

# DIRECT FOREIGN INVESTMENT TO DEVELOPING COUNTRIES: THE ISSUE OF OVER-PRESENCE

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## I. *Introduction*

Recently, complaints have been increasingly raised by developing countries against Japanese and American direct investment in manufacturing industries. It culminated in a riot in Indonesia and in Thailand in January 1974 during the visit of the Japanese Prime Minister. Reasons are various and broad, some superficial and others profound.

This issue should be investigated from four points of view: (1) the proper role of direct foreign investment in developing countries; (2) the kind of industries which are transplanted to developing countries through direct foreign investment; (3) the accumulated direct foreign investment compared to the total economic activity of the host country—this brings about the issue of “over-presence”; and (4) the behaviour of foreign firms and their expatriates in the host country.

(1) We have already touched upon the points (1) and (2) fairly extensively elsewhere.<sup>1</sup> Direct foreign investment in developing countries should play the role of a “tutor.” In other words, the main role of direct foreign investment is to transplant superior production technology through training of labour, management and marketing, from advanced industrial countries to lesser developed countries, or, in brief, it is the transfer of a superior production function which replaces inferior ones in the host country. Direct foreign investment should be an initiator and a tutor of industrialisation in less developed countries. The fact that a subsidiary or joint venture is established in a host country is only the beginning of national (or macro) economic effects, although in contrast with so-called “enclave” direct investment, the establishment of a joint-venture alone is significant. Direct foreign investment gradually has an effect spread over the specific industry in the host country through the training of labourers, engineers and managers, and makes the establishment of competitive firms by local capital possible, ultimately improving the production function of the entire industry in question and making the new industries competitive in international markets. When the process is completed, it can be said the new technology is really transferred and established in the host country.<sup>2</sup>

(2) In order to materialise the role of a “tutor” efficiently, it is most important for developing countries to choose carefully what kind of industry and what type of technology

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<sup>1</sup> See, Kiyoshi Kojima, *Japan and a New World Economic Order*, Croom Helm and Tuttle, 1977, Chap. 4 and 5.

<sup>2</sup> See, Kiyoshi Kojima, “Transfer of Technology to Developing Countries,” *Hitotsubashi Journal of Economics*, February, 1977.

they want to receive. A steady economic development in these countries is fostered through an orderly establishment of industries assisted by direct foreign investment and an orderly transfer of technology starting with labour intensive and relatively simple technology, and gradually moving towards more capital-intensive and sophisticated technology. In other words, developing countries should start receiving direct foreign investment from industries in which they have comparative advantage in production and comparative advantage in improving productivity. The latter brings about an orderly transfer of technology which begins in those industries where the technological gap between providing and receiving countries or firms is smallest and therefore the transfer of technology is easier and its spread-effects larger. The Japanese type direct foreign investment exactly meets these criteria but the American type does not; the Japanese type consequently contributes effectively to economic development in developing countries.

(3) Even in the Japanese-type direct foreign investment there remains another problem which is that of "over presence." Foreign firms should not suppress the local firms but spread better technology and management skills so that eventually the local entrepreneurs become able to initiate and manage operations as efficiently as the foreign firms. But, these effects are hindered if too many foreign firms enter and the negative effect increases if the firms concentrate in a certain industry or rush too quickly to establish many new plants in a short period.

(4) Behaviour of the foreign firms and their staff are condemned from various points of view: too many Japanese expatriates presented; they herd together and do not mingle with local people; they look forward only to a return to parent company headquarters; local staff are not properly promoted or not used in important decision making; salary differentials between Japanese and local staff are large; wage of local workers are not sufficiently attractive while work discipline required is too stringent and neglects local customs; quick withdrawal to the mother country of apparently too big a profit; the practice of transfer pricing and other tax evasion; bribing government officials, and so on.<sup>3</sup> Most of these complaints seem to be superficial and emotional. But, it should be remembered particularly in the case of Japanese direct investment in South-East Asian countries that many of those complaints are closely related to the fact that direct foreign investment has been rushed within a short time span and is not yet accommodated to the local environment and it has not achieved results that moderate these complaints.

<sup>3</sup> These complaints which are thought to be coming from the weakness of Japanese direct investment abroad, are well illustrated in M.Y. Yoshino, *Japan's Multinational Enterprises*, Harvard University Press, 1976, Chapter 6.

Tsurumi summarises misbehaviour of Japanese subsidiaries as follows:

(1) *Exclusiveness*: Japanese expatriate managers and engineers exclude local managers and engineers from important decision-making processes of their subsidiaries as well as from important tasks of communicating with Japanese parent plants and offices located in Japan and elsewhere.

(2) *Too many Japanese Expatriates*: Compared with other foreign multinational firms, Japanese parent firms send too many Japanese expatriate managers and engineers into their subsidiaries abroad. They occupy not only the top management echelon of the subsidiary organization but the middle and lower management echelon as well.

(3) *Cultural Insensitivity*: Socially, Japanese expatriates keep to themselves outside their subsidiaries. They seldom socialize with local residents. They remain insensitive to social and cultural "taboos" of host countries. They do not learn local languages. And they send their children to "Japanese" schools.

Yoshi Tsurumi, *The Japanese Are Coming: A Multinational Interaction of Firms and Politics*, Ballinger, Cambridge, Mass., 1976, pp. 250-1.

In this paper, an analysis is focused on the issue of "overpresence" so as to cover (3) and (4) above. The analysis will cast light on policy recommendations such as the importance of spread-effects and "fade-out" (Section II and III).

Although Japan has successfully transplanted labour-intensive industries to neighbouring developing countries, she now has to increase her direct foreign investments towards intermediate goods production such as steel and basic chemicals. Section IV deals with the most effective types of a second-stage investment for Japan. Because of the advantages of scale economies, the feasibility of intra-industry specialisation between neighbouring developing countries and with Japan is discussed.

Finally, a concluding remark is in Section V on advanced countries' integrated policy for promoting manufactured exports for developing countries.

## II. *Is There an Over-presence of Japanese Firms in Asia?*

Japanese direct foreign investments increased significantly in the 1970-73 period, especially in manufacturing industries in neighbouring Asian countries and Japan's share of total foreign investments of each host country reached a fairly high level. These facts seem to be one of the main reasons of 'over-presence' condemnation, for a massive avalanche of direct foreign investments creates accommodation difficulties and fear of domination in host countries.

Some statistics will show the extent of the investments. Japan's total amount of direct foreign investments (Bank of Japan permits) increased very substantially in the period, by \$904 million in 1970, \$858 million in 1971, \$2,338 million in 1972 and \$3,494 million in 1973. Thus, the cumulative total by 1970 of the past 20 years, that is, \$3,577 million, increased by 1973 to \$10,267 million, or 2.87 times. Because of the very favourable trade balance and rapid increase in foreign currency reserves in this first period, Japanese government changed its foreign investment policy from restrictive to expansive. At the same time, revaluation of the yen (which went up sometimes as high as 265 yen per US dollar from 360 yen) made foreign investment preferable to increased exports.

Since the oil price rise in October 1973, followed by the world-wide recession, Japanese direct investment abroad slowed down its rate of growth. Annual total outflow was \$2,395 million in 1974, \$3,280 million in 1975 and \$3,462 million in 1976.

The cumulative total by 1976, that is \$19,405 million, was 1.89 times as large as that of 1973 which shows a substantial slow-down of growth rate in this second period as compared to 2.87 times in the first period (See, Table 1).

Similar to such a trend in Japan's total direct foreign investment, investment in Asia (that is, east of the Middle East) increased by 3.02 times in the first period and 2.32 times in the second period, both of which show a greater growth rate than the total investment. Thus, the share of investments in Asia among the cumulative total increased from 21.8 per cent in 1970 to 28.2 percent in 1976.

Japan's direct investment in Asian manufacturing industries increased much faster in the first period than the general trend: the cumulative amount increased by 3.96 times from \$306 million in 1970 to \$1,211 million in 1973. But in the second period investment in Asian manufacturing increased by only 1.83 times, which was slower than Japan's total investment,

reaching \$2,221 million in 1976. Substantial Japanese investment flooded into Asian manufacturing activities within the short period 1970-73.

Now, in what Asian manufacturing industry did Japanese direct investment increase most rapidly? In Table 1, nine manufacturing items are shown in the order of importance in 1976. They may be classified into two categories: (A) *early growth group* such as textiles, electronic machines and appliances, transport equipment and timber and pulp in which

TABLE 1. JAPAN'S DIRECT FOREIGN INVESTMENTS: CUMULATIVE TOTAL PERMITTED BY THE BANK OF JAPAN AS OF THE END OF FISCAL YEAR:  
unit=US million dollars

	Cumulative Total			Growth (times)	
	1970	1973	1976	1973/70	1976/73
Japan's Total Investments	3,557	10,267	19,405	2.87	1.89
Directed to Asia, total	780	2,359	5,464	3.02	2.32
All manufactures in Asia	306	1,211	2,221	3.96	1.83
in which:					
Textiles	108	483	718	4.47	1.49
Electric machines and appliances	45	183	294	4.07	1.60
Other manufacturing	49	126	291	2.57	2.31
Steel and non-ferrous metals	6	99	270	16.50	2.73
Chemicals	23	76	204	3.30	2.58
Transport Equipment	14	77	136	5.50	1.77
Timber and Pulp	13	71	113	5.46	1.59
Food processing	33	47	99	1.42	2.11
Heavy Machines	15	49	97	3.27	1.98

Source: Ministry of Finance.

TABLE 2. ACCUMULATED UNITED STATES AND JAPANESE DIRECT INVESTMENTS IN ASIA  
(Million of U.S. dollars)

Host countries	United States			Japan		
	1971	1973	1973/71(%)	1971	1973	1973/71(%)
Sri Lanka	N.A.	N.A.	—%	2	3	150%
Taiwan	133	142	106	85	110	129
Hong Kong	286	291	101	139	180	129
India	329	332	101	12	15	125
Indonesia	512	812	159	241	344	143
S. Korea	277	301	108	33	310	939
Malaysia	] 307	162	] 297	50	121	242
Singapore		750		33	150	454
Pakistan	96	N.A.	—	5	6	120
Philippines	719	820	114	74	110	149
Thailand	124	172	138	91	200	219
Others including						
S. Vietnam	266	N.A.	—	14	15	107
Total	3,049	3,821	125%	779	1,574	202%

Reproduced from Yoshi Tsurumi, *The Japanese Are Coming*, 1976, p. 252.

TABLE 3. IMPORT OF MANUFACTURES FROM JAPAN AS A PERCENT OF TOTAL IMPORTS OF MANUFACTURES OF NINE SELECTED COUNTRIES, 1972

Country	Import from Japan as Percent of Total Import	Balance of Trade with Japan
Korea	56.3%	Deficit
Taiwan	59.2	Deficit
Philippines	35.3	Deficit
Hong Kong	32.7	Deficit
Thailand	47.4	Deficit
Singapore	30.9	Deficit
Indonesia	31.2	Deficit
Brazil	8.0	Deficit
Mexico	3.8	Deficit

Source: *The United Nations Commodity Trade Statistics*, The United Nations, 1973.

N.B.: Manufactured goods are defined as the three-digit SITC product categories of 100's to 800's, plus foods.

Reproduced from Yoshi Tsurumi, *The Japanese Are Coming*, *op. cit.*, p. 259.

Japanese direct investment grew faster than the average of total manufacturings in the first period whereas it grew slower than the average in the second period; and (B) *late growth group* such as other manufactures, chemicals, food processing, and heavy machines in which Japanese direct investments shows a growth trend reverse to the (A) group. Steel and non-ferrous metals appears not to belong to either category, for its growth was faster in both periods than the average but its very fast growth rate (that is 16.5 times) in the first period was due to the very small cumulative amount of investment in 1970 and in fact if 1971 is taken for reference year, the growth rate by 1973 was only 2.48 times which is lower than the average. Therefore, this item may be considered one of the (B) category.

It becomes clear, first, that from 1970 to 1973, Japanese investments rushed into such labour-intensive consumer goods industries as textiles, electric machines and appliances and transport equipment (mainly assembling) as well as in timber and pulp to obtain off-shore supplies. Secondly, it is also shown that Japanese investment in Asian manufacturings was gradually shifting in its focus, as appeared in the second period, to the late growth group which consists mainly of manufactured intermediate goods.

I now discuss an interesting figure, Table 2 which provided by Professor Tsurumi.

"The United States' investments in Asia were about four times as large as those of Japan in 1971 and were still about twice as large in 1973. In 1971, in every single country throughout Asia, Japanese investments remained a distant second to those of the United States. By 1973, excluding South Korea and Thailand, The United States was still the world's largest investor. And yet, each host country developed the impression that Japan had long dominated foreign investments."<sup>4</sup>

Then, Professor Tsurumi points out five reasons<sup>5</sup> why the Japanese investment appears to have more 'over-presence' than indicated by the total value of assets invested.

<sup>4</sup> *Ibid.*, p. 251.

<sup>5</sup> *Ibid.*, pp. 251-60.

First, because the Japanese investment consists of a large number of small-scale operations, she surpassed all other foreign investments throughout Asia in terms of the number of subsidiaries involved.

Second, Japanese investments in Asia and elsewhere were concentrated in manufacturing, especially light consumer goods industries, and their plants were often located in or around major population centers of host countries, making public visibility greater.

Third, Japanese manufacturing subsidiaries in host LDCs were often producing products that were not technologically sophisticated. They were competitors to and often stifled indigenous firms as well as would be Asian investors.

These three points consist of characteristics of what I called 'Japanese-type direct foreign investments'. Because of these characteristics, Japanese investments have advantages in transplanting smoothly the right kind of industries to neighbouring LDCs, on the one hand, but, on the other, they arose an impression of over-presence and invite condemnation.

Fourthly, as shown in Table 2, the growth rate of Japanese direct investments in each Asian host country was often explosively high in the years from 1971 to 1973. This situation produced the appearance of a 'massive avalanche' of Japanese investments in Asian host countries.

Finally, in addition, as shown in Table 3, imports of manufactures from Japan as a percent of total imports of manufactures reached as high as 30 per cent in 1972 in many Asian countries. Japanese manufactured goods imported and produced locally taken together appeared more publicly visible than those of other countries. The 'trade deficit' of the host country with Japan created an additional condemnation.

To sum up, There are two indicators which inspire the charge of over-presence against Japanese direct foreign investments:

First, when the Japanese investments in a certain host country increase to more than a critically substantial importance or, in other words, a peril point,<sup>6</sup> condemnation begins to arise. What is a peril point cannot be defined numerically. If the Japanese investment shares more than half of the total foreign investments in the host country, a fear of Japanese domination may appear. In many developing countries in Asia and Latin America, U.S. investments had been dominating and, therefore, they rather welcome Japanese and European investments in order to get rid of U.S. domination and also to receive investments on more favourable terms, letting those diversified sources compete to each other. One third of U.S. investments in a certain host country may be the critical point before which any Japanese investments are thought to be moderate.

Secondly, the speed of growth of Japanese investments flowed in certain host country within short time span is a source of trouble. It should not be a massive avalanche, which creates many accommodation difficulties in the host economy.

It should also be noted that too much and too rapid direct foreign investment also creates difficulties for investing country due to what I call 'boomerang effects'. The Japanese direct foreign investments are originally trade-oriented; that is, transplanting manufacturing bases to neighbouring developing countries, strengthening their international competitiveness

<sup>6</sup> Perhaps the term 'peril point' is originally used to the threat of increased imports, but the logic involved is similarly applicable to trade and foreign investment. The case of increased imports is dealt with Kiyoshi Kojima, "Direct Foreign Investment between Advanced Industrialized Countries," *Hitotsubashi Journal of Economics*, June 1977.

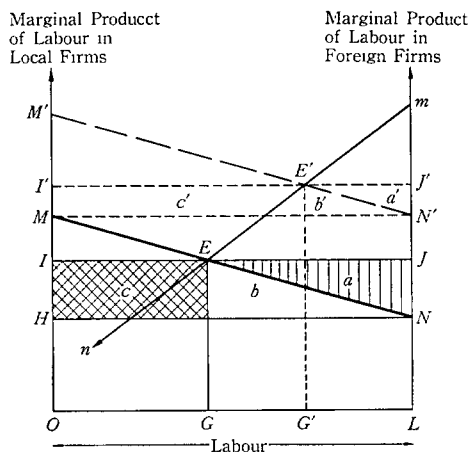
and, eventually, they make it possible to export their products to Japan and other third countries. Japan (that is, the investing country) should increase imports of the manufacture in question (even if she had been exporting it before her direct investment). This is the 'boomerang effect' of offshore sourcing type direct foreign investments. In order to absorb increased imports of the manufacture in question, Japan should liberalise its imports and foster structural adjustment so as to contract the competing domestic industry and transfer the resources to other more promising industries. Therefore, the direct foreign investment should be undertaken with such a speed and to such an extent that its boomerang effect is smoothly absorbed or domestic structural adjustment is successfully promoted. Too much and too rapid direct foreign investment makes it difficult to carry out sufficient structural adjustment. Japan now faces this difficulty as a result of the 1970-1973 investment flood.

### III. A Model of Over-Presence

The reason a direct foreign investment in a certain host country is condemned to be 'over-presence' must be theoretically clarified. Assume as in Figure 1 that a host country produces a commodity or, in general terms, national income with a given labour force,  $OL$ , that is measured horizontally.<sup>7</sup> The marginal product of labour (MPL) schedule for local firms,  $MN$ -curve, is drawn with respect to the origin  $O$ . In order to realise full employment, equilibrium is indicated at point  $N$  under the wage rate,  $OH=LN$ ; national income is equal to area  $OMNL$ , with total returns to labour (wage bill) of  $OHNL$  and the remainder to capital,  $HMN$ .

Now, let us assume that foreign firms invest in this host country with the MPL schedule,

FIG. 1



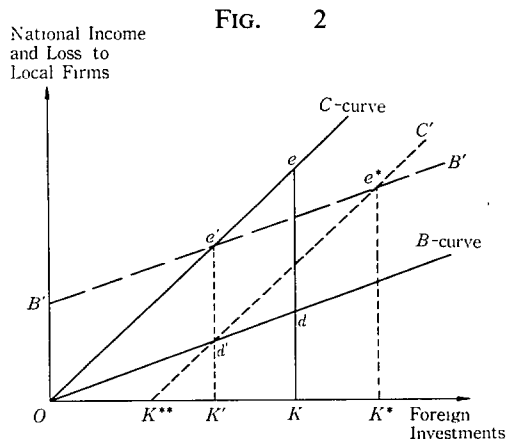
<sup>7</sup> The method of analysis is the same as MacDougall and Kemp except that we use the marginal product of labour schedule instead of the marginal product of capital schedule. See, G.D.A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach," *Economic Record*, March 1960, reprinted in American Economic Association, ed., *Readings in International Economics*, Richard D. Irwin, 1968, Chap. 10. M.C. Kemp, *The Pure Theory of International Trade*, Englewood Cliffs, N.J., 1964, Chaps. 13-14.

*mn*-curve, which is drawn with respect to *L*. The MPL schedule for foreign firms is drawn at higher level than and with different elasticity from the MPL schedule for local firms since the foreign firm's capital embodies superior technology and better management. The new equilibrium is at point *E*, where the wage rate is equated in local and foreign firms, and *OG* of labour is employed in local firms and *LG* in foreign firms. The total product produced in the host country then increases by area *EmN*, of which *EmJ* is remitted to foreign investors, and consequently the national income retained in the host country is area *OMEJL* with a net increase, *EJN* (or area *a*).

It is expected from the macroeconomic point of view that in so far as the net increment in national income, such as the area *a*, continues to grow, by the increased foreign investments with much higher MPL curves, these foreign investments should be welcome, but typically they are not. The reason is that the entrance of foreign firms with superior technology and management skill increases the productivity of labour force as a whole resulting in the gain in wage bill equal to the area *a+b+c*. But the returns to local capital or profits declines by area *b+c*, which is greater than the net increment to national income, the area *a*. Complaints against foreign direct investments then arise because local entrepreneur's interest is hurt<sup>8</sup> even if macro-economic gain is increasing.

It should be noted that, complaint may also be made by labourers if the entrance of foreign direct investment creates frictional unemployment due to the fact that the labour force discharged from the local firms is not able to move quickly and fully to the new foreign firms, where the quality of the labour force required differs between the two parties, or where the transfer of the labour force is not easy because of differing geographical locations. This labourers' complaint is discussed later in this section.

Then we may be able to derive two curves as shown in Figure 2. One is *benefit-curve*, *OB*-curve, which shows the net contribution of direct foreign investments to the host economy, such as the area *a* in Figure 1 which increases as foreign firms enter into the host economy in increasing size with more superior technology and management skill (that is, with much higher MPL curves). Another is *complaint-curve*, *OC*-curve, which shows the loss



<sup>8</sup> A wage increase is claimed for foreign firms and they usually offers wage rates higher than in local firms in order to attract workers. But, it should be recognised that such wage-increases reduce the profits of the local firms with unchanged labour productivity.



incurred to the local entrepreneur's profits, such as the area  $b+c$  in Figure 1.

As pointed out already, the area  $b+c$  is greater than the area  $a$ , and, therefore, the  $OC$ -curve always lies above the  $OB$ -curve. In Figure 2 when foreign investments are  $OK$ , complaints,  $Ke$ , exceeds benefit,  $Kd$ . This means that the complaint raised by local entrepreneurs is so strong, even if the damage is trivial, that no foreign investment is allowed to enter to the host country. It is obvious that as the foreign investment increases, the complaint is strengthened. The foreign investment may be allowed to enter by some amount if the local entrepreneurs are not aware of the loss of profits they incur from the increased foreign investments. It is especially true when the foreign investment establishes a joint venture, instead of whollyowned subsidiary, with local entrepreneurs who might be crowded out. From this point of view, besides other reasons, the joint venture is preferable to the whollyowned subsidiary or enclave. Furthermore, if the loss in entrepreneur's profits could be compensated by the gain in wage bill, or, in other words, if only the net macro-economic gain such as  $OB$ -curve in Figure 2 is considered, as foreign investors often argue to the host country, then the foreign direct investments will continue to increase and easily dominate the host economy. Such case is hardly ever realised, however.

If we turn to see important *dynamic* ramifications of direct foreign investments, there are a number of cases in which even competitive local entrepreneurs welcome foreign investments on a fairly large scale. First, let us consider such a case in which the direct foreign investment realises substantial 'spread-effect'. The spread effect shifts the MPL schedule of local firms up to  $M'N'$ -curve from  $MN$ -curve<sup>9</sup> in Figure 1. Now the new equilibrium under the given foreign investment schedule is at point  $E'$ , where the wage rate becomes much higher and the total wage bill increases by area  $H'I'J'N$  as compared with the situation before foreign investment. This area offsets the loss in entrepreneurs profits (area  $b'+c'$ ). The net macroeconomic gain is area  $a'$ , a *static* gain as before, plus area  $HMN'N$ , a *dynamic* gain due to spread effects. Thus the benefit curve shifts to  $B'B'$ -curve in Figure 2, the vertical distance  $OB'$  being equal to the spread effects.

Owing to the spread effects, local firms become more competitive and crowd out foreign firms by an amount  $GG'$  in terms of labour employed in Figure 1. In the other words, a part of the direct foreign investment has successfully finished the role of tutoring and now is forced to fade out. The presence of foreign firms decreases, in Figure 2, to  $OK'$  from  $OK$ .

It should be recognised that the favourable spread effect to the host economy does not only shift up the benefit-curve but also move the complaint-curve rightwards to  $K^{**}C'$ -curve. The inflow of foreign investment by the amount  $OK^{**}$  does not invite any complaint but it rather is assumed to be a minimum amount necessary to generate spread effects. If so, a smaller amount of foreign investments than  $OK^{**}$  might be thought as 'under-presence' and further inflow is earnestly required.

Now, the new complaint curve,  $K^{**}C'$ , crosses the new benefit curve,  $B'B'$ , at point  $e^*$ . Beyond this point, complaint exceeds benefit and consequently further inflow of foreign investments may be condemned as 'over-presence,' as was the case at the point  $O$  under no spread effects.

Then, foreign investments with the amount inbetween  $OK^{**}$  and  $OK^*$  might be thought

<sup>9</sup> The new  $M'N'$  curve may have elasticity different from the original  $MN$ -curve, but, for the simplicity of explanation, the two are drawn in parallel fashion.

as 'modest-presence'. Take, for example, such an amount of foreign investments as  $OK'$ , with which vertical distance between the  $B'B'$  and  $K^{**}C'$  curves becomes equal to the increased productivity due to spread effects. Here, although local entrepreneurs still incur some loss of profits as large as  $K'd'$ , the net macroeconomic gain,  $K'e'$ , is so large that the local entrepreneurs cannot sacrifice the latter but trade-off with it. Even the loss of entrepreneurs' profits,  $K'd'$ , is easily compensated, if they request, by the large increment of wage bill. Let us look at again Figure 1. The total increase in the wage bill is area  $HI'J'N'$  whereas the loss of entrepreneurs' profits is area  $b'+c'$ . If wage bills as large as area  $MI'J'N'$  are redistributed to local entrepreneurs, this means an over-compensation by area  $a'$  (the static net gains), still leaving the spread effects entirely to the gain in wage bills, area  $HMN'N'$ . (It is shown in Figure 2 that even if  $K'd'$  is paid as compensation to local entrepreneurs,  $d'e'$  is left to the increased wage bills.)

To sum up, spread effects of direct foreign investments make it possible to generate a dynamic gain for the country with which labours and local entrepreneurs can share, and consequently a modest presence large enough to generate a spread effect is welcome.

Secondly, similar beneficial effects of direct foreign investments are conceivable in a case where the entry of foreign firms into the host country mobilises surplus labour and / or other natural resources.<sup>10</sup> If this is done to the extent that no increase in factor prices is brought about, no complaint is raised by local entrepreneurs and a benefit curve like  $OB$ -curve in Figure 2 is derived. As foreign investments increase further, say up to  $OK^{**}$  amount, factor prices are pushed up and complaint inspired, along  $K^{**}C'$ -curve. Then, point  $d'$  where the benefit curve intersects the complaint curve in this case becomes a critical point.

Thirdly, direct foreign investments can assist gradually the upgrading of the industrial structure of the host economy, though it should be done in proper order, from raw primary goods production to processing them, from consumer light industries to intermediate heavy and chemical industries, and from assembling and parts manufacturing to integrated production. These investments increase value-added retained in the host country, and move the benefit curve upwards, shifting the critical point for the amount of foreign investments allowed to the right. Whether or not the complaint curve is moved rightwards depends upon how far foreign investments are required in order to materialise spread effects for indigenous firms.

Besides these three dynamic ramifications, direct foreign investments are often welcomed by host governments for other reasons such as establishing key industries for defense or prestige purposes and improving the balance of payments. Although we cannot neglect these purposes, they usually do not promote steady economic development of the host country. Moreover, these governmental policies easily invite monopolistic enclave foreign investments which have very few spread effects and usually a limited employment effect from highly capital-intensive characteristics.

Another broader issue is why a massive avalanche of direct foreign investments within a short time span creates difficulties in the host economy and consequently fierce 'over-

<sup>10</sup> Benefits of this case are clearly explained by the 'vent-for-surplus' theory. See H. Myint, 'The Classical Theory of International Trade and the Underdeveloped Countries', *Economic Journal*, June 1958, pp. 317-37. This kind of employment-creating foreign investment is welcome even in developed countries for their regional development.

presence' condemnation. Most of them are frictional and temporary difficulties in accommodating to the flood of new foreign firms into the host economy.

1) A massive avalanche of direct foreign investments may stifle seriously competitive indigenous firms, since the foreigners bring in superior technology and management skill.

2) A rapid increase in the number of foreign firms and bankruptcies of local firms may produce frictional unemployment, at least temporarily, as mentioned above.

3) A serious shortage of local factors complementary to massive new foreign firms may appear. Demand for indigenous labour of a quality suitable to foreign firms, raw materials, land, water, energy, transportation and other infrastructure may increase, resulting in abrupt rise in wage and other factor prices and in the general price level. This makes not only foreign firms less profitable than expected but also accelerates local firms' difficulties. Since foreign firms, especially in their infancy, require a large amount of imported raw materials, intermediate products and plant and equipment, balance of trade in the host country may also suffer from serious deficits.

These three causes may raise and steepen the complaint curve not only through local entrepreneurs but also through labourers and even emotional frustration of local people in general.

4) On the other hand, because of the infancy of foreign firms' activities which rushed in within a short period, no spread effects have yet materialised.

5) Because it is a massive avalanche, the local market becomes too small for each firm while exporting is yet impossible. Foreign firms struggle in competition with each other, leaving no room to extend 'spread effects' to indigenous firms.

These two elements mean that the benefit curve moves very little within a short time span. Without any spread effect, direct foreign investments are neither effective to, nor welcomed by the host economy. Therefore, direct foreign investments in a certain host country should be undertaken in modest size within a certain time span and, after the substantial materialisation of spread effects of those investments, a second round in more sophisticated industry should follow.

#### IV. *The Reorganisation of North-South Trade*

Currently, the north-south problem seems to be facing a turning point: there is a shift in emphasis from aid and trade expansion of a 'surplus disposal' type to that of a 'structural adjustment' type. Structural adjustment in developed countries is an essential element if new development policies are to be successful. Multilateral and nondiscriminatory free trade is most important if world trade is to be increased. How to provide the basic conditions necessary to realise and maintain the free trade system is an important problem that needs to be explored. The international monetary system must be revised so that any balance of payments disequilibrium is quickly removed by a more flexible adjustable peg system. Then, many tariff and non-tariff barriers to trade which have been introduced, mainly for balance of payments reasons, can be eliminated. But trade liberalisation and smooth adjustment of balance of payments will require *structural adjustment* in each country's industries in response to changes in comparative costs. Inefficient industries which have lost comparative advantage should be contracted and capital and employment must be

transferred to other growing sectors through adjustment assistance policies.

Structural adjustment policy usually focuses its attention on contracting old, comparatively disadvantageous sectors of the economy; but promoting the growth of new, comparatively advantageous sectors is equally important. Structural adjustment in declining, inefficient sectors is undertaken successfully only in a dynamic economy in which the growth sectors' expansion is rapid enough so that resources from contracting sectors may be absorbed smoothly.

Thus, there is a strong belief that upgrading the industrial structure in Japan (and other advanced countries) through knowledge-intensive industrialisation would also favour the industrialisation of developing countries and as such facilitate the reorganisation of north-south trade. But this solution crucially depends upon the volume of horizontal trade in knowledge-intensive products between advanced countries. The promotion of this trade also needs serious consideration. In this sense, the north-south trade problem cannot be separated from the problem of maintaining growth in the trade among advanced countries.

While Japanese trade policy has been reluctantly changing in favour of manufactured exports from developing countries, our imports have increased rapidly in terms of their growth rate. For instance, imports of manufactures from developing Asian countries increased from \$95 million in 1965 to \$2,881 million in 1975, of which South Korea, Taiwan and Singapore accounted for 80 percent.<sup>11</sup> Imports of textile goods mainly from Asian countries increased from \$43 million in 1965 to \$383 million in 1971 and to \$1,715 million in 1973. Textiles and raw materials taken together were \$3,902 million so Japanese imports of textiles surpassed, for the first time since the War, her exports of manufactured textiles of \$3,279 million. This is a sign of boomerang effects of Japan's past investments in foreign textiles industries. Recently, in 1975, Japan asked Korea, Taiwan, Hongkong and China to put voluntary export restraints on textiles in the same manner as a few years ago the United States was asking Japan to restrain textile exports. This reveals that Japanese structural adjustment has been lagging and needs to be promoted more seriously.

Undertaking structural adjustments effectively therefore becomes a central issue for advanced countries if really wide markets for the manufactured goods of developing countries are to be created. Strong resistance, both economic and political, can be expected. Various steps will have to be taken to assist the adjustment, along the lines of the United States Trade Expansion Act of 1962 and the amended act of 1968.<sup>12</sup>

The Japanese economy has only limited experience of adjustment assistance policy. One example is that of the textile spinning industry. This industry was originally very capitalistic and depended little on government assistance before the war. It developed through the growth of small firms, their integration into big firms, the control of production through a cartel and the diversification of production from cotton to synthetic and chemical fibers. After the war, government intervention in spinning industries was introduced through the Textile Structural Adjustment Law of 1956, and the amended law of 1964 and 1967. Those laws aimed at scrapping old, inefficient spinning mills and building new, more efficient

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<sup>11</sup> See, *Japan's Reaction to Neighbouring Countries Industrialisation and Manufactured Exports*, Nihon Boekikai, May 1977, p. 37.

<sup>12</sup> US adjustment assistance policy is critically evaluated, and needed improvement is suggested by *US Foreign Economic Policy for the 1970's: A New Approach to New Relations*, National Planning Association, Pamphlet No. 130, Washington D.C., November 1971, pp. 194-211.

mills of optimum size. Government subsidies were provided as compensation for scrapping old spinning facilities. New spinning capacity was limited. But because of the superior efficiency of new capacity, the volume of production increased. In other words, the governmental assistance to the spinning industry contributed to increased production, to modernisation of the industry and to the strengthening of its international competitiveness, rather than to a reduction in production capacity and to the reallocation of resources to other industries. Since it consists of large firms, the spinning industry is more alert and adaptive to structural adjustment than smaller processing textile firms. Japanese foreign investment has to date been 'trade-oriented'. It was aimed at complementing Japan's comparative advantage position. The major part of investment was therefore directed toward natural resource development in which the Japanese economy is comparatively disadvantaged. Even investment in manufacturing has been confined either to such traditional industries as textiles, clothing and steel processing in which Japan has been losing its comparative advantage, or the assembly of motor vehicles, production of parts and components of radios and other electronic machines in which cheaper labour costs in Southeast Asian countries are achieved and the Japanese firms can increase exports, substituting for exports of final products, exports of machinery and equipment for the factory and technological knowhow.

Japanese direct foreign investment has thus been quite sensitive to change in its comparative advantage position. According to the progress of industrialisation in neighbouring Asian countries, Japanese direct foreign investment will step up to the second stage with the aim of establishing a network of intra-industry specialisation with those countries not only in consumer goods but also in intermediate goods production as well as machinery.

Thus, both aid and direct investment are an important element in creating export capacity in developing countries and promoting the reorganisation of north-south trade.

It is most important to create detailed horizontal (i.e. intra-industry) specialisation based on a finer commodity classification.<sup>13</sup> In the case of labour-intensive goods like textiles, there is already wide acceptance that they should be located abroad and imported into Japan. This admits however of intra-industry specialisation under which some kinds of textiles would be imported and other higher quality textile products would be exported. Export of parts and imports of assembled products is another form of horizontal specialisation. We have reached the stage where we must increasingly consider the same kind of intra-industry specialisation in the heavy and chemical industries (including both intermediate goods and machinery).

It could, for instance, become necessary to progressively install integrated steel plants in neighbouring developing countries. Of necessity however these would remain small-scale. Nevertheless, iron and steel covers a great range of products and so by specialising in a particular product, each steel works could take advantage of the economies of scale and operate efficiently. In this way, it would not only supply local demand but also provide imports for Japan. Japan in turn could export other varieties of iron and steel. Through such regional dispersion of Japanese iron and steel firms, we could build up a system of intra-industry specialisation and a relationship of interdependence that would be mutually

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<sup>13</sup> An excellent study on this problem has been published: see Herbert G. Grubel and P.J. Lloyd, *Intra-industry Trade: The Theory and Measurement of International Trade in Differentiated Products*, Macmillan, 1975. Also, Kiyoshi Kojima, 'An approach to Integration: The Gains from Agreed Specialisation', in his *Japan and a Pacific Free Trade Area*, Macmillan, 1971, Chapter 2.

inseparable. The same kind of intra-industry specialisation might gradually be introduced into the petro-chemical industry or in manufactures using iron and steel and in machine production.

This may be the only way in which we can raise the industries of neighbouring countries from the stage of light industry to the stage of heavy and chemical industry and finally raise their economies to the level and quality of Japan's. Until neighbouring countries reach an economic level equal to Japan's and we create interdependent relationships so close that they become inseparable, Japan can never achieve international political and economic stability. We might well take as one of our objectives the building of the Western Pacific economic region into something resembling the European Community.

I believe that Japan should promote a network of intra-industry specialisation particularly with neighbouring countries of the Western Pacific region in all the sectors of natural resources, agriculture, light industry, intermediate products of the heavy and chemical industries and the machinery industries and should raise the level of their economies and build up relationships of interdependence that will be inseparable. These are the kinds of attractive positive targets for international economic policy that should be forthcoming. These targets are made feasible through the effective operation of the 'Japanese type' direct foreign investments.

There is still a tendency to try to solve the problems of the world economy, such as inflation and the international trade and payment systems within the advanced countries alone, but such a solution will not be easy. This is an opportunity for the advanced countries to tackle in earnest the problems of the developing countries to which they have so far been paying only lip service. Here are possibilities for effectively using Arab oil money. Not only have the advanced countries run up against relative stagnation in technological progress but technological innovation itself has taken some wrong turns, as in the production of luxuries and robot production. There is great scope for raising productivity by transferring existing technology and industries to the developing countries through effective direct investment. The scope for increasing purchasing power in those countries is practically unlimited. Only by doing their utmost to raise the economic level of the developing countries and reorganising north-south trade will the advanced countries find a way towards solving their problems of inflation and unemployment.

## V. *Conclusion*

The policies of advanced countries for increasing exports of manufactured goods from developing countries should promote structural change on both sides, and the development of north-south trade. Thus, an integrated aid, investment, trade preference and structural adjustment policy is required. Trade preferences for developing countries are justifiable if divergence from the GATT principle of non-discrimination is temporary, and if they foster liberalisation of world trade. They are positively desirable if they encourage transformation in the international division of labour in such a way as to strengthen specialisation in the export of labour-intensive goods from developing countries. But trade preferences alone may not bring about sufficient benefits. Aid and investment linked directly to preferential tariff and structural adjustment could offer more benefits to developing countries.

First, directly productive aid and investment in the form of capital goods, advanced techniques of production, managerial knowhow and worker training should be provided to developing countries on an increasingly large scale if the efficiency of new export-oriented industries, primary as well as manufacturing, is to be improved to the point where they become increasingly competitive in world markets. Secondly, developed countries should provide preferential treatment to developing country exports launched with the help of directly productive aid and investment, coupled with multinational firms' sales promotion. Preferences aimed at insuring wider markets would serve as a kind of aid and investment 'after-care', and might well be regarded as indispensable to realising the full benefits of aid and investment. It is important that the provision of trade preferences should be closely linked with the provision of aid and investment, since both are likely to be ineffective and wasteful of resources if applied independently. Thirdly, structural adjustment in advanced countries should be closely linked with the result of the aid and investment.