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JAPANESE CAPITAL IN CENTRAL EUROPE

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Abstract

From the 1960's onward Japan's presence in Central Europe gradually increased. First foreign trade developed, then Japanese sogo shosha (general trading companies) established themselves, Japanese banks extended credits and, after the systemic changes in Central European countries of 1989, direct investments into the region showed a dramatic increase. The real importance of Japanese investments is far greater than their statistical share owing to their modernizing effect. For Japanese business, Central Europe is a strategic door to the huge markets of both the former Soviet Union and Western Europe. After recent privatization Central European countries have been seriously hoping for active Japanese participation but, due to their long decision-making processes, Japanese firms are being squeezed out by German and U.S. firms.

I. *The Process*

In this study, we will regard capital as it appears in three forms: commodities, finances and direct investments. In the literature generally only direct investments and partly finances are regarded. Nevertheless, the inclusion of commodities should not be neglected for two reasons. First, because trade flows also involve capital goods and secondly, developments in trading patterns allow for qualification of the cooperation between the partner countries.

Japan's presence in Central Europe was rather insignificant before the 1970's and confined solely to foreign trade exchange. Since then a rapid increase in trade as well as in the number of operating industrial joint ventures became realities. This development can be depicted as a continuous process consisting of the following phases:

Phase 1: 1960-1970
Foreign trade exchange carried out

Phase 2: 1970-1989
—Japanese general trading companies establish themselves in Central Europe
—Japanese banks extend credits to Central Europe
—First direct investments (mid 1980's) made

Phase 3: 1989-present
Direct investments made:
—into services
—into manufacturing

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The process described above clearly applies to the case of Hungary, where by far more direct investments are found than in other Central European countries. These other countries are currently in different stages of this process.

At present the relations between Central European countries (especially Hungary, Czechoslovakia and Poland) on the one hand, and Japan on the other, seem to have arrived at a turning point, since these countries decided to undergo rapid privatization with the help of foreign capital, followed by integration into Europe. This poses a big challenge to Japan. On the one hand, the forming of new market economies provides attractive business opportunities and a gate both to Western Europe and the CIS-markets. But, on the other hand, owing to their long and detailed decision-making process regarding investments, Japanese companies will probably miss the chance of acquiring state enterprizes to be privatized and will be squeezed out by German and Austrian companies. In other words, Japan must already now face western competition in Central European markets.

In the following we will review the different fields influenced by Japan's presence, namely foreign trade, finance, and direct investment with the conclusion devoted to opinions regarding this direct investment.

II. *Foreign Trade*

Japan concluded agreements on trade and payments with Central European countries in the early 1960's. Trade began to develop but did not exceed $10 million until the 1970's. In the early 1970's Central European countries opened to the West and wished to accelerate their development by taking foreign credits. Japan was also willing to contribute and promised to deliver a total of 145 industrial plants, of which 50 were to go to Poland and 45 to Romania. However, following the blow of the second oil shock, Poland and Romania asked for rescheduling of their debts, the Central European economies turned to stagnation, and most of the promised Japanese plants were cancelled.[1] Foreign trade was also sensitive to these changes: the trading volume of $1.5 billion in 1970 showed little increase for almost the next 20 years, when revolutionary democratization in 1989 gave new impetus to trade. Nevertheless, during this period trade underwent structural changes. Japan's trade considerably increased with Hungary and Poland, slightly increased with Czechoslovakia, and dramatically decreased with Romania (due to political instability) and Bulgaria (due to debt rescheduling).

Trade took an upswing from the late 1980's but remained still at a low volume. In 1990 Japan's total exports to the five Central European countries totalled US$888 million, with total imports amounting to $654 million. This amounted to only 0.3 percent of Japan's total foreign trade which is telling of its marginal importance. Similarly, as a foreign trade destination of Central European countries Japan ranks only between fourteenth and twentieth.

Mutual trade shows a consequent dynamic growth from the mid 1980's. Such trade is of growing importance to Central European countries because of their need to modernize production facilities and restructure. At present Japan's trade is mainly with three coun-

[1] Nihon Keizai Shimbun, July 1, 1992.

TABLE 1. JAPAN'S FOREIGN TRADE WITH CENTRAL EUROPE*

	Export		Import		Balance
	$ mill.	% of prev. year	$ mill.	% of prev. year	Exp.-Imp.
1986	634.6	—	316.2	—	318.4
1987	592.1	93.0	446.7	141.3	145.4
1988	743.3	125.5	761.6	170.5	−18.3
1989	691.1	93.0	725.6	95.3	−34.5
1990	889.2	128.7	664.8	91.6	224.4
1991	927.5	103.6	688.2	103.5	233.3

* Hungary, Czechoslovakia, Poland, Romania, Bulgaria, Yugoslavia, and Albania.

Source: Wagakuni to Too Shokoku to no Boeki Kankei (Japan's Foreign Trade with Eastern European Countries), JETRO, 15 April, 1992.

TABLE 2. JAPAN'S TRADE WITH CENTRAL EUROPEAN COUNTRIES IN 1990

(million US dollars)

	Import	%	Export	%
Bulgaria	34.8	0.01	54.0	0.02
Czechoslovakia	128.4	0.05	50.4	0.02
Hungary	146.4	0.06	142.8	0.05
Poland	184.8	0.08	308.4	0.11
Romania	98.4	0.04	81.6	0.03
Yugoslavia	61.2	0.03	250.8	0.09
Total	654.0	0.28	888.0	0.31

Source: Foreign Trade by Commodities, OECD, 1990, Vol. 4, Paris.

tries: Hungary, Czechoslovakia and Poland. They represent a 70 percent share of Japan's total trade with Central Europe.

This trading pattern reflects the difference in development levels between Central European countries and Japan. The main items (80 percent) of Japanese export to Central Europe are machines, electronics or parts for such and cars, while imports are dominated by ferrous and non-ferrous metal semiproducts, chemicals, and agricultural and food products.

The activity of Japanese general trading companies located in Central Europe also contributes to boosting trade, because in many cases they utilize a triangular trading pattern consisting of reexports from Central Europe to countries other than Japan. Therefore, these figures do not appear directly as Central European exports to Japan.

When exporting to Japan, Central European countries run across two types of trade barriers, namely those of tariff and non-tariff restrictions.

As to the tariff barriers, Japan reduced customs tariffs in several rounds beginning in 1986, resulting in tariff exemptions for 2,000 products accounting for forty percent of total imports. Seventy percent of manufactured goods belong to this category. However, there is still an average 12.1 percent tariff for agricultural products and goods with lower level of manufacturing.[2] As the exports of Central European countries fall mainly

[2] Trade Policy Review 1990, p. 175.

into this second category they are thus burdened by import taxes. For example, the average import tax on Hungarian exports to Japan was 13 percent in 1991.[3]

Non-tariff barriers, especially in the case of agricultural products, are causing more trouble because of complicated import licensing, tariff administration, and frequent changes of import quotas. Adverse factors also include informal trade-policy constraints such as administrative procedures, import regulations, and different technological and health standards.

III. *Finance*

Banking connections with Central Europe began as early as in the 1970's but did not develop significantly until the mid 1980's. By now all the Central European countries have financial relations with Japan to some degree and are using Japanese credits in financing their debts.

Of the Central European countries only Hungary has a branch office in Japan. Up to present a total of two hundred Japanese banks have contributed directly or indirectly to providing credits for Hungary. Because of these extensive connections we shall depict financial capital using the Hungarian case.

In Hungary Japanese credit involvement experienced dramatic growth between 1985 and 1988. At that time Japan's relative abundance in credit resources met with the debt policy strategy of the National Bank of Hungary, according to which a switch to long term credits was deemed to be favorable.[4] After several private placements Hungary successfully entered the samurai-bond market.

As a result of the reshuffling of Hungary's debt structure, Japan's share amounts at present to one-third of the total Hungarian debt. That is, out of the US$20 billion gross debt $7.5 billion is due to Japanese credits. This amount consists of two main parts.

1. Credits provided by institutions

   To this category belong credits provided by consortia, central financial institutions, and bilateral credits. Of the total $7.5 billion Japanese credit stock $4.7 billion is provided in this form. Initially, when Hungary began to develop financial relations with Japan, four times during the period from 1985–1986 ¥10 billion packages were initiated as private placement in this circle.

   Up to US$420 million of the 500 million credit line which was promised in 1990 by the Japanese Prime Minister has already been used. This credit is granted by the Eximbank. Even Japanese banking specialists used to refer to this credit as "unspecified," meaning for free use. In fact, however, this credit is used in cofinancing with the World Bank for structural adjustment projects. In other words, credit can be used only for projects approved jointly by the World Bank and the Japanese Eximbank. The credit is for free use still in the sense that it differs from those credits usually pro-

[3] Sass, M. (1991) Japán kereskedelempolitikája (Trade Policy in Japan), Institute for World Economics, Budapest.

[4] Dr. Gy. Surányi, President of the National Bank of Hungary on Hungarian-Japanese financial-relations, Tözsdekurir, Aug. 29, 1991.

vided by the Eximbank for the export of Japanese goods. Further credit promises were also made on the Japanese side for project financing, for example in environment protection, on the condition that Hungary should prepare a detailed study on such projects. To make use of this possibility will be however a hard task, since even in developed market economies these projects are not self-financing and a budget deficit like that of Hungary could hardly take additional repayment burdens.

2. Bonds

From 1987 onward a total of eleven series of samurai-bonds were issued by Hungary. Their present share in Japanese credits is US$2.8 billion. It is well known that the conditions of issuing such bonds are rather strict, mainly because it is necessary to obtain an appropriate qualification of the country by Japanese credit authorities. In 1987 Hungary was qualified as AA- debtor country which was a quite high level. Later it was lowered to A- which was still good. But in 1991 it was surprisingly lowered further to BBB+. This is a surprising fact considering the positive balance of payments over the last two consecutive years. For this low qualification two explanations are possible. One may be the effect of a degradation made by US authorities one year earlier, and the second is a general opinion about growing instability in Central Europe. Notwithstanding, during the last five placements bonds could in fact still be issued with more favourable (lower) interest conditions.

Hungary's credit-taking boom lasted until 1989, since then Hungary takes roughly as much credit as is needed for debt servicing. This fact can be explained mainly by three circumstances. First, Japanese banks are now waiting on developments in Central Europe. Secondly, the banks have to improve their so-called capital/adequacy ratio, which is accomplished by not increasing foreign outlay assets. Thirdly, Hungary has a positive balance of payments for the last 3 years and the debt servicing of earlier credits will culminate in 1997.

Cooperation with Japanese banks is good. While mainly helping in bonds operations, the Daiwa Bank also provided assistance outside Japan. It helped to issue Hungarian bonds through the World Bank, for example.

The proposal of the *Central European Payment Union* would give another chance for Japan to participate in European finance. The two new integration groupings following the collapse of COMECON, namely the Trilateral Cooperation System (Hungary, Czechoslovakia and Poland) and the Central European Initiative (the former Pentagonale) need a new payment system which would help them join the EC monetary system. There are several proposals as for the construction and estimations as to the base capital of such a payment union.[5] The so-called Dienstbier-proposal from 1990 envisaged a stabilization plan for Eastern Europe plus the Soviet Union and a multiclearing system, estimating the necessary aid for stabilization at $16 billion. J. Brabant also suggested a simultaneous solution involving aid and payment problems. He included a total of seven countries with the Soviet Union and calculated the starting capital at a surprisingly low level of $2.5 billion to be provided in addition to quotas contributed by member countries.[6]

[5] See for details: G. Bakos: Free Trade Zone in Central Europe, in: Proceedings of the Sixteenth European Studies Conference, University of Nebraska, 1991.

[6] Brabant, J.: Integrating Eastern Europe into the Global Economy: Convertibility through a Payments Union, 1991.

Japan's participation in helping to create the payment union would have several positive effects for both sides. Trade in the region, including the activities of Japanese investors and businesses would be supported. Japanese credits through the payment union could be used in a more harmonized way and more effectively for restructuring in Central European countries. Through the payment union Japan could gain access to the European monetary system.

IV. *Direct Investments*

As with foreign trade, Central Europe occupies a marginal place in Japan's overseas direct investments. In 1990, Japan's foreign investments totalled US$52.7 billion, of which 48% was invested in North America, 25% in Europe, 12% in Asia (Table 3). Until now the cumulated value of direct investments into Central Europe was $65 million which is 0.005% of Japan's 1990 investments into Europe. And almost all of that amount was invested in Hungary ($63 million).

According to Jetro, in September 1991 there were 39 Japanese investments in the six Central European countries (Table 4). Direct investments were concentrated in three

TABLE 3. JAPANESE FOREIGN DIRECT INVESTMENT PROJECTS IN 1990

	$ mill.	%	number of projects	%
North America	27,192	47.78	2,426	44.49
Asia	7,054	12.39	1,499	27.49
Europe	14,294	25.12	956	17.53
Oceania	4,166	7.32	572	10.49
South America	3,628	6.37	339	6.22
Middle East	27	0.05	1	0.02
Africa	551	0.97	70	1.28
Total	59,912	100.00	5,453	100.00

Source: Zaiseikinyu Tokei Geppo (Financial Report), Japanese Ministry of Finance, 1991.

TABLE 4. JAPANESE DIRECT INVESTMENT PROJECTS IN CENTRAL EUROPE AS OF SEPTEMBER 1991
(number of projects per sector)

	manufacturing	finance	service	total
Bulgaria	1	0	3	4
Czechoslovakia	0	0	1	1
Hungary	5	4	7	16
Poland	0	0	8	8
Romania	0	0	7	7
Yugoslavia	2	0	1	3
Total	8	4	27	39

Source: Jetro[7]

[7] JETRO Too nyuzureta (Eastern Europe Newsletter) December, 1991.

countries: Hungary with 16 cases, Poland with 8, and Romania with 7 cases. The sectoral breakdown shows that investors favored services and manufacturing. Considering the volume of invested capital (Table 5), however, manufacturing ranks first and finance second. The high investment for manufacturing is mostly due to Hungary, where the Suzuki car-project is responsible for the lion's share. In the service sector most investments were made to establish sales and after service of Japanese products like cars and electronic goods.

In terms of timing, most of the investments in Hungary, Czechoslovakia and Poland were activated after 1990, which was due to the more favorable conditions for foreign investments in these countries (Table 6).

Prior to systemic changes, these countries liberalized legislation favoring foreign investments (see Table 7).[8] The main results of this legislation are: foreign capital share can reach 100 percent, joint ventures enjoy a tax exemption, profit transfer is free even if the national currency is formally not convertible, and imports to the joint venture are customs free. Therefore, foreign investments or joint ventures are in a more favorable position than domestic enterprizes. This legislation opened the way to later privatization with foreign capital.

Central European countries are now carrying out the privatization of state owned enterprizes, in which they hope for the participation of western capital. Japanese direct investments are welcomed mainly for two reasons. One of which is that they bring high technology and effective work organization methods. Secondly, because Japan's participation will help to diversify foreign investors and avoid too strong of a dependency on

TABLE 5. JAPANESE DIRECT INVESTMENT IN CENTRAL EUROPE AS OF SEPTEMBER 1991

($ 100 US)

	manufacturing	finance	service	total
Bulgaria	n.a.	0	n.a.	n.a.
Czechoslovakia	0	0	3	3
Hungary	45,950	15,620	1,674	63,244
Poland	0	0	1,444	1,444
Romania	0	0	162	162
Yugoslavia	n.a.	0	0	n.a.
Total	45,950	15,620	3,283	64,853

Source: ibid.

TABLE 6. NUMBER OF NEWLY ESTABLISHED JAPANESE DIRECT INVESTMENT PROJECTS BY YEAR

	1986	1987	1988	1989	1990	1991	Total
Czechoslovakia						1	1
Hungary	2	2	1		8	3	16
Poland				1	4	3	8
Total	2	2	1	1	12	7	25

Source: ibid.

[8] Inotai, A. (1991) Foreign Direct Investments in Reforming CMEA Countries: Facts, Lessons and Perspectives, in: Multinationals in the New Europe and Global Trade, Ed. Klein, M.W. and Welfens, P.J., Springer, Washington.

TABLE 7. FOREIGN INVESTMENT LEGISLATION IN EASTERN CENTRAL EUROPE

	Czechoslovakia	Hungary	Poland	Bulgaria	Romania
Legislation: first	1985	1972	1976	1980	1972
effective	1990	1988	1988	1989	1990
Foreign participation (%)	100	100	100	no limit	100
Corporate tax rate (%)	40	40	40	30–50	30
Tax exempt period in priorized areas (years)	2	5–10	3–6	5[1]	no
Tax reduction in priorized areas (in percent of effective tax rates)	—	40–60	—	—	—
Tax on dividends	25	no	30	10–15	10
Repatriation of profit only after profits in hard currency;	yes	no	no	yes	no
other profits (conversion share)	—	free	15%	—	8%
Customs free imports to venture	yes	yes	yes[2]	yes	yes
Approval: number of institutions[3]	several	2	1	several	several
feasibility study	no	no	yes	no	yes
required	yes	—	yes	—	yes
—only if foreign equity is higher than (%)	—	50%	—	49%	—

Notes: [1] Only for high-tech activities established in customs—free areas.
[2] In the first three years.
[3] Including consulting firms (if approval is provided by one ministry or agency).
Source: Inotai, A. (1991), p. 151.

TABLE 8. JOINT VENTURES IN HUNGARY

	Number of new foundations	Foreign investment ($ millions)	Japanese direct investment
1972–88	250	250	......
1989	1,000	300	......
1990	4,000	900	......
1991	5,600	1,600	......
Total	10,850	3,550	80

Source: Annual Report, National Bank of Hungary, 1991.

TABLE 9. DIRECT FOREIGN INVESTMENTS BY SOUTH KOREA, 1991

	Number of projects	US$ millions
Hungary	5	74.4
Czechoslovakia	1	10.8
Poland	3	0.7
Romania	1	0.5
Total	10	86.4

Source: Figyelö, 1992, 14.

capital imports from certain countries, whereby mainly the German dominance is meant. However, as we shall see from the following opinions, these expectations usually do not match with traditional Japanese business mind-set, which is characterized by long decision-making process. Thus, even if in the last two years the number of new foundations rapidly grew, Japan's share in the total foreign investments remained very low. For example, in Hungary, the country with the most Japanese direct investment, US$ 63 million was invested, a mere 3% of total foreign investment in Hungary for the period 1972–1988 (Table 8). Even if the most active years 1989–1991 are taken as base, Japan's share remains similarly low at 4.7%.

Even if Japanese direct investments increased dramatically in recent years, Japan cannot be satisfied since another Asian giant, South Korea, became its rival in Central Europe as table 9 indicates.

The data indicate that South Korean direct investments at present exceed those of Japan.

V. *Excursion: the Magyar Suzuki Project*

In Central Europe the Suzuki project is the largest direct investment. Hence, it will be useful to investigate it in more detail. The Magyar Suzuki project was preceded by long negotiations and preparations, but the joint venture began operation according to schedule, on October 1, 1992.

The Market

Although the potential Hungarian automobile market may seem small because Hungary's population is only 10 million, it is really quite substantial as a result of the need for a quick renewal of Hungary's aged car stock. The average age of Hungarian cars is roughly 10 years. Roughly 1 million of Hungary's 3 million cars ought to be immediately replaced, because they are more than 10 years old or have a high-polluting 2-stroke engine. About 40 percent of all Hungarian cars, including the Trabant and Wartburg, made in the former GDR, have a 2-stroke engine.[9]

Hungary's high demand for automobiles is also demonstrated by import data. In 1989, car imports totalled 204,345 of which 136,280 (67 percent) were imported by state car trading companies and 68,065 (33 percent) were imported by private individuals. In 1989, imports by private individuals were particularly high as a result of the temporarily low import duty of only 10 percent. However, even in 1990, when the import duty rose to 35 percent, 30 thousand cars were imported by tourists.

According to latest estimations, there is a market in Hungary for 120 to 140 thousand cars yearly. Suzuki's management is considering boosting production to 50 thousand cars by 1995, of which half could be sold in Hungary and half in Western Europe.

The world marketing strategy of Suzuki is to establish regional manufacturing and

[9] Kapitány, Zs. - Kállay, L.: The East European Motor Industry: Latest Developments, Economic Intelligence Unit (EIU), International Motor Business, 1990, No. 3.

marketing centers for its various products. Three categories of car are in play. The mini car Maruti is produced in India. The subcompact category Swift and the bigger sedan version will be made in Hungary. The third type, an off-road vehicle, is the product of the Santana factory in Spain.

The Basic Agreement and Capital Sharing

The agreement was negotiated for almost ten years before finally signed in 1990.

The basic agreement with Suzuki specifies that the five-door model of the Suzuki Swift, with either a 1.0 and 1.3 liter engine, will be produced starting in 1992. An output of 15,000 is planned for 1992, with production reaching 50,000 by 1995 and eventually reaching a maximum of 100,000 per year thereafter.

The Magyar Suzuki joint venture was founded in April 1991 with shares broken down as follows:

Total project value: $70 million		
Japanese share:		51%
of which		
Suzuki	40%	
C. Itoh	11%	
Hungarian share:		40%
International Finance Corporation		9%

In the figures Suzuki's share is somewhat overrepresented because in reality 20 percent of its share is contributed in the form of foregone license fees.

The total value of the investment is, however, $240 million. The additional $170 million is financed through credits with international financial market interest rates. For example, a significant part of the production machinery is imported from Japan, for which the Japan Eximbank extended a credit. The Eximbank demanded a guarantee from the National Bank of Hungary. The National Bank provided this guarantee, but as the whole transaction will later be transferred to commercial banks, the National Bank charged the guarantee fee to Magyar Suzuki as if it had already paid to a commercial bank. Further, the IFC holds a mortgage on the site and the buildings.[10]

The Hungarian government has decided to promote the joint venture by granting a series of preferences to participants. In the Suzuki project, land upon which the car factory is constructed was sold to the joint venture at a price considerably below its market value. The joint venture will also enjoy a full exemption from income tax during the first five years, after which a preferential reduced taxation rate will be applied. As for import taxes, the agreement envisaged an exemption for imported machines, equipment and parts to be used on cars for export, while parts used on cars to be sold domestically, would be subject to an import tax of only 5 percent. Later this was reduced to 3 percent, and at present there is no import tax since a zero tax import car parts quota was granted jointly to Suzuki and General Motors (the total value of the quota is 10 billion Forint).

As the joint venture approached completion, the government's support was felt less. Mr.

[10] Not so Swift, Tözsdekurır, Aug. 29, 1991.

Shinohara, general-director of Magyar Suzuki, claims that in the beginning the Hungarian government promised financial support to the car industry but that subcontractors are now suffering from a shortage of capital. Also, full-fledged import liberalization left the developing car industry without any protective umbrella. Therefore, a consequent industry-policy would ne becessary.[11] On the other hand it must be mentioned that Suzuki tried to involve Hungarian authorities as much as possible by requesting that they take over additional (external) costs associated with the plant. One example is the infrastructure, where Suzuki wanted the Hungarian side to build a special service road to the site. Or, in another case, Suzuki found the local environmental norms too severe and bargained a compromise, which resulted in reducing the costs of environmental protection.

Economic Benefits

The Suzuki project requires wide *cooperation with the Hungarian supply industry.* While Suzuki will provide the important engine and gear-box components, within the first year of operation 50 percent of all work on the project—20 percent in assembly and 30 percent in parts supply—will be contributed by Hungary. In future years the Hungarian share should rise to 70 percent. As can be seen from the following draft of the value composition, the Hungarian share consists of two parts, that of the base assembly factory (Magyar Suzuki, Esztergom) and that of other subcontractors. According to the draft, the share of the base plant is not going to increase, therefore involving more subcontractors will become a crucial issue when increasing the total Hungarian share.

Originally about 50 Hungarian companies were targeted as subcontractors. During the project's realization Suzuki had to face mainly two problems when trying to involve subcontractors. One was that the ambitious program of privatizing state companies was started which, generally made the legal status of enterprizes unsure. The second was that the government struggled with an aggravating budget deficit and thus was unable to give financial support needed for restructuring. Potential subcontractors need an investment in the range of Ft 15 to 100 million ($180 thousand to 1.2 million) for restructuring and modernizing in order to supply Suzuki parts of the quality required. At present Suzuki could contract only slightly over 20 subcontractors. According to a tender survey 130 companies would be able to supply parts provided they can obtain a restructuring injection. The possibility of how Japanese bank credits could be made available for this purpose is

TABLE 10. SUBCONTRACTING AS VALUE COMPOSITION OF THE CAR (%)

	1992	1993	1994
Suzuki Japan (imports)	70	60	40
Hungarian share consisting of	30	40	60
Magyar Suzuki (Esztergom)	20	20	20
Other subcontractors	10	20	40
Total	100	100	100

Source: Ministry of Industry, Budapest.

[11] Shinohara úr nem panaszkodik (Mr. Shinohara does not complain), Népszabadság, Aug. 4, 1992.

now under investigation. It is in the interests of Suzuki to increase the Hungarian share to over 50 percent as soon as possible, because in this case the joint-venture-made car can be qualified as of Hungarian origin and be exported to the EC, thus surmounting the EC's car import quota imposed on Japanese-made cars.

Some subcontracting deals have been already finalized. For example, the Precision Instrument Factory of Eger and Showa of Japan signed a license agreement to manufacture shock-absorbers. The Hungarian firm has bought the necessary license and expertise and began production in June 1992. Bakony Works of Veszprem has also formed a joint venture with Suzuki to buy the license for windscreen wipers and wiper motors. The Sumitomo Wiring System signed a technical cooperation agreement with the IMAG-factory of the Ikarus bus factory. The Japanese partner provides the manufacturing technology and helps to train the workforce. IMAG has several contracts with Magyar Suzuki for supplying wire harnesses and seat frames.

However, the present state of affairs in subcontracting cannot be qualified as satisfactory. There are two reasons for this, which come mainly from Suzuki's approach. One is the inflexibleness of the cooperation of Suzuki with the Hungarian government, the other is the lot size problem. In the following we will go into more detail.

First, as for the inflexibleness, Suzuki never disclosed its feasibility study to Hungarian governmental organizations. There was a general study made regarding the possibility of an assembly plant in Esztergom, but it lacked main indicators such as development of output, profitability, etc. No estimations were drawn up for the subcontracting background. Suzuki never turned to Hungarian officials to consult on these issues; only recently did it present a rough calculation on investment needs in order to upgrade subcontractors. According to information from the Ministry of Industry, in order to reach a subcontracting share of 20 percent of the car's total value in 1993, a total of 25 subcontractors that had been suppliers for the IKARUS bus factory would need a total of a Ft 2.8 billion ($35 million) capital injection. Of this, Ft 1.8 billion would be in credits. In order to help, a special credit construction has been arranged with a 15 percent interest rate, which is only half of the usual rate. The Industrial Development Bank (Budapest) informed all 25 subcontractors about the credit line, out of which 12 sent in their application, of which 4 remained after screening, the rest not being able to prove credibility. These latter subcontractors could either be upgraded by Suzuki through Japanese bank credits or by joint ventures with other Japanese companies. The joint venture solution would also be a good opportunity since a new joint venture can get the so-called job creating credit amounting to a maximum of Ft 100 million. (Likewise, when Ford's subcontractor came to Hungary in 1992, it also used this joint venture and could immediately enjoy this Ft 100 million credit line.) Therefore, efforts would be needed on Suzuki's side to attract other Japanese companies to boost subcontracting in Hungary.

Secondly, the lot size problem was obvious from the beginning though, but became prominent again in the subcontracting. That is, the maximum output volume pegged at 50,000 cars yearly is in fact much lower than the generally accepted optimal level of over 100,000 cars. Suzuki says, anyway, that the minimum is 10,000 cars for the assembly plant in Esztergom below which production would be unprofitable.[12] There are already several

[12] Inter-Japán Magazin, 1992, No. 1.

new parts manufacturers in Hungary supplying mirrors, plastic parts, wires, etc. to West European car makers. As they are supplying in large enough lots to be profitable, Suzuki's low volume orders would be disadvantageous. Further, in the case of Western European carmaking, the maker usually helps the subcontractor by providing the initial equipment freely, a practice which could likewise be adopted by Suzuki.

Magyar Suzuki will inevitably contribute to *employment and labor skill.*[13] The Suzuki factory in Esztergom employs 1,200, almost all of which are inexperienced. Quite interestingly, Suzuki assembled a totally new labor force, even though in Hungary there was already a skilled labor force in bus production and related factories. Nevertheless Suzuki took the harder way by bringing Hungarians to Japan for training. (This was also the case in the U.S. where Japanese auto manufacturers such as Honda and Toyota hired totally inexperienced workers at their facilities in Ohio and Kentucky, even though many GM employees etc. were available. This was usually theorized as a move by the Japanese companies to avoid having to retrain workers, who may have poor work habits, etc., or may not do things "their" way. Also, average age was lower, thus they needed lower salaries for more energy (productivity) and later pensions.) Both managers and workers were trained in Japan for several months, about half of the starting staff receiving training. The other half was trained on the job in Hungary. Trainees had to sign a contract with Suzuki obliging themselves to repay the training costs if they quit within 2 years. Experience showed that only a modest number of 15 trainees left complaining of working conditions. It is interesting to compare employee benefits at Suzuki and Hungarian Opel. Managers at Opel, both foreign and Hungarian, are provided with an Opel car at their disposal, while at Suzuki only the Japanese managers have such a car. Through subcontracting, Suzuki will generate an additional 17 to 18 thousand jobs in other companies. In the subcontractor companies, Suzuki will help to install new machines and to introduce effective work methods which increase the labor skill and productivity.

As far as *marketing* is concerned, the Suzuki agreement leaves most of the marketing responsibility with the Hungarian partners. Although the joint venture company is given the exclusive right to sell the assembled cars and parts on European markets, Suzuki is required only to advise the venture and promote sales through its marketing network. No specific obligations are imposed on Suzuki. Furthermore, although Suzuki is required to recommend the parts made in Hungary to Western buyers, it is under no obligation to sell the joint venture's products on Western markets.[14] After initial production increases,

TABLE 11. PRODUCTION AND SALES

(number of cars)

	1992	1993	1994	1995
Production	740	22,300	42,300	50,000
Sales: in Hungary	740	20,300	24,300	26,000
Exports	—	2,000	18,000	24,000

Source: Ministry of Industry, Budapest.

[13] Sato, T.: Trading with the USSR and Eastern Europe, Tokyo Business Today, June, 1990.
[14] Figyelö, 1987, No. 48.

however, it seems probable that Suzuki will target both Eastern and Western markets, helping increase sales through its West-European network.

According to the project-draft, during the first two years the marketing will target Hungarian consumers and only starting in 1994, when production substantially increases, will exports be activized, reaching nearly 50 percent of total production by 1995.

As for Eastern export markets, negotiations are underway to set up a sales office in Moscow.

A further problem is linked with *payments*. The Hungarian currency, the Forint, is at present still not convertible formally, although the access to convertible currency through commercial banks has been considerably eased. Therefore, the project's balance of payments must be also considered, since the imported parts and equipment must be paid for in hard currency. Some Japanese experts believe that the Suzuki joint venture will require an excess of Hungarian imports over exports during the next ten years. Other experts believe however that Hungarian exports may exceed imports as early as the third or fourth year of production, provided output of the joint venture reaches 20 thousand cars and Hungarian contribution to the project is not less than 60 percent.[15] Possible payment problems will prompt Suzuki to increase car sales to Western markets. In addition, Suzuki is considering engaging in counterbalancing trade, that is to develop exports from Hungary like wine, chicken and other foodstuffs, some of which would be exported to Japan, while others would be to third countries.

Finally, *competition* should be mentioned. Since the initial years when the Suzuki project was drawn up, market conditions have changed considerably. On the one hand, another joint venture car factory opened production in 1992, while on the other several Western car makers began operating sales outlets.

The other joint venture car factory is that of General Motors for production of Opel cars and engines. This contract was signed at the same time as the one with Suzuki.[16] General Motors invested DM 80 million into an assembly factory and DM 440 million into an engine factory. Yearly 15,000 cars will be assembled and 200,000 engines manufactured (the maximum capacity is targeted at 400,000 engines). The cars will be sold partly in Hungary, partly in Western Europe, while most of the manufactured engines will be exported to other Opel plants in Western Europe for use in assembly. The Hungarian supply-share is 15 percent. After a 3-month experimental run the joint venture started production in July 1992.[17] Furthermore, the U.S. manufacturer Ford is also present on the Hungarian market with its car-part factory opened in April 1992.

In addition, in the past two to three years several Western car makers opened up sales agents points in Hungary, selling 1,000 to 2,000 cars each annually. Some of them provide consumer credit facilities to attract new customers.

Still, the Hungarian car market is not yet saturated. For example, at present consumers wishing to buy a Maruti (a small category Suzuki car made in India) or other imported Suzuki models, have to wait two to three months.

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[15] Figyelö, 1990, No. 21.

[16] Bakos, G.: Japanese Capital in Hungary: the Case of Automotive Industry, in: In Search of a new Relationship between Japan and Europe, JAES, Tokyo, 1991.

[17] Az Opel motorja (Opel's engine), Figyelö, July 23, 1992.

VI. *Opinions*

In 1991, Jetro conducted interviews with ten Japanese firms and joint ventures in Hungary, Czechoslovakia and Poland, asking them of their experiences on Central European markets (source: see note 7). In the following we shall first review the reasons for directing investments into Central Europe, and then the main problems.

1. Reasons for investing

—Geographically the area is advantageous. Through establishing a business center or joint venture it is easy to cover the whole European market as well as the CIS-markets. The Central European companies have developed long-standing connections over several decades with other Eastern markets and the Soviet market, therefore, their local experience will help the market expansion of Japanese firms. In this sense Central Europe is the best gate to the Soviet market.

—Rapid changes in Central Europe favor a Japanese foothold. In these countries the old command-type system of distribution has collapsed, and now is the right time to set up a new sales network. New business chances are recognized also by West-European and US firms which are already actively penetrating. Thus it is now the best time for Japanese companies to establish themselves here before it is too late.

—Advantages of market and production factors. Japanese companies agree that Eastern markets are less competitive than those of Western countries. In some cases, the local partner companies had a unique advanced technology. In general, the technical knowledge and skill of engineers is as high as in developed Western countries, while relative wages are lower. In scientific research the level of human networking is even higher than that of Western countries.

Companies have some different opinions regarding Central Europe, mainly depending on the time of their appearance in the region. Newcomers in the financial and service sectors are positive about future perspectives. They reportedly invested because economic reforms provided new business chances. However, some companies in the manufacturing sector which went to Central Europe in the mid 1980's are not so positive about recent changes. This is because they began production in the old economic system and now, under the new conditions, they are suffering from a considerable decrease in demand for their products. These companies have begun to shift their sales from domestic market to the Western markets.

2. Main problems

a) Forming new legislation

—In Central European countries the new system's legislation is being formed. The regulations on foreign direct investment are not settled completely and are not free of contradictions. Changes in the regulations are causing instability.

—It is difficult to find out which part of the administration is responsible for certain problems. Sometimes officials of the same department decline documents which they earlier accepted.

b) Negotiations with governmental officials

—Personal connections with influential officials are important because the usual western business rules are not yet developed.

—It is always necessary to obtain permission from officials, most of whom are bureaucratic. Negotiations are timeconsuming.

c) Infrastructure

—Although the basic infrastructure (supply of water, gas, and electricity) is adequate, the telecommunications system is outdated, making telephone and fax connections rather difficult. It is necessary to bring all the important equipment from the West.

—It is difficult to find space for offices or warehouses. Real estate prices are steeply increasing.

—Production infrastructure, consisting of the network of local suppliers of necessary parts, is also a problem due to low quality levels.

d) Labor force

—Although the level of education of employees and the technical level and skill of engineers is high, it is difficult to find specialists with a good command of English or managers with market experience.

—Japanese-style labor management is not appropriate because of the cultural differences. It is also difficult to induce cost-oriented behavior in employees.

—Labor laws and regulations inherited from state-owned enterprizes essentially remain in place and are more labor protective than in Western countries. As a consequence, seniority must be taken into account when determining salary, and further, the national government strictly controls working environment conditions.

e) Others

—Information in English is scarce.

—Sudden fluctuations of the exchange rate and changes in the tax system pose difficulties.

—Transfer of money requires more time than in Western countries.

Mr. K. Fujii, Business Planning Department Chief of the Japan Institute for Overseas Investment, characterizes the problems slightly differently in connection with the Hungarian experiences.[18] He collects the opinions into two groups, Hungarian expectations toward Japanese investors and necessary conditions as seen by Japanese investors.

1. Expectations towards Japanese investment

a) Japanese investment is expected not only to alleviate the debt burden, but also to bring technology and know-how, and to contribute to the modernization and restructuring of Hungarian industry. As a result, import substitution should proceed and exports should increase. Export expectations are supported by the geographic rationale that Central Europe is soon joining the EC and EFTA, which will make Hungary the gate to these huge markets as well as the former Soviet Union.

b) Education and engineers' knowledge is of a high level while wages are lower than in Western Europe, a combination which should be attractive to Japanese investors.

c) Because of historically good social and economic relations with Austria and Germany,

[18] Hangari muke kaigai toshi ni tsuite (On investments directed to Hungary), Newsletter—Hangari, Tokyo, 1992, Nos. 3–4.

foreign investment is flowing in from these countries. Such being the case, now is the perfect time for Japanese investment, for later the possibilities will not be so open. For Hungary, as a recepient country, it is desirable to have investors from several foreign countries rather than to rely on one country. Japan's participation would be in line with this reasoning.

d) Hungary is now carrying out the privatization of state owned enterprizes and would like to see Japan buying up Hungarian companies. Traditionally, Japanese companies make an investment decision only after they have thoroughly investigated the partner and are convinced of its reliability. The mutual exchange of information and learning takes time. "Thus, to invite Japanese investors it will not suffice just to complete a list of enterprizes for sale."—Mr. Fujii adds.

2. Conditions necessary for Japanese investors

a) Even if in Hungary there is a deetatization, which is necessary to develop a market economy, still some governmental organizations should bear the responsibility of safeguarding capital investment. Also, a strategic policy is needed towards foreign investments concerning import regulations, exports, and taxation.

b) The COCOM restrictions have finally been lifted, so high technology export is now possible. Still, it is not enough for a technology to be advanced, it must also be the one best adaptable to Hungarian companies after which training is needed to prepare for the next step.

c) The decision-making style of US and Western European companies clearly differs from that of Japanese companies. US and Western European companies have a rapid decision-making process regarding investments, but problems occur later during the realization. In the case of Japanese companies, decision-making is slow but afterwards there is no delay in the realization. Therefore, Japanese investors need more time.

d) After production starts in a Japanese company or joint venture located in Hungary, the product's export competitiveness is not sufficient on Western markets. In this case the Japanese mother company should give up a part of its EC-market share and help the Hungarian company.

e) Japanese companies initially thought that operating in Hungary would be highly risky because local part-suppliers would need additional investment to catch up in terms of quality. Now they feel this risk to a lesser degree because they can cooperate with West-European-Hungarian joint ventures in local supplies.

According to an opinion from the Research Institute of MITI, Japanese business traditionally focused on Asian countries and US markets. For Japanese businessmen therefore Central European countries seem to be a fairly remote area where business environment and human relations are different from the familiar Asian domain. In regard to the gate-role of Central Europe to the all-European market, Spain and Portugal are more attractive because of their relatively higher stability. A considerable problem is the lack of information on Central European countries, their development and business opportunities.

Finally, let us reiterate some observations gained by the Office of the Commercial Counsellor of Hungary in Tokyo. These can be rendered into two groups, those of the expectations and the business behavior.

1. Expectations

a) Comparing Hungary to Japan, Japanese businessmen are used to the relative stability in Japan and when they go to Hungary, their impression is that changes there are favorable though, but also very rapid, therefore they consider the situation unstable. Probably this was the reason why leading Japanese dailies misinterpreted the latest regulation on joint ventures located in Hungary. Last year the joint ventures were requested to re-register before December 1991. This was interpreted in Japan as if tax allowances had been abolished in Hungary. But the fact remains that the re-registered company can still enjoy tax allowance even for as many as ten years.

b) Japanese businessmen still think that some governmental institution should provide business guarantees as was the case under the former centralized system.

2. Business behavior

a) Hungarian businessmen, in the hopes of establishing contacts with Japanese companies, come directly to the Japanese company's headquarters in Japan. There they are somewhat disappointed to experience a rather cool response from the Japanese side. This is, however, due to the fact that the Japanese company's local offices in Western Europe have been entrusted to develop contacts with Central Europe. Therefore, Hungarian businessmen should keep this in mind, first approaching indirectly through these branch offices the Japanese company instead of coming directly to Japan.

b) Decision making in Europe is quick, in Japan, slow. Before reaching a decision on investment, Japanese companies ask a research institute to prepare a study on the foreign country's development and its financial system. Following a feasibility study on the project, they visit the partner company several times, establish contacts with its specialists, and only after a thorough investigation do they decide. This preparation takes several years, usually from 5 to 6 years. Changes in contact persons on the Hungarian side during this time have a negative effect on Japanese businessmen. The long decision-making time also means that Japanese companies are hardly able to buy up within one year a Hungarian enterprize, which would be desirable during the present privatization. Further, the long decision-making time is often interpreted by the Hungarian side as hesitation, and as a result the Hungarian company turns to Austrian and German firms. Experience also indicates that Japanese investors refrain to buy up already pre-existing companies especially, if there are no reliable financial records about its past performance. Rather, they prefer to establish a new company. This may be a further reason why Japanese companies might not meet the Hungarian expectations in privatizing state companies. The Suzuki joint venture strengthens this impression because the Japanese company established a new factory in spite of the fact that in Hungary two big automotive companies (buses and trucks) existed, and Suzuki began to recruit and train a labor force, instead of inviting workers with experience from existing companies.

c) Hungarian companies are slow at operative contacts, they do not respond quickly, the telephone and fax contacts are not reliable. Also, company information in foreign languages is scarce. Quite a new problem is that many new small Hungarian companies appear in Japan without a banking background, which further weakens the confidence of the Japanese company regarding Hungarian firms.

VII. *Conclusions*

Mutual advantages

Further development of direct investment is to the benefit of both Central European countries and Japan. In Central European countries these investments can substantially help privatization and restructuring. Trade and direct investments are of a relatively modest volume, though their real economic importance is far greater than their statistical share. As we can see in the case of the Magyar Suzuki project, direct investment helps through subcontracting to increase employment, modernization and labor skill beyond the mere value of the investment itself. The same applies to Japan but rather in the sense of trade strategy: Japan can gain a foothold in a region with a population of 120 million plus gain access to the former Soviet Union's market with 270 million people. Also, after the three core countries (Hungary, Czechoslovakia, Poland) join the EC, Japanese firms located in these countries will automatically enter the EC. For Japan, Central Europe is a gate to the huge markets of Western Europe and the CIS. Therefore, it is in the interest of both sides to make further efforts.

Expectations and realities

Japanese business is rather sensitive to political change or instability. The vague economic policy and industrial strategy of the new governments in Central Europe are not bolstering confidence, either. But, even together with the initial maladies of the new systems, the development aims at a democratic, market-based economy.

By Central European countries there is an expectation of greater participation by Japan in privatization and modernization. While decision-making in Japanese companies is quite long, Central European companies and governmental agencies should provide more information. Probably these differences will result in a certain compromise, as the Central European governments increasingly realize that privatization cannot be carried out within a few years. On the other hand, increasing stability in these countries will attract more confidence and capital from Japan.

In the privatization process and while exploring new business opportunities, Japan must be aware of strong competition from Western European and US firms. In addition, managerial skill and governmental policies are important concerning direct investments. An interesting analysis of the Daihatsu project which failed against Fiat in Poland, pointed out that as compared with Fiat, Daihatsu did not have enough managerial resources, particularly in the field of investments to Eastern European countries, and further that the Italian government had more positive policies toward Eastern European countries than the Japanese government.[19]

Finance

In finance the development of credits without specification can be considered a progressive step and an important sign of confidence on the part of the Japanese. In order to promote restructuring projects, such should be in accordance with economic and partic-

[19] Morita, K.: An Economic Analysis of Japan's Foreign Direct Investment into Poland: the Daihatsu-FSO Case, Hiroshima University, 1992.

ularly industrial policy. This would require closer cooperation between leading financial and governmental institutions of both sides.

An interesting opportunity for Japan would be participation in the Central European Payment Union. This would help not only Japan's presence in all-European finance, but also the operation of local Japanese companies and effective restructuring in the region.

Mutual learning

Mutual learning through information exchange about business possibilities and behavior is not very developed. Exchanges of study groups from business associations and industrial associations could be of considerable help in finding effective ways of cooperation.

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