments which are consequently able to confer significant scale economies on component suppliers and, further along, to those suppliers' other customers. The advantages of proximity mean that some of these part suppliers are likely to be sited in the same area as the car makers and will operate at a scale and with per unit costs which are advantageous because of the demands of the auto manufacturers.

This co-location is significant but, from a policy point of view, it is important that these parts suppliers and car makers are already involved in a face-to-face transaction. As Coase's discussion of Pigou's work showed, dealings over the external scale economy can be subsumed into the negotiations which would be needed even in its absence. Hence, it is likely that the parties alone can deal with the interdependency involved. Policy efforts are better placed elsewhere and the policy question is whether there is good evidence that the presence of automotive manufacturing activities controlled by Japanese FDI confer diffuse external benefits, especially by its links to third parties, especially in other industries, with whom the manufacturer has no transactional relationship.

There is some evidence that automotive FDI provided such policy relevant benefits to other industries when the Australian industry was under the control of US MNEs.[244] But

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[243]For example, it has been said that this industry introduced two major transformations of production techniques: the move to mass production in the first part of this century and, under Japanese leadership, the shift to so called lean production. Sachwald comments that Japanese automotive FDI in the European Community has benefited European automotive component makers via "qualititative spillovers".

[244]It has been argued that "(t)he technical and managerial assistance afforded by General Motors-Holden enabled the Australian suppliers to become so efficient

how might these synergies be made available? Automotive component suppliers can act as one conduit. Some of the evidence for this conduit role can be assembled by looking at the impact of the automotive industry on the regional economy of South Australia.

South Australia is one of six Australian States. Its manufacturing activities are concentrated in the capital city of Adelaide, sited 700 km from the next nearest State capital. South Australia has been one of the three most industrialised Australian States and the motor vehicle industry is well represented there with two of Australia's four passenger motor vehicle manufacturers and some 55 parts manufacturers.[245] Because of this concentration, Adelaide has the "Detroit of Australia" (Manning, 1993, p 113). Our thesis suggests that, in such circumstances, the city would develop other manufacturing industries which are linked, by transactions or by broader similarity, to automotive manufacturing. The evidence suggests that this has been the case in the linking of the automotive and white goods industries and in the role of the industry in spreading "the science that underpins the making of things" (Manning, 1993, p 116).

Firstly, the South Australian economy is over-represented in both the national motor vehicle and whitegoods industries.[246] These activities share a common set of suppliers (although the present input-output data are too aggregated to show this[247]) and there is well informed opinion that they developed in tandem in Adelaide through a common set

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that they graduated quickly from the making of simple components to a broad range of diversified parts and became proficient in producing, say, forgings <u>for use outside the vehicle industry</u>." (Carr, 1978, p 30, emphasis added)

[245]The MMAL facility was bought from Chrysler Corporation in 1980. General Motors began operations in 1931 and Chrysler in 1947, both acquiring older, locally-owned cart body builders.

[246] South Australia's Share of Selected Australian Manufacturing Activities, 1999 (%)

	motor vehicle & parts mfr	household appliances	all manufacturing
employment	26.4	17.4	9.6
value added	29.7	19.0	9.3

Sources: ABS cat nos 8221.0 and 8221.4

[247]Unfortunately, we have no useful input-output data here. Even within the 109 industry format, motor vehicles and parts production are lumped together so that

of linking industries.[248] Certainly, data from the early 1980s show that only 58% of automotive parts suppliers were more than 40% dependent on the automotive industry (Commonwealth, 1981, App 5).

Secondly, an historical review of the development of the South Australian manufacturing sector (Manning, 1993) provides many examples of local companies that, by supplying the automotive industry, achieved a "base load" of demand on which they could build capacity and expertise and which was then applied to supplying other activities, including white goods manufacturing (ibid, p 114). There are also cases of supplying firms which developed independent capabilities and diversified output after beginning by supplying the automotive sector and many cases of motor vehicle suppliers being taught and, in some case, innovating manufacturing techniques for use in automotive production but of a generic nature and with numerous applications to other industries (ibid, pp 114-6).

Thirdly, evidence of the broad structural importance of the automotive industry comes from various government reports. For example, analysis of the State's input-output structure shows that the automotive industry (including parts making) relies heavily on local sources of componentry which made up more than 25% of inputs (SA Government, 1991, pp 17-19). Motor vehicle manufacturing has also played a major role as a customer to a number of other local basic manufacturing activities, taking 10% of the State's iron and steel output and 12% of leather and plastics. It has been estimated that more than one-third of all manufacturing inputs to motor vehicle and whitegoods production are sourced from industries within the State (SA Government, 1994).

The automotive industry also provides the local demand which leads to the co-location of activities like tooling and foundry work. Again, while these activities are primarily

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it is not clear how much of the linkage is parts and how much built up cars.

[248]Mr Don Dunstan, Premier of South Australia from 1970-79 (Stutchbury, 1986, p 88).

directed at the automotive industry, it is estimated that 30-40% of their output is destined for other industries, whitegoods production in particular.[249]

In short, the evidence suggests that, as a result of diffuse external effects emanating from the automotive industry, the economy of South Australia has developed synergistic, broad capabilities and specific industrial competencies. As a result, the automotive industry has played a lynch pin role in developing the State's industrial structure. It is highly likely that the Japanese (and other) foreign investors which created these effects would be unable economically to specify, monitor and enforce contractual arrangements with all or even many of those who benefit from their presence. Hence the role for targeted assistance to them.

This reasoning provides argument for offering assistance, such as tariff protection, to motor vehicle manufacturers so as to create the beneficial effects which flow out beyond the immediate first tier of effects on parts suppliers. It is a position which contrasts strongly with that of Pigou who argued that all unpriced interdependence necessarily involves government providing subsidies to the instigator. Such a point of view would have government mimicking market outcomes and assisting motor vehicle manufacturers and taxing component suppliers when it is highly likely the two are able to negotiate over the effects which pass between them.

Coase’s policy advice would leave it to the firms directly involved and would recommend that government looks instead to the further spread of ripple effects as reasons for industrial structure policy. Pigou would not only substitute government for private negotiations unnecessarily, his conception would also have government trace the effects as they ripple out, taxing beneficiaries so as to subsidise the instigators. This, as we have also seen, would place untenable information demands on government.

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[249]It is estimated that there are 122 tooling firms and 25 foundaries in South Australia, with 70% and 60% respectively of their activity being in the automotive sector (personal correspondence with the Adelaide office of the Federation of

The transaction cost economising rationale suggests government has the simpler task of deciding, as a matter of judgement not measurement, whether the local gains exceed the assistance costs: neither identifying gainers and losers nor contracting with them and not requiring empirical proof via some grand cost-benefit analysis.

A reliance on policies which lack empirical verification is not new in this industry. There was no cost-benefit analysis of the original tariffs and quota. Moreover the most recent government inquiry into this industry (IC, 1997), while it made use of empirical modelling, did not set policy on that basis. The Commission noted that their modelling left out some factors "because the mathematics is intractable [sic]... [and because of] ... uncertainties about data and behaviour" (p N1). Policy was based on other sources of information which were "equally important" (p O 2). Of course, this fits with the view of policy development as a matter of non-empirical judgement which has emerged in this study. Certainly, the IC's modelling did not consider the indirect effects, such as those on the whitegoods industry, to which such policy importance has been attached here.[250]

This all means that, while we have a strong transaction cost rationale for assistance to the motor vehicle industry, that establishes principles only and not a method of calculation. In short, it is not possible to set the tariff precisely, even 'though the rationale for assistance is clear, except by what the IC has called "informed judgement" (p O 2).

Moreover, it might be that the tariff is not the only or the best form of assistance. In addition or as a partial substitute, government could promote the generation and spread of beneficial effects through the economy by institutional innovations which improved the negotiating environment. This alludes to are the type of transaction cost economising policies which arose in the cases of beef and coal discussed in Chapter 7.

Automotive Parts Manufacturers).

250 This is despite the MONASH modellers claiming that their general equilibrium approach provided and "economy-wide framework" (p O 1).

For example, government could promote Japanese involvement in the Australian automotive industry by developing institutional arrangements which harmonised engineering standards or created forums in which to explain and develop Australian industrial relations or industry policy such as the tariff reduction regime (Chapman, 1991, p 90). In this way government would create arrangements familiar to Japanese interests in that they would parallel aspects of private sector involvement in Japanese policy development.

Such an augmentation to Australia's motor vehicle would change the relative transaction costs of various alternative organisational arrangements, so that licensing would become relatively more attractive. In other words, institutional innovation, led by the public sector, could reduce the relative need for FDI as it increased the ease of dealing with bilateral interdependency. As argued above, this might expand the opportunity for bilateral economic activity so that it maintained or increased the amount of FDI while it reduced it relative to other arrangements.

In short, if the objective were to be the development of indigenous firms (as the reforms of the 1980s suggested) which employed the technology of psychologically distant Japanese firms, it could be assisted by institutional innovation to ease the technology transfer as well as by maintaining some tariff protection to ensure that local sites were chosen. But as argued before, it is not clear that merely having indigenous ownership of motor vehicle manufacturing would advantage Australia, especially as those firms too could use the domestic market only as a base and would need to develop strategic, marketing and investment links with other international players.

The last remaining issue to be illustrated by this case is the possibility, raised in section 6.3, that the peculiarly Japanese quality of the FDI will systematically weaken the tendency for beneficial effects to create the conditions for self-reinforcing local growth.

As previously noted Japanese parts suppliers' investments in Australia create largely special purpose organisations which then do not act as conduits to transmit external

effects outside the motor vehicle production chain. Hence, the effect on whitegoods described above will not eventuate from Japanese parts makers, even though non-Japanese suppliers of Japanese car makers will provide such a stimulus. It would appear that this is a case where the advantages of intra-Japanese trading outweigh the advantages of proximity so that Japanese parts makers do not integrate more broadly into the Australian economy.

In other words, the benefits of increased scale do not flow from Japanese motor vehicle manufacturing, through Japanese component producers to other Australian firms. Instead, the benefits are likely to be diverted off-shore to other Japanese firms with which the motor vehicle and parts manufacturers operating in Australia also deal. The difference is that Japanese parts makers do not diversify their product ranges as might be expected if the parts makers were locals. As one writer has put it (from a more radical perspective, co-location can "lead to the development of an economic structure which is not integrated at the local level" (Jenkins, 1987, p 30).

The point is that the advantages of intra-Japanese trading lead to co-location of parts makers but, somewhat ironically, weaken the spread of those advantages by severing the feedback loop with locals. We reasoned in Chapter 6 that, from the transaction cost economising perspective, this kind of effect might be the biggest danger associated with Japanese FDI. Again, the appropriate policy response is for government to address the same impediments which might underlie the FDI. In other words, to reduce the psychological distance experienced by Japanese interests operating in Australia. This will help embed Japanese affiliates more fully into the Australian economy and will add to the local beneficial spin-off effects they create.

8.5 Summary of Conclusions from the Illustrations

This final section draws together conclusions from this and the previous chapter. It looks to commonalities and comments on a number of the key propositions deduced in the preceding chapters.

The illustrations have met the minimum requirements: they have shown the relevance of the policy implications which were deduced from theory in Chapter 4 and formulated into a policy agenda in chapter 6. Interpretations both from transaction cost and imperfect competition theory have been useful and the policy implications derived from them have relevance. However, they remain illustrative investigations, not formal tests of hypotheses. The major points to come from them.

Firstly, in each instance, it has not been difficult to isolate locational advantages, natural and immutable or created and policy-dependent, which Australia has over Japan and which account for the choice of an Australian location. These advantages mean that there is an inescapable international dimension to these activities so that Japan's involvement in them cannot realistically be kept solely at home.

These instances therefore suggest that Japanese FDI has a bilateral character in that the Australian location has an absolute advantage relative to Japan.[251] If a third nation were more advantaged still, it would be the site for the FDI, not Australia.

It is an important observation because it suggests that Japanese FDI should be regarded as an international not a global phenomenon; it does not generally seek out any profitable business opportunity but, at least in the instances studied, opportunities which emerge relative to conducting the activity in Japan.

Secondly, the illustrations show that when Japanese interests invest in Australia they modify their behaviour in ways which are likely to be sub-optimal compared with maintaining peculiarly Japanese relations in Japan. FDI is not favoured. Indeed, the

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[251] The condition of absolute advantage is a subset of comparative advantage which creates the potential to benefit from trade.

contrary appears to be more true. The case studies are consistent with the view that Japanese interests invest not because of a desire to move outside of Japan but to make use of the foreign advantages even though this means maintaining relatively expensive economic relations with non-Japanese.

The illustrations also conform to other deductions made in previous chapters. They have identified examples of all three corporate strategies described in theoretical terms in chapter 4. As noted before, vertical, horizontal and diversified growth can all be explained in terms of transaction cost economising or oligopolistic strategy. Nonetheless, the relevance of these patterns of corporate growth to FDI behaviour confirms that it is apt to view FDI as fundamentally a manifestation of international corporate growth and to apply the corresponding theory.

The illustrations also emphasise the importance of Japanese business groups and other, peculiarly Japanese arrangements so that, with very few exceptions, all the Japanese investors in all three cases can be identified as belonging to one or other Japanese business group or as being insiders in the relevant Japanese production and distribution systems. Some of the unusual inter-firm relationships found in Japan are replicated in Australia, as can be seen in the role of *keiretsu* groupings in beef or the transplant of manufacturer-subcontractor relations in motor vehicles. In addition, some FDI-specific organisational forms also emerge, as in the giant joint venture to construct the Port Waratah Coal Services coal loading facility or the coal procurement organisation of the Japan Coal Development Company created by Japanese electricity producers.

Thirdly, the investigation process adopted in these illustrations of firstly identifying investors, then given or, in some cases, estimating the size of their respective FDI affiliates in Australia and comparing this to industry aggregates made clear that Japanese interests in Australia lack complete vertical integration.

Hence, although the deduction from transaction cost theory suggest that there are advantages in intra-Japanese trading, Japanese foreign direct investors do not avoid all

contracting with non-Japanese locals. Integration among Japanese firms in Australia is not complete nor can it be reasonably described as hegemonic. The fact that the integration is partial suggests also that co-location of Japanese organisation via FDI is selective. This is consistent with the sense of Japanese FDI being reluctant generally and limited in extent.

Turning now to policies related to these illustrative cases, particular stress is placed on the first element of the agenda sketched in Chapter 6, the organisational issues and institutional arrangements. In each example reasons have been found to extend or strengthen organisations and institutional arrangements which ease impediments or can enhance competition. By contrast, many of these institutions, such as the MLA, the AJBCC and Australia's industrial relations system and its tripartite policy development structures, are being questioned or have already been disbanded under the current liberal policy reform agenda.

Of those studied here, the challenge is currently most apparent in the reform of the MLA and the analysis in section 7.2 questions the move to windback and privatise its role. To reform existing institutions of this sort by simply making them private and then expecting them to do more than is done by existing private organisations such as FDI is contradictory. The public sector's role must be to act in ways different from the private sector and a public-private hybrid approach to institutional innovation is a more useful model from which to work.

The second element of the agenda from Chapter 6 concerns policies with regard to the industrial structure and car making has been identified as a powerful generator of positive spin off effects which diffuse through the industrial structure and add coherence and competitiveness to it. If, as seems to be the case, the only way to create such spin offs is via locating the motor vehicle at home and the only way to do this is by tariffs and FDI, then both may be justified.

The third element of the policy agenda is the application of anti-monopoly legislation. As previously stated, the fact that action has not been taken under Australia's Trade Practices Act against Japanese FDI should not be taken as conclusive evidence the investment is not motivated by monopoly purposes. Rather, the examples are consistent with the point made in section 6.3 that any anti-competitive behaviour must be judged not in Australia alone but in relation to activities in both source and host nations by means of an agreement with Japanese authorities regarding monitoring and compliance. The illustrations have shown that task to be complicated and difficult so that it is unlikely to be undertaken successfully by Australian authorities alone.

Chapter 9: Contributions and Conclusions of this Study

This thesis has argued that measurement problems are endemic in studying the policy implications of Japanese FDI in Australia. The research which would be needed to delineate Japanese from other FDI in Australia and Japanese FDI in Australia from Japanese FDI elsewhere would require analysis of very large amounts of comparative and longitudinal data which has not been attempted. In any case, the outcomes of that work would not carry any obvious policy implications. At the least, the work which would be needed to support apparently policy-relevant propositions such as those about the immaturity of Japanese FDI and the potential for convergence has not been done.

Measurement problems also abound in addressing policy questions directly by attempting to value the net effects of FDI. This thesis has argued that such an approach in simply not tenable: those effects are multifarious, multivalent, ungeneralisable and therefore uncertain so that no policy calculus is feasible.

These insights suggest the need for FDI policy reform in Australia where a great deal of emphasis is placed on a screening process intended to exclude instances of FDI which do not provide net national gains.

in response to the difficulties with measurement, the thesis uses the theory of FDI to generate and support some critical policy conclusions by deduction. This does not overburden the reasoning and conceptual insights which underlie modern theory, although it does require analysis and some reinterpretation of the underlying work to derive a coherent policy position agenda

In particular, the thesis has argued that, from a policy perspective, FDI theory fails in critical ways. At present it is dominated by Dunning's eclectic synthesis which, while it is an imaginative strategy for explaining the FDI decision, neuters the policy implications in the process of gaining explanatory power.

The result of questioning the synthetic basis of Dunning's work has been to develop policy insights by restating its constituents parts, theories of transaction cost and imperfect competition. This has led to a clarification and to a reinterpretation of the foundational works in FDI theory, with the precepts of transaction cost theory being more and of imperfect competition theory being less radical than they appear.

Transaction cost theory is antithetical to the notion of ubiquitous competition and it can be used to reformulate a rationale for policy from outside the theory of market failure. Transaction cost theory suggests that the emphasis currently given to competition policy in Australia and elsewhere is overdone.

Rather than it being an omnipotent force or a relevant ideal in organising economic activity, the situations in which competition is sufficient or singularly relevant emerge as special cases. Certainly, competition has a role to play but not to the exclusion of robust organisational and institutional innovation involving and in many cases led by the state. Nor are competitive processes a complete substitute for government assistance which is targeted to particular activities. The ACCC would be no substitute for a robust FDI policy development organisation.

Transaction cost theory is interpreted as operating outside the realm of competition and therefore outside the ambit of conventional theory despite that it has been incorporated into explanations of FDI as a theory of market failure and therefore as an extension of the orthodoxy in the Kuhnian process of "normal science" (Kuhn, 1968). This is a mistake. Coase has stated that incorporating his radically different view would lead to pervasive effects in orthodox theory but this has been overlooked in applying it to FDI. He has also made clear that the orthodox approach which relies on comparisons with some perfectly competitive ideal is unhelpful. This thesis restates that understanding.

Not only does this theoretical analysis provide coherent policy implications, it also gives plausible account for Japan's egregious FDI asymmetry. Transaction cost theory

explains it in terms of the economics of cohesion and solidarity as revealed in Japan's peculiar institutional innovation and business environment.

But this thesis has argued that imperfect competition theory is also useful and it too can be sensibly combined, in an additive not a synthetic manner, with transaction cost theory and/or notions of mercantilism and patriotism, to provide an augmented oligopoly view of Japanese FDI. This accounts for Japan's FDI asymmetry as a systematic attempt to exclude foreign control from the Japanese economy to keep within it the super-normal returns associated with protection and barriers to entry. These rents are then distributed by the processes of Japanese political economy, often to assist in the process of industry restructuring.

The policy implications of these theoretical deductions relate primarily to three matters: competition policy, industrial structure policy and institutional innovation and the economic environment.

These are related initiatives. A narrow focus on competition does provide a coherent view of economic organisation and it fails to incorporate the transaction cost view that significant impediments to economic activity are endemic and organisational growth, both private, public and mixes, are critical for growth and efficiency.

Moreover, Australia's competition policy fails also to incorporate fully the view that FDI has made competition international and that a supra-national focus must be adopted to understand and regulate it. National Competition Policy is an inadequate response to international direct investment. That is so even if FDI simply bilateral, between nations, as Japanese FDI appears to be and not a comprehensively global phenomenon.

However, as the illustrations show, understanding and monitoring the scope of competition and organisational change in Japan is a complex task and the detail needed cannot be gleaned from Australia alone. The ACCC needs to implement Australian policy with respect to Japanese FDI affiliates in cooperation with the FTC in Japan.

Industrial structure policy has also emerged as a critical policy issue surrounding Japanese FDI. Not only has FDI been conceived as a means by which the industrial structure of Australia and Japan intermingle and change through time but this view has also been shown to have considerable currency among business and government sector interests in Japan. These parties would likely react well to Australian policy proposals couched in terms of industrial restructuring via FDI.

Moreover, transaction cost theory provides a strong rationale for industrial structure policy in its focus on policies associated with diffuse external effects, such as are exchanged among activities geographically concentrated within the national economy. It implies policies targeted to attract Japanese FDI activities which create or can make use of diffuse external effects within the Australian economy.

The work of this thesis has also spilled over to the related issues of liberalisation of Australia's economy generally and its deregulation of foreign investment flows. Australia has developed an incongruous mix of liberalisation and intervention around FDI: it maintains screening restrictions on FDI while comprehensively liberalising other foreign investment and exchange and without offering support to indigenous firms.

This combination has been associated with very large increases in FPI inflows to the private sector which have grown both absolutely and in relation to other forms of capital inflow and now play a much larger role in financing the expanded current account deficit. Further, because Australia has not developed the integrated policies which would guide industrial restructuring by local firms and promote the technological development of indigenous firms, as Japan has done, its indigenous firms are unlikely to develop into national champions, large enough and exhibiting the suite of capacities and capabilities needed for them to play successfully the expanded role required of the private sector in a liberalised economy.

Nonetheless, the reasoning employed in this study does not suggest that this need constitute a net loss for Australia. It is not obvious that domestic firms which, like foreign firms, can buy, sell, borrow and invest anywhere, are necessarily superior. Further, while the solidarities, homogeneities and cohesion in Japan have provided additional reasons to support indigenous firms there, those conditions do not apply in Australia. Hence, Australian policy makers can be less concerned with the lack of indigenous firms and more welcoming of the organisational capabilities provided by foreign firms than in Japan.

However, there is an evident weakness in this approach in that it will leave Australia with indigenous firms that lack the size and the putative advantages which would allow them to raise foreign capital at advantageous interest and exchange rates. The likely net result of Australia's incongruous policy mix will be that its private foreign debt will continue to grow in the hands of MNE affiliates operating in Australia and of Australian financial intermediaries. This will increase the level of FDI in an unstructured way and will leave Australian banks in particular vulnerable to another round of speculative mania as was experienced in the late 1980s and early 1990s.

The question therefore arises as to whether, given their exemplary credit raising activities in the past and their historically low level of debt at present, the highly creditworthy Australian governments should make the policy changes required to undertake at least more of the borrowing themselves. Of course, such a reform is unlikely in the context of current liberalisation which favours the private sector because it is thought to be more efficient in that it is more subject to competitive forces.

Nonetheless, the transaction cost view of FDI or growth in other private sector organisations is that it is undertaken precisely because competition alone is insufficient as an organising principle. For government to then respond to FDI primarily with the liberal policies of privatisation and competition is incongruous. In short, from the transaction cost perspective on FDI, the liberal policy reforms are over-extended, perhaps, as Pusey

suggested, because those reforms come from theory which fails to acknowledge its own limits (Pusey, 1993).

The optimal Australian policy mix is probably one in which government plays again a more direct role in raising foreign capital, while it both welcomes and offers some targeted assistance to Japanese FDI and ensures it is subject to vigorous competition. The prerequisite for the Australian government to fulfil its role with respect to Japanese FDI is to develop an on-going understanding of domestic and bilateral, public and private transactions and organisations. These are the building blocks for strategic FDI policy.

The final task is to review the answers provided for the questions raised in chapter 1.

The first question was, do national governments have a role in the era of globalisation? To this the study has answered yes but adds that governments' role has changed. Firstly, in many cases, unilateral policy initiatives are less useful. This study has isolated three ways in which effective policy requires more than the efforts of a single national government: the coordination of tax arrangements, the application of anti-monopoly legislation and the complementary implementation of industrial restructuring via FDI. Go-it-alone policy is less optimal than it once was.

This suggests that the response of national governments to globalisation and, particularly, to the extension of FDI and MNCs, should be to form international bodies to create economic policy and to implement it. The bilateral nature of Japan's FDI flow suggests that Australia and Japan can usefully pursue their common economic interests surrounding FDI through bilateral bodies, at least so long as Japanese MNEs maintain their home nation character.

This study has also drawn a parallel between the geographically concentrated clustering among private interests and the geographical focus of national economic policies. It is a particularly important association for understanding industrial structure policy and has led to the proposition that government has a role in attending to immobile assets,

including both publicly funded infrastructure and those associated with the mix of activities undertaken in the economy. Essentially, government has a role in attending to the effects which spin-off from immobile assets within their boundaries.

Although it is somewhat peripheral to this study, it is also apparent that nations continue to be significant economically as currency areas, as areas of common legal and institutional arrangements and as regions of cultural focus. In all these ways too national governments continue to matter.

The second question set at the beginning was to assess the existing state of knowledge about Japanese FDI and to ask if it had policy implications which were clear and close at hand. This question is answered in the negative. Policy does not derive from official data and existing studies of Japanese FDI are sporadic, uneven and focussed primarily on explaining the phenomenon itself rather than what, if anything, should be the Australian response.

The most that can be said from these sources is that Australian policy makers should broadly welcome Japanese FDI because it is probably a more stable, more equity-rich inflow and more likely to constitute a net addition to Australia's capital stock than are other sources of foreign investment on which Australia could rely.

Even when, in response to the poor state of current knowledge, the study turns to theory to advance the understanding, we find that, from a policy point of view, it is in an eclectic muddle.

The only rational basis for policy when we have no generalisable case studies and no proven theory is to return to the fundamental views and seminal works which underlie the eclectic synthesis and to reconstruct the antithetical viewpoints, deriving relevant policies which respond to both. That has been the task of this study.

The third question was to assess whether Australia's current policy is sound. Again, the answer must be no. The work of the FIRB is based on the faulty proposition that we can value and sum the effects of FDI on a case-by-case basis. Even if there were adequate techniques to estimate what is immeasurable and to value what would have occurred otherwise, the FIRB has nothing like the resources which would be needed to specify *ex ante* and monitor *ex post* the effects of FDI so as to ensure a net national gain or, even, no net national loss.

We have also referenced views which associate liberal reforms with increased volatility in Australia's exchange rate and external accounts and with speculation. Others have questioned these reforms because they contribute to increasingly unequal distributions of Australian wealth and income (Bell, 1997, p 233; Stilwell 1993; Saunders, 1993). This study has been concerned rather with the implications of Australia's incongruous policy mix, which appears to continue to restrict FDI and relies increasingly upon private FPI inflows while providing only weak and sporadic assistance for the development of indigenous firms.

The fourth explicit question for this study was to determine whether the peculiarities of Japanese FDI and of Australia's position in relation to it implied specific policies. While opinion is divided and the evidence is inconclusive as to whether or not Japanese FDI is different, the economy from which it comes has some very distinct characteristics, especially that its net FDI position is egregiously low and the relationships among firms and between government and firms in Japan are unusual. This suggests three sets of special measures.

Firstly, the peculiar nature of Japanese economic undertakings implies policies to ensure that potentially important synergies which might be created by Japanese FDI will lead to clustering within Australia rather than to networking among Japanese interests, many of whom will not be located in Australia. Secondly, the policy referred to above of monitoring, in conjunction with Japanese authorities, the anti-competitive behaviour among Japanese interests and of coordinating a bilateral response to problems isolated in

Australia seems more needed in light of the peculiarities of Japan's economic system than might be usual in a FDI relationship. Thirdly, the particular stress Japanese views of FDI place on its role in industrial restructuring suggests that Australian policy makers could pursue matters of industrial structure policy with Japanese interests in Australia and with Japanese authorities in Tokyo.

As to the particular characteristics of the Australian situation, the task which emerges for FDI policies is not to protect an indigenous economic core, as in Japan, but to create an environment which supports the efficient conduct of economic activity, including policy development, given the presence of large amounts of FDI.

Finally, the study has developed a policy rationale that makes clear the distinction between public and private. The often unstated conundrum is to understand why, if an action is likely to create net benefits, do private interests not undertake it. The answer provided by this study's reading of transaction cost theory is that, in some cases, the costs of specifying, monitoring and enforcing the required contractual arrangements are prohibitive or, at least, reduce the uptake of such opportunities to a sub-optimal degree. In such cases, it might be appropriate for government to act, although that decision also requires the estimation that the likely costs and benefits falling within the nation (which cannot all be valued and summed) will be beneficial on balance.

In other words, the deductions have generated a clear policy rationale but have not eliminated the need for judgement, which remains endemic. Hence, the study has established policy principles but not any simple policy decision-making device. Nonetheless, it has reached an important conclusion.

Appendix 1: International and Historical Comparisons of the International Investment Position of Selected Nations.

The following Table 1.1 provides data on the current account flows and the net stock of capital account items for selected, advanced nations in various years. It shows the great variety which exists. A current account outcome can be associated with any of a wide variety of combinations of FDI, FPI and other long and short term capital movements.

Table 1.1: Current Account and Net International Investment Position of Selected Countries, 1980-97 (US$m)

	Current Account	Capital Account					Net Position
		FDI	**FPI**	**Other L/ Term**	**Short Term**	**Reserves**	
Australia							
1980	-3.2	-7.9	-0.9	-8.0	1.4	4.9	-10.5
1990	-16.1	-14.4	-25.8	-81.6	-2.1	19.3	-131.6
1997	-12.5	-49.5	-159.9	-13.3	-	17.6	-205
Canada							
1980	-0.7	-29.4	-34.5	0.3	-3.5	3.1	-64
1990	-22.6	-34.4	-134.8	-7.1	-52.6	18.6	-210.3
1997	-9.3	4.2	-249.7	-10.6	-	18	-238.1
Ger-many							
1980	-12.2	1.0	4.3	-6.1	-8.4	44.6	35.4
1990	48.1	66.0	-55.3	78.7	263.1	77.1	429.6
1995	-21.0	140.5	-252.0	256.4	206.5	84.6	436
Japan							
1980	-8.2	12.8	-16.6	35.9	-148.9	20.2	-96.6
1990	35.9	191.4	199.9	235.1	-377.0	79.7	329.1
1997	94.4	244.8	320.1	173.0	-	220.8	958.7
UK							
1980	6.0	12.7	-22.6	-0.9	-18.8	21.1	-8.5
1990	32.5	13.3	133.6	-44.7	-147.4	41.1	-4.1
1997	7.9	93.6	149	-390.9	-	37.8	-110.5
US							
1980	0.4	103.8	-80.2	56.9	-12.9	21	88.6
1990	-94.3	179.8	-621.1	105.0	-62.4	174.7	-224.0
1997	-155.4	173.2	-1472	-158.5	-	134.8	-1322

Source: IMF Balance of Payments Statistics Yearbook (various issues)

Note: After 1995 the category of short term investment ceased to be separately reported.

Within the variety there are some apparent pairings of nations with similar profiles. For example, Australia and Canada can be seen as similar on the basis of their persistent (but, in the case of Canada, not entirely consistent) current account deficits and net FDI inflow or the cases of Japan and the UK could be paired because they both show net outflows of FDI and FPI and inflows of short term capital. However, even a cursory examination makes it equally clear that these are not neat pairings.

Table 1.1 also shows spectacular growth of foreign investment. Although this is not consistent for all categories and countries, it is clear that international financial arrangements between nations have deepened greatly since 1980. This growth is especially evident for Australia and Japan but is true for all the nations selected.

In addition to growth in the international economy, the Table shows that, for some nations, the current account position has been relatively constant throughout the 1980's and 1990's.

The following Table 1.2 highlights the relation of these international capital flows to the domestic processes of saving and investment.

Table 1.2: Savings, Investment and Foreign Finance, Selected Nations, 1980, 1990, 1993 and 1999, % GDP.

	Saving	**Gross Capital Formation**	**Foreign Financing***
Australia			
1980	7.2	24.9	-2.2
1990	3.6	18.7	-5.0
1993	1.0	16.4	-3.6
1999	4.2	25.1	-5.5
Canada			
1980	11.3	23.2	-0.7
1990	4.5	20.7	-4.1
1993	0.9	18.0	-4.1
1999	7.4	19.9	5.0
Japan			
1980	18.3	32.2	-1.1
1990	19.8	32.7	1.2
1993	18.2	31.1	3.2
1998	12.9	26.7	2.8
UK			
1980	21.0	19.8	1.5
1990	16.9	20.3	-3.4
1993	14.2	16.2	-1.9

1999	16.3	17.5	-1.1
US			
1980	5.1	16.0	0.5
1990	2.2	14.6	-1.4
1993	1.9	13.9	-1.5
1999	6.0	21.1	-3.4

Source: OECD Quarterly Accounts, various issues

Notes: (a) foreign financing = Gross capital formation less savings less consumption of fixed capital.

It shows the importance of foreign sources of finance in relation to the size of the domestic economies and the rate of capital formation and is based on the relationship, intimated above, that any net change in a country's foreign investment position involves the transfer of capital (what is called foreign finance in the table) and is the result of imbalances between saving and investment at home (IMF, 1991, p 20).

As with Table 1.1, these data suggest that some characterisation of nations is possible: that there are high saving - high investing nations like Japan with low foreign capital dependence; low savings - high investing nations like Australia and Canada both with high levels of foreign financing; and other permutations. However, as before, there is no simple pattern or any obvious relationship amongst a group of advanced nations.

The following Table 1.3 provides more complete data since the early 1980s.

Table 1.3: Outflows of FDI, 1982-97, selected nations (shares of total)

	Japan	**UK**	**US**	**All nations**
				$US bn
1982-6*	0.13	0.18	0.19	57
1987-91*	0.18	0.14	0.13	195
1991	0.16	0.08	0.16	192.7
1992	0.09	0.10	0.22	195.2
1993	0.06	0.14	0.40	223.5
1994	0.07	0.13	0.29	256.0
1995	0.07	0.13	0.30	326.9
1996	0.08	0.11	0.26	312.5
1997	0.06	0.15	0.29	418.7

Source: (1) 1982-91:UNCTAD, 1995

(2) 1991- IMF Balance of Payments Yearbook.

Note: * = average annual flows

Appendix 2: The Historical Development of Japan's External Accounts and FDI

In describing the salient features in the development of Japan's FDI position we begin with an overview of her external accounts during the contemporary era as is provided by the following Table 2.1.

TABLE 2.1: Japan's External Accounts, average annual rates of change, 1950-95 (%).

	1950s	1960s	1970s	1980s	1990s
GDP	9.6	17.8	12.6	5.9	1.3
Imports	14.3	11.2	21.6	7.3	1.2
Exports	14.3	15.0	17.1	11.7	1.4
Current surplus to Imports (1)	-2.6	23.2	-3.5	27.0	49.7
FDI net outflow (2)	u.a.	16.1	29.3	31.1	3.7
FPI & Other net outflow (2)	u.a.	52.9	24.5	36.3	1.3
Short term capital inflow (2)	u.a.	16.5	14.9	9.7	-10.8

Source: (a) IMF Balance of Payments Statistics Yearbook, various issues.
(b) OECD Quarterly Accounts, various issues.

Notes: (1) Is the ratio of surpluses to imports for three years from the last of the previous decade e.g. 1950 = 1949, '50, '51.

(2) For 1980s and 1990s, is the average annual rate of change of stocks over the decade for each listed item in the capital account. For 1950s, '60s and '70s shows change in average annual flows.

(3) 1957-69 short term capital does not include transactions of government.

During the period up to c. 1960, considered in Japan to have been a period of reconstruction and regaining economic independence, the Japanese economy was constrained by its current account so that, growth was reined in by monetary policy whenever it put pressure on official reserves (Uchino, 1983).[252] However, despite concerns expressed after the announcement of the so called Income-Doubling Plan of

[252] According to one of Japan's leading bureaucrats of the time, monetary authorities used US$2bn. as a benchmark for the safe level of foreign reserves. When growth was fast and import levels pressed reserves below this level, restrictive credit conditions were used at home to slow growth. If reserves exceeded $2bn., easy money was used to speed up growth (p 171).

1960 (Uchino, 1983, pp 111-2), the current account constraint disappeared with growth. Exports easily outpaced imports and the current account moved into surplus (growing to greater than US $2 bn p.a. at the end of the 1960's).

On the capital account, long-term capital exports rose strongly, especially portfolio and other investments. FDI continued its steady growth path which had begun in the 1950's and short-term capital imports also grew during the 1960's. However, Japan's external constraint had not disappeared entirely, as was shown during the 1970s when the deficits re-appeared after each Oil Crisis (1973 and 1979). The capital account surpluses associated with these deficits were achieved by a combination of moderation in long term capital exports and sharp rises in short-term capital imports at each deterioration in the current account (Komiya et al, 1991[253]; Ozawa, 1979[254]). These responses therefore helped to smooth the variations in FDI outflows.

Nonetheless, the underlying trend in Japan's external accounts emerged increasingly strongly in the 1980's when the trade and current account surpluses became entrenched (despite the floating and subsequent appreciation of the Yen) and both long-term capital exports and short term capital imports continued to grow.

Turning now to the post war development of FDI itself, it was noted in the text that the earliest new investments were of the "D and I" kind. This emphasis is reflected in the focus of FDI in the mining industry and is one reason for the inordinate concentration of Japan's investments in less developed countries and, during the early post war FDI, in Australia and Oceania (Komiya et al, 1990, p 3). As in the pre-War period, the Japanese government was heavily involved (Ozawa, 1979, p 37). In part this was because the foreign exchange rationing undertaken at the time gave government direct leverage over FDI and partly it was because of the MITI's

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[253]The short term capital inflow was prompted by the need to cover the higher import bill, coupled with the actions of monetary authorities to shore up foreign reserves (which reduced the foreign exchange banks' ability to absorb the oil price shock). The short term borrowings off-shore were one result of the strategy for easing adjustment in Japan (Komiya et al, 1991). "With floating exchange rates, we believe that Japan could not help but rely on the flow of short term capital to finance the current account deficit that resulted from a worsening of the terms of trade. " (ibid, p 124)

[254]As Ozawa has put it: "Japan's strategy for financing her overseas investment shifted from one of dependence on her trade surplus to one of taking advantage of capital overseas" (p 18).

selective assistance to investment outflows, especially those which contributed to securing the key raw materials Japan lacked at home (Komiya et al, 1990, p3). The *sogo shosha*, specialists at dealing with foreigners, played a central role in this period, including information-gathering and procurement functions for other Japanese firms often, but not always, with a long term link to the trading company.

The general foreign exchange shortage operated in Japan up until the early 1970's and it might be thought that this would have encouraged borrowing off-shore to finance FDI and that, therefore, Japanese FDI would not have been associated with a net export of capital. However, at that time there were equally tight controls on borrowing off-shore so that Japanese firms, like the Japanese economy as a whole, borrowed only some short term funds while investing in long term assets overseas. Ozawa reports evidence which also suggests that the limited off-shore capital raising which did occur was not just a source of predominantly short term capital but also provided only a relatively minor share of that.

As stated above, FDI from Japan began in significant quantities only in the early 1970's. The floating and subsequent appreciation of the yen led to a more supportive government attitude because outward FDI was seen as one means of easing pressure on the exchange rate and the government began to provide modest, general assistance for it.[255] This shift of attitude is considered by some to have been crucial in the acceleration which followed. The first Oil Crisis of 1973 called a halt to this growth but it was only temporary. Indeed, the Crisis led to a subsequent increase in FDI as D & I investments were undertaken to diversify and increase energy supplies. In addition, the sharp rise in the price of energy gave further reason to move resource intensive industries off-shore to lower wage sites. These developments are reflected in the data at Table 2.3.1 in the text which show an increasing proportion of outward FDI going to the manufacturing sector, particularly in Asian nations. Japanese FDI also went increasingly to commerce and other tertiary industries and, concomitantly, the flow to mining and other primary sectors declined relatively.

From 1973 until the end of the decade, Japanese FDI remained relatively constant at $US 1-2 bn p.a. and was associated with the emergence of balance of payment surpluses and

[255]This was done by special loan programs, with certain generous tax exemptions at home (whereby taxable income of the investing firm could be held in a tax exempt reserve against any foreign losses) and by general encouragement (Dunning, 1990, p 210).

with large increases in Japanese wages and other costs which had been accumulating over the high growth period.

The more recent developments in Japan's external accounts are related in the main text.

Appendix 3: The Historical Development of Australia's External Accounts and FDI

Australia's long term international investment position and its relation to the rest of the economy can be gleaned from the following Table 3.1.

TABLE 3.1: LONG-TERM CHANGES IN THE AUSTRALIAN ECONOMY; 1861-1996 (% GDP, average for each decade).

	GDP growth (%) (1)	**Exports**	**Imports**	**Current Account** (2)	**Investment**
1860s	2.68	26.3	27.6	5.7	11.8
1870s	5.01	22.0	20.3	2.3	14.4
1880s	4.5	15.9	19.4	8.4	18.9
1890s	-0.9	21.9	18.0	3.3	12.1
1900s	3.47	25.1	17.9	-0.4	14.5
1910s	0.73	21.0	19.0	1.8	15.4
1920s	3.17	18.6	18.8	1.3	19.5
1930s	1.93	17.7	14.2	-0.9	13.9
1940s	3.58	18.2	14.0	-0.5	14.1
1950s	4.18	17.9	16.0	2.0	23.8
1960s	5.10	12.7	12.3	3.0	25.5
1970s	3.51	12.7	10.9	1.8	24.6
1980s	3.28	13.2	13.6	4.7	24.5
1990s	2.69	14.4	14.6	4.4	21.0

Sources: (a) 1861-1900 from Butlin (1964).
(b) 1900-1 to 1949-50 from Maddock et al (1967).
(c) 1949-50 to 1988-90 from Reserve bank of Australia(1991)
(d) 1989-90 to 1995-6 from ABS.

Notes: (1) 1860 - 1900 at current prices; 1900- at constant prices.
(2) Equals current account deficit i.e. negative figures are surpluses.

Data for the 19th century highlight the acceleration of growth, capital formation and the current account deficit during the 1870's and 1880's and the decline and constraints which followed. The public sector played an important role in these developments in building rural and urban infrastructure and in promoting and subsidising immigration (Butlin, 1964, pp 5-6). These activities relied heavily on foreign funds which British investors

provided to Australian colonial governments in large quantities in return for government-backed debentures, so called colonial consuls (Butlin, 1964).[256]

The private sector was also involved in the transfer of funds. In the early part of the colonial period, FDI by UK individuals was important. However, FDI was generally of minor significance during the last half of the 19th century, the inflow being dominated by FPI, primarily (but not only) to colonial governments.[257] As observed above, FDI (in Australia and elsewhere) is a 20th century phenomenon, while FPI is an older form (Hall, 1964; Dunning 1972, p 10).

Another point implicit in these developments has been the association of foreign investment and immigration. The links have been both direct and indirect. A direct link exists in as much as the foreign investment flow was largely the result of government borrowing and some of the funds were used specifically for subsidising immigration. In addition, government borrowing and spending established the urban infrastructure and rural social overhead capital (especially transport and communication facilities) that were needed for the reception and employment of new arrivals (Thomas, 1968).[258]

Private investment financed from overseas also had similar, stimulatory effects. Further, the inflow of foreign funds allowed higher levels of gross domestic capital formation for any given level of local saving. Faster growth could thereby occur without severe restraint on local consumption and this further encouraged immigration. In short, foreign investment in the 19th century played a central role in addressing the fundamental constraints to Australian economic development (Sheridan and Chapman, 1992, pp 28-31).

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[256]These so called colonial consuls were issued in London at yields which declined during the period, reflecting the growing adroitness of these issues and the apparent creditworthiness of the colonial governments. As Butlin has commented, the scale and sophistication of these foreign investment flows "was a remarkable achievement and, elsewhere in the (British) Empire, a matter of envy" (Butlin, 1964, p 337).

[257]FPI also flowed to private interests through foreign deposits with banks operating in Australia, debentures issued by Australian based pastoral companies, mortgages held by UK life offices and cash brought in by migrants (Butlin, 1964, pp 418-20).

[258]"(T)he impact of capital inflow must not be taken in isolation: those big inflows were always accompanied by immigration" (p 54).

As shown in Table 3.1, the experience of the first four decades of the 20th century saw continuities with the pattern of the 19th. Government maintained a significant role in importing capital and in directly developing economic infrastructure and enterprises (Sinclair, 1976, pp 170-5). The growth pattern of the 19th century, which had temporarily ended with the intervention of the Great War, was resumed in the 1920's before the severe recession in the 1930's.

The development of Australia's external accounts after the 1930's is described in the main body of the text.

The country composition of foreign investment and trade is shown in the following Table 3.2.

TABLE 3.2: Country Composition of Foreign Investment in and Trade with Australia, by Nation 1950-1999 (shares of total, %).

	1950	1960	1970	1980	1990	1999
Japan						
Exports	4.0	14.4	25.0	26.9	26.1	18.2
Imports	1.3	4.5	12.4	15.6	19.2	11.9
F I	n.a.	n.a.	8.5	9.4	18.0	7.4
US						
Exports	8.2	8.1	13.4	10.8	10.9	8.8
Imports	9.9	16.2	24.9	22.1	24.1	21.4
F I	23.5	31.7	38.0	26.0	18.1	26.4
UK						
Exports	39.4	26.4	11.8	5.0	3.5	7.8
Imports	53.1	35.7	21.8	10.2	6.5	4.7
F I	85.9	57.0	34.0	20.5	17.9	23.9

Sources: (a) 1950 and 1990 from ABS

(b) 1960, 1970 and 1980 from Reserve Bank (1991)

Notes: (1) 1960 data is based on cumulative inflow 1947-62 but is for foreign investment in companies only.

(2) 1950 data is cumulative inflow 1948-9 to 1950-51

(3) 1970 figure for Japan based on data for 1972-3.

Export destinations changed significantly. Over the period 1950-1973, the UK share declined sharply, the US increased and Japan emerged as a major destination, increasing eight-fold in relative importance. Similar changes emerge on the import side with dramatic diversions of trade away from the UK and towards the US and Japan (the latter

increased its relative importance sixteen-fold). These changes are mirrored in the foreign investment inflows. The share from the UK declined while that from the US increased. Unfortunately, data for Japan are not published before 1972-3 but at that time it was at 8.5% of the total, equivalent to that from the EC excluding the UK. All of this suggests an important link of bilateral FDI and trade which is developed below.

Table 3.3 below provides data concerning the composition and rate of return on foreign investment in Australia to which reference is made in the main text.

Table 3.3: Composition and Rates of Return on Foreign Investment (1), (2)

	1950	1960	1970	1980	1985	1990	1995	1999
FDI as % all FI	37	52	64	53	33	36	32	32
Return on Equity(%)	n.a.	n.a.	13.0	13.0	4.0	7.0	6.0	5.1
Return on borrowing (%)	n.a.	n.a.	5.0	8.0	6.0	8.0	5.0	3.1
Return on all FI (%)	9.0	13.0	11.0	10.0	5.0	7.0	6.0	4.5

Sources: (1) 1950-1990: Reserve Bank of Australia (1991)

(2) 1995: ABS

Notes: (1) Rates of return calculated according to ABS definition of investment income.

(2) Rates of return calculated for three years about the turn of each decade.

(3) Borrowing data do not include "other FDI"

(4) In 1985-6 the basis for valuing FI in Australia changed from historic cost to market price. This likely accounts in large part for the reduction in return on equity 1980-5.

Appendix 4: FDI, Trade and Linkages

This short appendix explains the relationship deduced to exist between FDI, traded goods industries and others linked to them. In short, we would expect to find FDI concentrated in those industries which are engaged in or linked to bilateral trade and we can describe such instances of FDI with reference to the cases of vertical and horizontal corporate growth and in relation to input-output tables. As discussed in the text, diversified corporate growth is much harder to illustrate in this way.

Firstly, for simple vertical growth, the link can be expressed stochastically: the greater an Australian industry's importance as a source of Japanese imports or as a destination for Japanese exports, the more likely it will be a recipient of Japanese FDI. Such industries can be isolated by combining import matrices from the input-output tables with data on the composition of bilateral trade. Secondly, horizontal growth: the greater an industry's sales in Australia and the greater that industry's representation in Japan (for which Australian imports might be a good proxy), the more likely it will be a recipient of Japanese FDI.

However, because corporate growth by vertical integration follows linkages we can reason further that simple vertical integration can be extended so that the greater an Australian industry's importance as a user of the output from or source of the inputs to an industry which is a source of Japanese imports or a destination for Japanese exports, the more likely it will be a recipient of Japanese FDI. Similarly for an Australian industry linked backward or forward to another Australian industry in which horizontal FDI has occurred or is likely.

By analogous reasoning we can follow the linkages of these activities into the Japanese economy to predict, all other things being equal, the likelihood an industry will be a source of Japanese FDI in Australia. The language gets a bit tortuous but it is clear that these will be industries in Japan which have a vertical or horizontal relation to Australian activities and other industries in Japan linked vertically, backward from or forwards to these industries.

Epilogue

This short epilogue completes the thesis by placing the conclusions briefly within a broader perspective.

Firstly, this study shows the Australian experience that high FDI infow can be made compatible with prolonged growth and, more so in the past than since the period of rapid deregulation, with explicit redistributive objectives as well. Of course, we must equivocate on the basis that we can't know whether Australia's economy might not otherwise have developed better. Nonetheless, the conclusion seems robust.

The task for Australian policy makers is to extend that happy conjunction. It requires the same innovation in policy making that gave Australia colonial consuls in the 19th century and the linked policies of tariffs, FDI, immigration and arbitrated wages in the 20th century. Developments internationally and at home suggest that Australia requires a new model and policies for Japanese FDI will play a crucial role in extending Australia's success, particularly by linking it into the process of East Asian growth.

This conclusion emerges despite that Australia suffers a relative lack of indigenous firms and organisations. While policies favouring indigenous firms might be expected to develop efficiencies of solidarity if those firms share transaction cost economising traits, as appears to be the case in Japan, a deeper understanding of the situation shows that Australia's more multinational economy should therefore choose consciously to develop further transaction cost economising institutions and processes which make a virtue of heterogeneity. Hence, that multinational firms should receive national treatment and should be actively coopted into the process of policy formation and economic development.

A second, related point alludes to issues from outside this study's ambit. Chapter 1 emphasised that we would confine the investigation to the realm of self-interested,

economic behaviour and motivations. It is quite possible that broader understandings need also to be applied to achieve optimal policies. It might be, for example, that the efficiencies of solidarity which exist among indigenous firms create beneficial economic effects through non-economic or altruistic channels. In other words, that indigenous firms might cooperate better because they have collective, patriotic or cultural goals and motivations. This study has not followed that possibility.

Another, broader possibility is that the economic behaviours favouring private firms might create non-economic gains. Some would call these "collective or public capital goods" (Breton, 1964, p p 377; et al) and would want to include them within the ambit of economic study. That has not been the approach adopted here which has been chosen with more limited aims in mind. Implicitly, this study has taken the position that to include so called psychological costs and benefits is seriously to undermine the limits to the scope of economic inquiry.

Finally, we can, in a somewhat more speculative way, place of Japanese FDI in the long term history of Australia. While it is a relatively recent phenomenon, there are obvious parallels between Japanese FDI and the inflow from the US and the UK; all are cases of foreign control over Australian assets. There are also similarities with the FPI flows of the 19th century which provided finance to support British colonial control. In an even longer perspective, European settlement itself was but one in a long series of incursions.

For many Australians that long term perspective might have special relevance to Japanese FDI for two reasons. Firstly, as then Prime Minister Mr. Keating put it, non-Aboriginal Australians have "only one foot on the ground"[259] and it is this uncertainty about belonging which, in part, makes the intrusion of Japanese control a sensitive issue.

Secondly, Japan is the only external power which has militarily challenged European settlement in Australia. Japan will remain a major, non-Western player in the region and this too colours the view of Japanese FDI activities.

All considered, there seems to be an inconsistency between the popular view that the invasion which began in 1788 was inevitable and desirable while further foreign incursion such as that represented by Japanese FDI should be resisted. Noel Butlin in his 1989 Shann Memorial Lecture entitled "The Great Australian Takeover Bid" has argued the same point and relates the following historical anecdote.

In the 1890's, when the Australian interior was still largely unmapped, explorer Giles sat at sunset around a camp in "the most charming and romantic spot" he had ever beheld, as he wrote in his diary. He was moved to reflect upon the change that exploration and European settlement would bring to the Aboriginal people who inhabited that country and he wrote:

> "Progressive improvement is undoubtedly the order of creation, and we perhaps in our turn may be ... driven from the earth by another race ... " (Butlin, 1989, p 46).

Perhaps, but Japanese FDI is not the means by which this can happen. It is a more peaceable, narrower phenomenon which addresses and/or exploits the opportunities for bilateral economic relations. This study has attempted to detail the appropriate Australian policy responses.

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[259]Speech at Writers' Week, Adelaide, March 1992.

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