Japan's Role in Asian Development: Lessons for Sri Lanka

Dushni Weerakoon
and
Lekha Ratwatte

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Contents

1. Introduction 1

2. Industrialisation Strategies 2

   2.1 The Japanese Experience of Industrialisation and the "Ingredients" Approach 2
   2.2 Historical Underpinning 5
   2.3 An Influential Model? 8
   2.4 Industrialisation in Sri Lanka 11

3. Trade 13

4. Foreign Direct Investment 18

5. Official Development Assistance 28

6. A Role for Japan in South Asia: Benefits for Sri Lanka 31

7. Conclusion 38

Reference 40

Appendix 42

Japan's Role in Asian Development: Lessons for Sri Lanka

Dushni Weerakoon and Lekha Ratwatte

1. Introduction

Many of the development strategies of Japan's successful East Asian neighbours were patterned after Japan's industrial strategy based on selective intervention and semi-protected markets. In the drive to industrialisation, the Asian "tigers" -- South Korea, Taiwan, Hong Kong and Singapore -- have emulated much of the Japanese experience and benefitted vastly from trade and investment links with Japan. The emerging second-tier Newly Industrialised Countries (NICs) -- such as Malaysia, Thailand and Indonesia -- are fast catching up with the four tiger economies. Japanese trade and investment in these countries have bolstered their growth potential, and Japan is regarded as having a pivotal role to play in their ambitious plans to be fully industrialised countries in the foreseeable future.

Given the ever closer links between Japan and Asia, a similar role for Japan in the economic development of South Asia remains, in the minds of South Asians, a tantalising possibility. A mixture of factors is at work in Japan's tilt towards Asia in the recent past; a rising demand for consumer products and industrial plants across the region, political and economic constraints on growth in Japanese exports to the USA as demonstrated by the recent trade dispute over motor vehicle exports, and the fresh pressure on Japanese industry, brought on by the latest rise in the yen, to seek cheaper production abroad.

Japan's role in Asia has so far been largely confined to Southeast Asia. South Asia, in contrast, has enjoyed relatively limited economic links with Japan. Policy and political instability have dogged South Asian countries for much of the post-war period. Nevertheless, Japan has been an important trading partner of individual countries in the South Asian region . Historical ties between Sri Lanka and Japan have been strong. Sri Lanka was a strong advocate of Japan's efforts to regain international recognition after the Second World War, and the San Francisco Peace Treaty Conference of 1951 set the tone for post-war Japan-Sri Lanka relations. The Finance Minister of what was then Ceylon, J.R.Jayawardena, renounced

reparations for Japanese air-attacks and offered the country's full support to Tokyo in gaining membership to the United Nations in 1956. Japan has since been an important partner in Sri Lanka's drive towards rapid economic development. In per capita terms, Sri Lanka has received more Japanese aid than almost any other country. Japanese support and assistance has never been more marked than in the post-1977 period, particularly under the tenure of the Jayawardena government of 1977-1988.

There are two distinctive elements in this study. First, to assess the relevance of the Japanese model; and second, to assess the role of Japan as a trade, aid and investment partner. In Section 2, the paper makes a conscious attempt to broaden the basis of discussion about economic policy by introducing and exploring a major alternative approach to that of the World Bank/IMF structural adjustment and stabilisation programmes. Sections 3, 4 and 5 discuss the role of Japan in the rise of the East Asian "tigers" and the second-tier NICs (such as Thailand and Malaysia), and examine the possibility of a similar role for Japan in Sri Lanka. Section 6 looks at the alternative prospect of a role for Japan in the context of a regional initiative involving South Asia. Section 7 concludes.

2. Industrialisation Strategies

In Sri Lanka, as in many other developing countries, the fruits of following World Bank and IMF policy prescriptions have proved disappointing. World wide, criticism has been levelled at the Bank's structural adjustment approach and policy conditionality, and the criticism has been particularly intense in Japan, grounded on Japan's own experience with rapid industrialisation. In the following section we look at the Japanese experience of industrialisation and the lessons it holds as an alternative to the World Bank structural adjustment policy proposals.

2.1 The Japanese Experience of Industrialisation and the "Ingredients" Approach

The rapidly deteriorating balance of payments situation in many developing countries following the second oil price hike at the end of the 1970s prompted the World Bank to advocate the adoption of structural adjustment programmes. Bank recommendations were aimed at removing common "distortions" in developing countries, with the ultimate aim of achieving the twin objectives of sustainable macroeconomic balance and microeconomic efficiency. The distortions that needed to be corrected fell into two broad categories: first, the policy environment in which private sector decisions were taken and implemented; and second, the excessive size and involvement of the public sector in the economy. Based on these viewpoints, the World Bank spelled out a set of typical policy measures for the short to medium

term for policy and institutional reforms. These typically included trade and exchange rate liberalisation, domestic deregulation, financial liberalisation and divestiture of public enterprises through privatisation.

The central task of World Bank structural adjustment policy and associated institutional reforms was identified as correcting distortions in the incentive structure defined by policy environments and institutional arrangements. Thus, Yanagihara (1995) refers to Bank policy as the "framework" approach, where the focus is on the framework of economic system and management. The "framework" approach conceives the economy in terms of functions of institutions and mechanisms. Setting the "right framework" is considered a necessary, if not always sufficient, condition for success in terms of acheiving a sustainable external and internal macroeconomic balance and higher rates of growth.

World Bank structural adjustment policies have, by and large, been implemented across developing countries regardless of their stage of development and the degree of differentiation or sophistication of their economies. As a result, the Bank's approach has drawn criticism on the grounds that it pays inadequate attention to the organisational and institutional contexts in which economic agents find themselves or the limitations in the functioning of underdeveloped markets. The slowness of response to structural adjustment policy in low-income countries and some middle income-countries has renewed criticism of the Bank's approach. The central point of the criticism is a lack of adequate attention in Bank policy prescriptions to factors that determine the responsive capacity of the real sector to changes in government policy. These factors include the levels of development of infrastructure, accumulation of human capital, technological and managerial capabilities of private enterprises, and the development of various markets. While there has been recognition of the need to adopt supplementary measures to remedy such deficiencies, the Bank's policy prescriptions continue to emphasise the need to eliminate distortions in "frameworks". Even while the Bank has come to pay attention to factors such as infrastructure and human capital, they tend to be taken up from the perspective of the wider economic factor endowments. Yanagihara, thus argues that what is missing in the Bank's analytical viewpoint is "the evolutionary process of the formation and sophistication of an economic system as an integral aspect of economic development" (Yanagihara 1995: 17).

Based on the Japanese and East Asian experience of industrialisation, a policy document by Japan's Overseas Economic Cooperation Fund (OECF) advocated an alternative policy stance to that of the World Bank, with emphasis on the following policy areas:

* the need for direct policy measures to promote investment;
* conscious industrial policy for the promotion of leading industries;
* a recognition of the importance of directed and subsidised finance for the promotion of investment and infant industries; and
* a need to take actual economic, political and social conditions into consideration in making decisions with regard to privatisation.

Largely in response to the criticism of its stance, in Japan in particular, a research project on the role of public policy in economic development in East Asia was undertaken by the Bank. The outcome was the "East Asian Miracle" published in 1993. However, this has not been perceived as any real departure from the early Bank paradigm (Yanagihara 1994). The dominant school of thought in Japan argues for an "ingredients" approach as a distinct analytical standpoint and have adopted it in their criticism of the study and the World Bank approach in general. The ingredients approach adopts a different stance to the argument for getting the fundamentals right. Rather than leave everything to the functioning of markets, it recognises the need for partial selective intervention to ensure the effective functioning of market principles (Goto 1995).

The argument made by proponents of the ingredients approach is that the design of economic policy must be based on a realistic assessment of the existing productive capacities of an economy and of its capacity to achieve a given developmental goal (Yanagihara 1995). From the Japanese perspective, structural adjustment policies have to vary according to the stage of development. The ingredients approach focuses attention on the need to strengthen the capabilities of individual economic agents and on the formation, expansion and intensification of the networks that connect them. The Japanese perspective sees an economy as the sum total of the "ingredients" of which it is composed, where these "ingredients" refer to tangible organisational units such as enterprises, offices, factories and projects and their aggregations such as industries, sectors and regions. The ingredients may also cover factors of production such as land, labour, capital and technology at different levels of aggregation and specificity (Yanagihara 1995). Economic development is then projected as a quantitative expansion and a qualitative upgrading of the economy's "ingredients", accompanied by shifts in their composition. It is the strengthening of productive capacities and the evolution of organisational and institutional arrangements at the firm and industry level that are emphasised as the fundamental determinants of the dynamic process of economic development (Yanagihara 1995).

2.2 Historical Underpinning

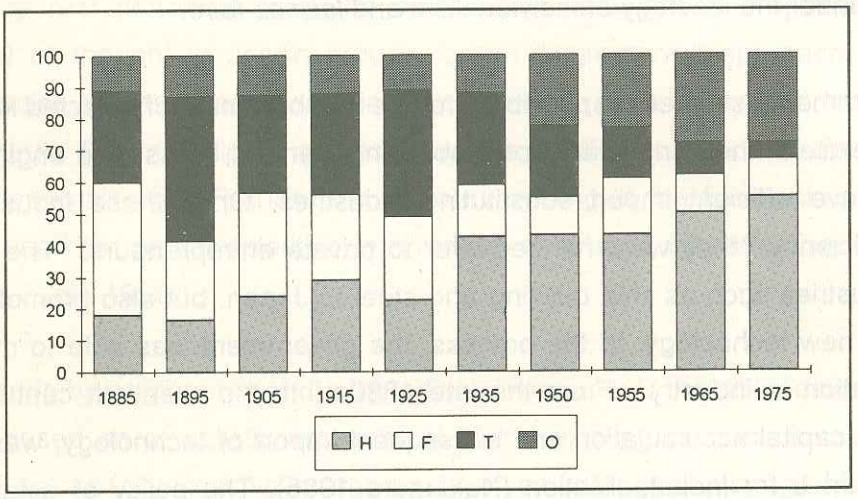
Japan's own path to industrialisation has shaped these views. In contrast to the modern economic growth experience of industrialized countries, Japan's industrialisation was rapid and unexpected. With roots in the Meiji dynasty (1868-1912), Japan began to carve out its own distinct path to economic development (from 1885 especially), spurred on by a desire to catch up with the West, both industrially and militararily. Throughout Japan's drive for industrialisation, a defining feature was the relationship between government and the private sector. From the outset, Japan saw a strong government dedicated to economic development to be essential and an integral part of "nation building" (Kwon 1994). This was in contrast to the British experience of industrial development -- that of the major power at the time -- which could prosper under the ideology of individualism and *laissez-faire*.

The Meiji government assumed responsibility for the establishment of selected key industries -- ranging from textile in the early years, to shipbuilding, cement, glass, and engineering -- in its efforts to achieve efficient import substituting industries. Once these industries achieved competitive efficiency, they were handed over to private entrepreneurs. The state not only introduced industries such as ship building and steel to Japan, but also promoted the regular introduction of new technology. In the process, the government was able to mobilise private sector participation in industry. From the late 1880s into the twentieth century, the private sector, through capital accumulation and subsequent import of technology, was an important partner in the drive for industrialisation (Nakamura 1985). The policy of establishing public sector enterprises and their subsequent sale to the private sector was to play a vital role in Japan's industrialisation strategy. It saw state nurturing and subsequent privatisation of major conglomerates, *zaibatsu*, and the evolution of a close cooperative relationship between business and government. It was a process which is generally no longer replicable, but the underlying state-business links warrant close attention.

In the aftermath of the Second World War, Japan's industrialisation policy differed from its Meiji past to the extent that it was no longer driven by military imperatives. Government involvement in the economy continued to be a decisive factor. Its influence remained powerful and widespread, though exercised through informal, cooperative arrangements with business. The renewed drive for industrialisation in post-war Japan was undertaken in the context of two defining features; a well developed agricultural sector and a stage of import-substitution behind heavily protective tariff and non-tariff barriers. The conventional view is that Japanese agriculture paid for the process of industrialisation during the early years, but that is only one

side of the story. Sustained growth of agriculture held a number of positive consequences for industrialisation. First, it expanded the domestic market for consumption goods and for certain other specific products like chemicals and machinery tools. Second, export earnings from agricultural products eased the country's balance of payments position and financed the imports that were necessary for industrial growth. Third, the surplus from the agricultural sector was available for utilisation in industrial investment. Productivity gains in the agricultural sector also meant that, increasingly, labour was released for employment in the industrial sector.

Figure 1
Manufacturing Output and its Composition in Japan



Notes: H - Heavy and Chemical Industry
F - Food Products
T - Textiles
O - Others

Source: Nakamura 1985

Rapid industrial growth was the result of the second important policy aspect of Japan's industrialisation. That is, an initial stage of import-substitution behind heavily protective tariff and non-tariff barriers. Figure 1 shows how Japanese industry has greatly expanded since 1945. The heavy dependence on textiles gave way to heavy industry, which rapidly out-stripped growth in food production and textiles. Industrial products, in contrast to agricultural products, displayed rapid and consistent productivity increases till 1970. Incentives for both import substitution and exports were supported by non-tariff barriers. Unlike many import substituting economies there was surprisingly high protection afforded to machinery. This reflected Japan's narrower technological focus in the later years. Effective Rates of Protection

(ERP) on the machinery sector were reduced in 1970 only after it was evident that the sector had become internationally competitive (Appendix Table A-1). Protection in capital-intensive sectors such as pulp, paper and chemicals also remained high. The textile industry was also highly protected.

Japan's success in its drive for rapid industrialisation has been widely credited to the institutional mechanisms through which the government established certain performance criteria to monitor performance and make selective interventions. In particular, the Ministry of International Trade and Investment (MITI) is said to have played a pivotal role in implementing Japan's policy of partial selective intervention. Government intervention took many forms: subsidies, in the form of priviledged access to credit facilities, strengthened protection offered to domestic producers, etc. Another form of policy intervention was granting credit to high yielding firms to help firms to realise static and dynamic economies of scale. Interest rate repression was a key to this directed credit program, and an important tool to influence the behavior of firms (World Bank 1993). This interventionist policy succeeded in achieving the desired goal of altering the industrial structure in Japan through careful screening and monitoring of projects and an orientation towards the private sector. The Ministry of International Trade and Industry also allocated foreign exchange to favored large firms and tried to ensure that technology payments to foreign firms were neither excessive nor duplicated.

Thirty years after the end of the Second World War, Japan had caught up with the richest nations of the world in terms of per capita income and output. Their major corporations are among the leaders in dozens of key industries, including electronics, automobiles, banking, ship building and steel production. More recently, despite having to struggle against a prolonged recession and an expensive currency, Japanese firms continue to maintain their international competitiveness through the rapid development of new products and the continuous upgrading of existing ones.[1]

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1 Since the beginning of the 1990s, Japan has been subject to its deepest and longest post-war recession with the bursting of the stock-market bubble in 1991. Growth on average over the past four years has been poor -- the last time Japan's GNP grew by more than 1 per cent was 1991. The unemployment rate at 3.4 per cent at the end of 1995 -- while relatively low for an industrialised nation -- is at a 42 year high for Japan. Japan is also undergoing change on the domestic political front, with the two principal political parties splintering and re-aligning themselves. Elements of political uncertainty and economic stagnation, however, is unlikely to translate into an industrial decline for Japan. The country registered a record trade surplus of US$ 121 million in 1994, and although that total declined in 1995, it is still very large by international standards. Japan's external reserves are only second to the USA and Germany.

2.3 An Influential Model?

The Japanese experience underscores the implications of the "ingredients" approach -- formulating economic strategy in the form of "ingredients" visions or plans for industries as well as for the overall economy. Japan employed direct policy measures to correct distortions in the incentive structure. For example, the government utilised fiscal and financial policies to promote strategic industries in post-war Japan. Directed and subsidised credit was used to promote desired industries and activities. Similarly, higher protection was offered to key industries that were considered desirable and vital for future growth. The historically close relationship between government and business meant that the working of the market mechanism in Japan was strengthened as networks were formed and developed.

Japan's trade and investment links with the rest of the world have also been governed by the nature of its approach to economic development. Its rapidly increasing balance of payments surpluses from the 1970s allowed Japan to redirect a substantial outflow in the form of official development assistance and direct investment. Japan's economic relations with its Southeast Asian neighbours in particular have been dictated by the need not only to procure a market for its expanding industries, but to establish a second production base to remain competitive in an expanding international market.

The changing face of Japanese manufacturing industry dictated Japanese FDI flows to Southeast Asia. It has come in three waves. The first wave was basically made to secure supplies of raw materials. The second wave came in the 1970s, aimed at the NICs, as Japan sought to enter their markets and to use them as export bases. The impetus for the third and largest Japanese wave of investment in Asia came in the mid-1980s with the revaluation of the Japanese yen vis-a-vis the US dollar. The 1985 Plaza Agreement among the Group of Seven industrialised nations brought a sharp appreciation of the yen and it encouraged Japanese manufacturers to find off-shore-production bases. Unlike the earlier wave of Japanese investment of the 1970s, which was mainly oriented towards the domestic market, the new wave was much more export-oriented. While it was triggered by the steep appreciation of the yen, it was the structural changes in the Japanese economy which greatly changed the pattern of comparative advantage in Japan and forced many Japanese manufacturing firms to relocate their labour intensive production processes abroad. The Japanese approach to economic relations -- placing strong emphasis on the formation of networks between firms in the form of long-term continuous transactions such as affiliation and subcontracting

arrangements -- have undoubtedly proved an advantage in establishing highly competitive ventures within such a setting.

East Asian economies, particularly the four "tiger" economies, have emulated the Japanese experience of industrialisation. Earlier claims by the World Bank that their economies followed "free market" policies has largely been replaced by an acknowledgement of the role of government intervention. The possibility of similar replication of the "Japanese model" in other developing countries has been widely debated, but an assessment of possible lessons for Sri Lanka from the Japanese experience of industrialisation cannot ignore the implications of the experience of the East Asian NICs. There were certain historical and geo-political factors that were obviously uniquely associated with the emergence of the original NICs, but that notwithstanding, the experience offers lessons that warrant careful study.

The geo-political position of their economies was of considerable importance. The overthrow of the Japanese was followed by US occupation and further reform. Throughout the 1950s and 1960s, their economies received large inflows of US aid. While aid flows have not been associated with the period of rapid industrialisation, inflows in the earlier period undoubtedly created the foundation on which industrialisation was based.

Another significant factor was the point in time at which the NICs export-oriented industrialisation policies were undertaken. The 1960s and 1970s was a period of rapid growth of international trade and market liberalisation. Quite clearly, therefore, the global economic environment was extremely favourable as far as the possibility of export-oriented industrialisation was concerned.

In some important ways, however, Japan created the conditions for the industrialisation of these countries. Land reform in Taiwan and South Korea was a significant outcome of colonisation by Japan, and proved to be an important factor in their subsequent development and industrialisation. The colonial links and associations with Japan were also of much wider importance in terms of the development of infrastructure, industry and technology. These economies emulated the "Japanese model" of industrialisation -- offering selective protection to domestic industries while pursuing an active export strategy. In so doing, they benefitted vastly from significant Japanese trade and investment in the region.

South Korea was clearly the East Asian economy to follow most closely the Japanese experience. There is close geographical proximity, but more than that, the economic

frameworks of South Korea and Japan are remarkably similar in many respects. At the centre of their economic success lies a strong government-business alliance, the dominance of a handful of large business groups, an emphasis on heavy industry, and competitive education systems that have produced efficient administrators to steer the economy towards rapid growth. South Korea's fast-growing industrial base owed much in its early years to Japanese involvement. Japanese aid and soft loans to South Korea financed investment in steel and railways in the late 1960s. During the 1970s, Japanese companies made significant investments in petrochemicals and consumer electronics. At the same time, Japanese electric and electronic companies led a flood of Japanese low-end manufacturers into the free export zones. A beneficiary of the Japanese experience, South Korea moved into the void left by Japan to supply the international market with cheap-labour manufactures.

The rapid economic growth of the second-tier NICs over the last decade has renewed the debate on the "Japan model". The concept of one "Asian model" applicable across the broad spectrum of the East Asian economic experience, however, needs to be qualified. There are differences. Japan and South Korea maintained high rates of savings that were rechannelled back to government-sponsored export-oriented industries. These countries built their economies over decades of deferred spending, high savings rates and export-led growth. While the newly emerging NICs maintain a very healthy rate of domestic savings at around 30 per cent of GDP, they are also big consumer spenders. Japan and South Korea industrialised in an environment of fixed exchange rates and closed capital markets, where consumption expenditure was easier to suppress. These economies also had more means of intervention to achieve an equitable distribution of the gains from rapid growth.

There is also an intense debate over the extent to which government policy "followed" or "led" the market and the efficacy of interventionist-style industrial policy. The relative efficiency of Japanese industrial policy, especially in promoting high technology has in large part been a reflection of the distinctive nature and structure of Japan's political economy. Here again, South Korea's approach was closer to the Japanese model. The state sought to encourage private enterprises to invest in prioritized industries through various incentives -- including the granting of credit on very favorable terms, affording protection to infant industries and providing various forms of infrastructural support. Amsden (1990), for example, has argued that industrial targeting initiatives in South Korea proved successful because the state was able to "discipline" firms by pressuring them to make productive use of the various subsidies they received and, typically, to lift export performance.

Business-government interactions in the newly emerging NICs of Southeast Asia are argued to differ from the experience of Japan and South Korea (MacIntyre 1994). The most obvious difference is the existence between government and business of clientelistic links -- that is, the selective application of government policy and the granting of rents on the basis of personal connections. However, while clientelism is perceived to be commonplace in countries such as Malaysia and Thailand, it is argued that the problem of bureaucratic "capture" is not endemic in these countries. Relatively open political systems, with political parties and business organisations, are argued to provide meaningful channels for political action by business groups to push for economic reforms (Bowie 1994; Laothamatas 1994). While the state structures in Thailand and Malaysia may be less coherent and disciplined than in Japan or South Korea, they are, nonetheless, presiding over impressive economic transformations.

2.4 Industrialisation in Sri Lanka

Sri Lanka's experience has differed from those of Japan and East Asia in two ways. First, Sri Lanka has attempted to industrialise in the absence of agricultural diversification and agro-industrial development. Second, while Sri Lanka implemented its own land reform programme, it was of a distinctly different nature to that of the East Asian countries.[2] Finally, Sri Lanka continued with a prolonged period of ever stringent import restrictions for much of the 1960s and 1970s that effectively discouraged production for the export market.

The Sri Lankan experience of industrialisation divides into three distinct stages. From independence to the mid-1950s, the country followed a generally "open" economic system, inherited from the colonial powers. A favourable balance of payments (BOP) position, given boom conditions for Sri Lanka's traditional exports instilled a certain degree of inertia in formulating an industrial policy for the country. Beset with increasing BOP problems from the mid-1950s, there was a discernible shift towards the adoption of a restrictive trade and payments policy. Effectively, the period 1960-1977, can be characterised as one in which Sri Lanka, as well as many other contemporary developing countries, followed a strategy of import substituting industrialisation (ISI) spearheaded by the public sector. State enterprises were heavily subsidised and protected from competing foreign imports by import licences and restrictions on foreign investment. It was only in 1977 that Sri Lanka once again changed direction with the introduction of a package of economic reforms in line with outward-oriented growth strategy policies.

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2 The Land Reform Law of 1972 imposed a ceiling of 25 acres for cultivation of rice and a ceiling of 50 acres for other uses. Lands in excess of these were to be vested with the Land Reform Commission established under the Act.

The measures introduced in 1977 were broadly in line with policy measures recommended by the World Bank/IMF structural adjustment programmes. Following World Bank guidelines, the policy package introduced in Sri Lanka included import liberalisation, a significant devaluation of the exchange rate, the removal of most price control measures, liberalisation of the financial sector and elements of privatisation. There was, however, a lack of a specific policy on industrialisation. Although there was an emphasis on the need for manufactured export growth, this was largely left in the realm of trade and payments liberalisation -- that is, to tariff liberalisation and exchange rate devaluation.

It was only in 1987 that the government set out an explicit industrial policy, with amendments in an Industrial Policy Statement in 1989. The latter set out policy intentions in a large number of related areas, including the following: (a) active promotion of products where Sri Lanka has a comparative advantage; (b) creating a competitive environment and deregulation of remaining controls; (c) encouraging domestic saving and promoting local and foreign investment and; (d) the granting of upfront assistance, provision of infrastructure, improving management, raising productivity, and other measures to reduce the costs of production.

The 1987 Industrial Policy Statement broadly favoured the following: low protection, an exchange rate which is not overvalued, compensatory support for exporters to provide a broadly neutral incentive structure, the commercialisation of public enterprises, and measures to attract greater Foreign Direct Investment (FDI) into the country. The Industrial Policy Statement of 1989 placed greater emphasis on the development of exports, tax holidays to reduce tariff differentiation, and development of infrastructure, as the main ingredients to generating industrial growth.

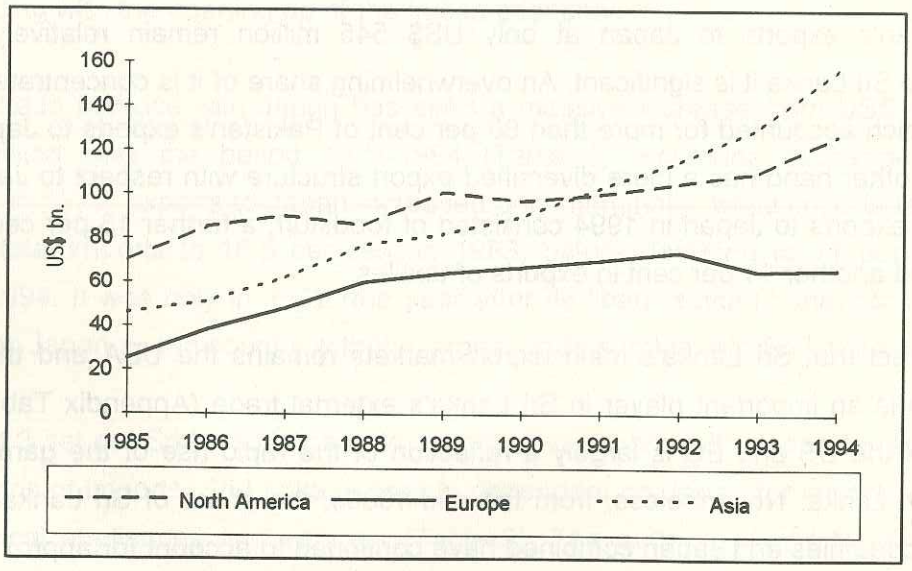
However, even if trade liberalisation had been achieved to a greater extent than was in fact the case, it would not have been sufficient for the spontaneous development of a diversified industrial structure. Countries like South Korea and Taiwan combined outward orientation with selective protection and institutional support for a few complex industries. These governments forcefully supervised the move into new industries through high and variable rates of effective protection, preferential access to credit, ample supplies of technical manpower and sophisticated science and technological institutions. Dependence on trade policy meant that it lacked any systematic approach to the protection of infant industries as a means to encourage the acquisition of technological capability and the attainment of international competitiveness. Other policies implemented can be regarded as supportive of the new trade policy rather than as representing a coherent industrial strategy in themselves.

Though the manufacturing sector did grow, it was concentrated in labour intensive sectors. The policy of a generalised promotion of manufacturing activities aimed at maximising gross earnings of foreign exchange failed to allow a shift form labour intensive to capital intensive activities. Instead, there was an initial surge in the production of industries such as textiles and wearing apparel, after which the stimulant of trade liberalisation petered out. In this regard, foreign investment played a major part in boosting Sri Lanka's manufacturing exports (thanks to low relative wage costs and unutilized Multi Fibre quotas). However, there was hardly any progress in the more complex assembly-type activities.

3. Trade

By and large, Japan's role in Asia in the post-war period has been confined to trade and investment. Its increasing trade links with the region is regarded as evidence of ever closer economic links with Asia. Japan's market share in Asia outstrips US and European competitors in several key sectors such as cars, consumer electronics and industrial machinery. Asia overtook the US as Japan's largest export destination in 1991, and in 1993, Japan's trade surplus with Asia surpassed its surplus with the US for the first time. In 1985, Japan exported a third more to the US than it did to Asia. Ten years later it exports a quarter more to Asia than to the US, and nearly three times as much to Asia as to Europe (Figure 2).

Figure 2
Trend in Japanese Exports



Source: The Economist, 22 April 1995

Appendix Tables A-2 and A-3 set out Japan's export and import trade with Thailand, Malaysia, India and Pakistan for 1994. The relative composition of Japan's export trade with some of Sri Lanka's competitors in the Asian region suggests a certain similarity in composition vis-a-vis Sri Lanka. The data indicate that the vast bulk of Japanese exports to these countries consist of machinery and equipment, with the partial exception of India (Appendix Table A-2). For example, of total exports to Pakistan from Japan in 1994, exports of motor vehicles alone accounted for approximately a quarter. Malaysia and Thailand still continue to be heavily reliant on Japan for imports of machinery and equipment.

Of more interest is a comparison of exports to Japan from these countries as they effectively constitute Sri Lanka's competitors in the Asian region (Appendix Table A-3). More than a third of Thai exports to Japan are agro-livestock products, where a substantial volume is exported via Thai-Japanese joint ventures (Glover and Lim 1992). Thailand also exports a significant proportion of machinery and equipment. In 1994, Thailand exported US$ 2.1 billion worth of machinery and equipment to Japan, whereas the comparable worth of exports from Sri Lanka was only US$ 12.6 million.

Raw materials such as wood, rubber and tin accounted for approximately a quarter of total Malaysian exports to Japan in 1994. In the early 1980s, nearly 90 per cent of Japanese imports from Malaysia consisted of primary commodities. The structure of Malaysia's exports to Japan has thus shifted away from raw materials to machinery and electronic and electrical products.

While Pakistan's exports to Japan at only US$ 545 million remain relatively limited, in comparison to Sri Lanka it is significant. An overwhelming share of it is concentrated in exports of textiles, which accounted for more than 80 per cent of Pakistan's exports to Japan in 1994. India, on the other hand has a more diversified export structure with respect to Japan. Over a quarter of its exports to Japan in 1994 consisted of foodstuff, a further 13 per cent in exports of iron ore and another 11 per cent in exports of textiles.

Despite the fact that Sri Lanka's main export markets remains the USA and the European Union, Japan is an important player in Sri Lanka's external trade (Appendix Table A-4). The dominance of the US and EC is largely a reflection of the rapid rise of the garments export industry in Sri Lanka. Nevertheless, from the mid-1980s, the share of Sri Lankan exports to East Asian economies and Japan combined have continued to account for approximately 9-10 per cent of total exports.

Table 1
Sri Lanka's Trade Balance with Japan: 1977-94

Year	Exports		Imports		Trade Balance	
	US$ mn	%	US$ mn	%	Japan/SL (US$ mn)	Sri Lanka (US$ mn)
1977	20.7	4.8	25.6	6.3	-4.9	22.5
1978	49.8	5.8	102.5	10.2	-52.8	-154.3
1979	67.4	6.8	194.5	13.3	-127.1	-471.7
1980	30.8	3.2	239.0	12.7	-208.2	-906.2
1981	47.4	4.6	241.8	13.8	-194.5	-759.9
1982	49.1	4.9	262.7	13.5	-213.6	-957.0
1983	45.6	4.5	298.4	16.5	-252.8	-806.7
1984	60.4	4.2	297.7	15.6	-237.3	-450.9
1985	64.9	4.9	279.8	13.8	-214.9	-722.4
1986	65.9	5.5	313.3	16.2	-247.4	-750.0
1987	64.4	4.8	291.2	14.7	-226.8	-650.4
1988	81.8	5.8	293.8	13.6	-212.0	-734.7
1989	80.2	5.7	233.8	11.7	-153.6	-601.3
1990	101.9	5.4	323.9	12.1	-222.0	-699.4
1991	98.7	5.1	348.2	11.8	-249.5	-968.8
1992	122.0	5.2	396.0	11.7	-274.0	-995.3
1993	144.3	5.2	441.3	11.3	-297.0	-1119.6
1994	163.4	5.2	520.6	11.0	-357.2	-1553.5

Source: Central Bank of Sri Lanka

Japan is the single largest source of imports to Sri Lanka -- consistently accounting for 11-13 per cent of total imports since 1980 (Appendix Table A-5). Sri Lanka has increasingly become heavily reliant on imports from the East Asian economies to source its import dependent garments industry. Since 1991, there has also been a substantial increase in imports from India, coinciding with the opening up of the Indian economy.

Sri Lanka's trade balance with Japan has seen a massive increase from US$ 4.9 million to US$ 357 million over the period 1977-1994 (Table 1). Following exchange and import liberalisation in 1977, exports to Japan increased only marginally, while imports leapt from 6.3 per cent of total imports to 16.5 per cent in 1983, before declining to 11 per cent of total imports by 1994. It was only in 1992 (the year after its liberalisation), that for the first time, India overtook Japan as the country with the largest trade surplus with Sri Lanka.

Tables 2 and 3 set out Sri Lanka's trade in imports and exports with Japan for some selected years. In terms of imports, Sri Lanka is heavily dependent on Japan for imports of machinery and mechanical appliances and vehicles (Table 2). The outlay on imports of vehicles has

increased consistently from 25 per cent in 1979 to over 40 per cent of total imports from Japan.

Table 2
Sri Lanka's Imports from Japan

Product (HS Code)	1979		1980		1993		1994	
	US$ mn.	(%)	US$ mn.	(%)	US$ mn.	(%)	US$ mn.	(%)
12. Oil seeds	0.3	0.3	0.3	0.1	0.5	0.1	0.7	0.1
16. Preperations of meat/fish	6.4	3.3	7.3	3.1	1.8	0.4	2.9	0.6
25. Salt/sulphur	0.2	0.1	5.4	2.3	2.5	0.6	2.1	0.4
27. Mineral fuels	1.2	0.6	0.5	0.2	1.8	0.4	1.0	0.2
28. Inorganic chemicals	1.0	0.5	0.9	0.4	1.8	0.4	1.4	0.3
29. Organic chemicals	0.9	0.5	1.2	0.5	3.4	0.8	4.0	0.8
30. Pharmaceutical products	0.4	0.2	0.5	0.2	1.0	0.2	1.3	0.3
31. Fertilizers	7.8	4.0	8.1	3.4	12.7	2.9	3.7	0.7
32. Tanning/dyeing extracts	0.8	0.4	0.7	0.3	2.5	0.6	2.8	0.5
37. Photographic goods	0.3	0.1	0.4	0.2	3.2	0.7	3.3	0.6
38. Misc. chemical products	0.4	0.2	0.6	0.3	1.7	0.4	2.9	0.6
40. Plastics	4.7	2.4	6.0	2.6	8.0	1.8	9.0	1.7
41. Rubber	2.5	1.3	4.1	1.7	8.1	1.8	6.3	1.2
48. Paper	1.6	0.8	2.3	1.0	3.1	0.7	3.3	0.6
51. Man-made fibres (contd)	19.3	9.9	13.6	5.7	31.8	7.2	36.6	7.0
55. Cotton	1.6	0.8	1.7	0.7	12.7	2.9	8.4	1.6
56. Man-made fibres (discont)	9.2	4.7	12.1	5.1	2.6	0.6	2.2	0.4
68. Articles of stone/plaster	1.2	0.6	0.4	0.2	1.0	0.2	1.0	0.2
73. Articles of iron/steel	19.1	9.7	22.7	9.6	17.7	4.0	24.8	4.8
74. Copper	0.7	0.4	0.8	0.3	1.9	0.4	1.7	0.3
84. Machinery & mechanical appliances	29.7	15.2	29.6	12.5	83.6	18.9	68.8	13.2
85. Electrical machinery	14.6	7.5	17.7	7.5	46.1	10.4	71.2	13.7
87. Vehicles other than railway	48.8	25.0	81.8	34.6	153.9	34.9	215.7	41.4
90. Optical/photographic equipment	2.0	1.0	2.3	1.0	11.7	2.7	14.6	2.8
Other	20.7	10.6	7.6	6.5	26.2	6.0	30.9	6.0

Source: Department of Customs, Sri Lanka.

There has been little change in the composition of Sri Lanka's exports to Japan over the past fifteen years. Exports of pearls and marine products continue to dominate the picture (Table 3). Exports of pearls alone have consistently accounted for a little under a quarter of total exports to Japan, though there have been some gains in exports of labour-intensive manufactures such as toys and garments. More encouragingly, Sri Lanka has also made strides in raising her level of exports of electrical machinery to Japan, although they remain fairly negligible at around 5.4 per cent of total exports to Japan in 1994. In absolute terms, while imports of electrical machinery increased from US$ 0.6 million in 1992 to US$ 8.9 million

in 1994, exports of machinery and mechanical appliances fell sharply from US$ 8.6 million in 1993 to US$ 3.7 million in 1994.

Table 3
Sri Lanka's Exports to Japan: 1979-94

Product (HS Code)	1979		1980		1993		1994	
	US$ mn.	(%)	US$ mn.	(%)	US$ mn.	(%)	US$ mn.	(%)
3. Fish/crustaceans	11.8	17.6	6.2	20.1	27.3	18.9	39.2	24.0
6. Live trees/other plants	0	0.0	0	0.0	0.6	0.4	1.4	0.9
7. Edible vegetables	0	0.0	0	0.0	0.2	0.2	0.5	0.3
9. Coffee/tea	7.8	11.7	6.5	21.3	13.2	9.2	15.5	9.5
12. Oil seeds	3.5	5.2	1.6	3.3	0.1	0.0	0.1	0.0
15. Animal/vegetable fats	0.8	1.2	0.0	0.0	0.4	0.2	0.2	0.1
25. Salt/sulphur	1.9	2.9	1.5	4.9	1.4	1.0	1.5	0.9
26. Ores/slags	0.8	1.2	0.9	3.0	1.5	1.0	1.2	0.7
27. Mineral fuels	16.7	24.8	0.0	0.0	4.6	3.2	0.0	0.0
30. Pharmaceutical products	0.0	0.0	0.0	0.0	0.7	0.5	1.1	0.6
37. Photographic goods	0.1	0.1	0.1	0.4	0.3	0.2	0.4	0.2
38. Misc. chemical products	0.0	0.0	0.0	0.0	0.6	0.4	1.6	0.6
40. Rubber products	1.5	2.2	1.3	4.3	5.1	3.5	5.4	3.3
42. Articles of leather	0.0	0.0	0.0	0.1	0.6	0.4	1.5	0.9
44. Wood	2.5	3.7	1.9	6.4	0.4	0.3	0.6	0.3
48. Paper	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
56. Man-made fibres	0.0	0.0	0.0	0.0	0.1	0.1	0.4	0.3
57. Paper yarn & woven fabrics	2.7	4.0	2.0	6.5	2.4	1.6	3.0	1.8
61. Non-knitted apparel accessories	0.2	0.3	0.4	1.3	9.0	6.3	0.9	6.1
62. Other made-up textile articles	0.0	0.0	0.0	0.0	0.7	0.5	1.4	0.8
69. Ceramic products	0.0	0.0	0.0	0.4	0.6	0.0	1.2	0.7
71. Pearls	15.3	22.8	7.1	23.1	34.2	23.7	40.0	24.5
73. Iron/steel	0.0	0.1	0.1	0.3	0.3	0.2	0.4	0.2
74. Copper	0.0	0.0	0.0	0.0	0.5	0.4	0.8	0.5
84. Machinery and mechanical appliances	0.1	0.1	0.0	0.0	8.6	5.9	3.7	2.3
85. Electrical machinery	0.0	0.0	0.0	0.1	3.0	2.1	8.9	5.4
97. Toys/games	0.0	0.0	0.0	0.0	16.1	11.2	10.5	6.4
98. Misc. manufactures	0.3	0.5	0.5	1.7	6.1	4.2	7.0	4.3
Other	1.1	1.6	1.1	3.2	5.5	3.9	6.4	4.3

Source: Department of Customs, Sri Lanka

Sri Lanka's comparative advantage in manufactured exports vis-a-vis Japan lies in low skill, labour-intensive products. India and Pakistan have exploited their advantages to penetrate the market for textile and garments in Japan, exporting US$ 295 million and US$ 440 million worth of textiles respectively in 1994. Sri Lanka's exports of textiles and garments to Japan remain marginal, the percentage of total exports of this sector to Japan stagnating at around 1 per cent. Given that Japan is not a signatory to the Multi-Fibre Arrangement (MFA), and Sri Lanka

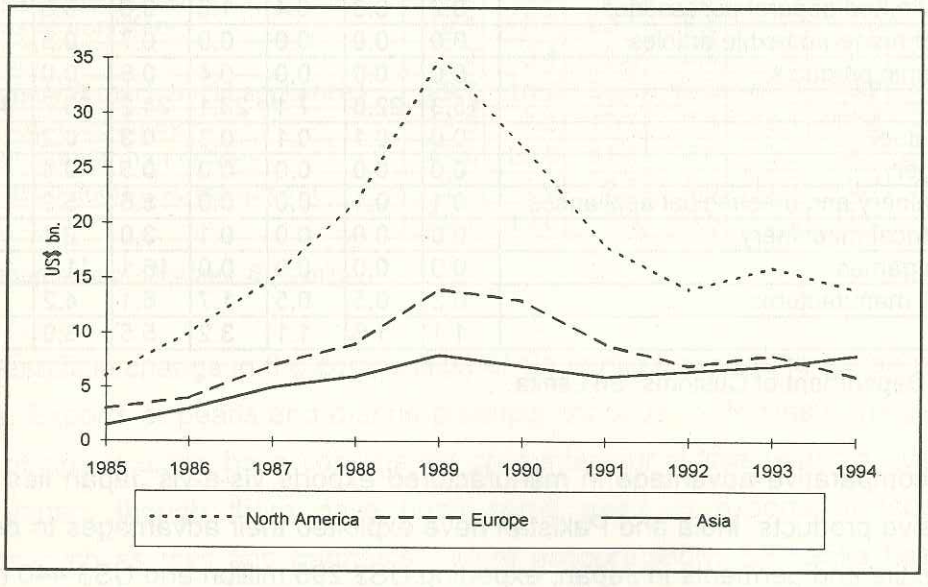
has been making rapid strides in exports of non-quota garments (increasing from 13 to 20 per cent between 1993 and 1994), Sri Lanka's poor export record to Japan is disappointing.

4. Foreign Direct Investment

While Japanese companies were granted permission to invest overseas in 1951, it was not until the 1970s that there was a substantial outflow in line with Japan's increasing balance of payments surpluses. The year 1972 is regarded as the "first year of investment". In the two years, 1972-73, Japanese FDI was greater than in the preceding twenty years. Overseas investment became an integral part of Japanese corporate strategy in the light of Japan's growing current account surpluses, rapid appreciation of the yen, and increasing real labour costs at home.

Japan is by far the largest single foreign direct investor in the Asian region as a whole. In the early 1980s, the U.S. and the U.K. were the traditional leaders in foreign investment, but, by 1989, Japan had become the dominant source of FDI. Japanese FDI to Asia multiplied more than three-fold from US$ 2.3 billion in 1986 to US$ 9.3 billion in 1994 (Figure 3). Since 1992

Figure 3
Trend in Japanese FDI



Source: The Economist, 22 April 1995

nearly a fifth of Japan's FDI has gone to Asia. In the early 1980s, Japan and the US had the same level of investment in East Asia. Now, the stock of Japanese investment in the region is roughly double that of the US.

The recent upsurge in Japanese investment in Asia has undoubtedly arisen because of the economic boom in the region. A survey conducted by Japan's Export-Import Bank at the beginning of 1995 suggested that, over the coming three years, three-quarters of Japan's new FDI will find its way to Asia (The Economist, 22 April 1995). Such optimism, however, may be somewhat misplaced. The most significant surge in Japanese FDI to Asia took place in the post-1991 period. In the five years from 1985, when the yen began to appreciate, roughly two-thirds of Japan's FDI went to the US and Europe and barely a tenth went to Asia.

Nevertheless, as Asia continues to boom, we can expect Japanese investment in the region to keep growing. Japanese companies have established dominant positions in the sectors in which they are traditionally strong -- cars, electronics and machine tools. This will give them great competitive strength, not just in Asia, but also in Western markets supplied by relatively low-cost Asian plants. Enthusiasm for the region has been fuelled by low returns on investment in the US and Europe. An official survey of Japanese manufacturers suggest that while Asian subsidiaries recorded a 4 per cent profit margin in the year to March 1994, subsidiaries in the US made little or nothing and those in Europe made losses equal to 1 per cent of turnover (The Economist, 22 April 1995). In response, as Japanese firms cut their investments outside Asia, the share of Japanese investment in Asia has shown a marked increase. In absolute terms, however, the flow of Japanese FDI to Asia is yet to regain the peak level of 1989.

The relative importance of Japanese FDI in Sri Lanka, however, has been rather muted. With the liberalisation of the economy in 1977, Sri Lanka embarked on a concerted drive to attract FDI into the country. The main thrust of the policy was centred around the establishment of Export Processing Zones (EPZs) to create a climate conducive to attracting foreign investment. FDI inflows to Sri Lanka, however, have averaged roughly 0.5-1 per cent of GDP since the mid- 1980s, although there has been an increase in the 1990s. Compared to rates of well over 5 per cent of GDP in Malaysia and Thailand, Sri Lanka's total FDI inflow has been rather disappointing.

Table 4
Approved FDI in Sri Lanka from Selected Countries (end 1994)

COUNTRY	UNITS		FOREIGN INVESTMENT	
	No.	% of total no. of projects	US$ mn.	% of total foreign investment
a. Hong Kong	30	3.0	54.3	4.6
b. JV[a]	23	2.3	52.9	4.8
a. Singapore	16	1.6	30.2	2.8
b. JV	29	2.9	200.5	18.3
a. Korea	76	7.7	158.6	14.5
b. JV	30	3.0	28.0	2.6
a. Taiwan	9	1.0	6.4	0.6
b. JV	14	1.4	5.7	0.5
a. Japan	32	3.2	73.2	6.7
b. JV	32	3.2	16.3	1.5
a. Germany	23	2.3	25.8	2.3
b. JV	34	3.4	39.4	3.6
a. UK	44	1.1	6.8	0.6
b. JV	35	3.5	38.6	3.5
a. USA	16	1.6	28.5	2.6
b. JV	28	2.8	14.2	1.3

Notes: a. JV - Joint venture projects
Source: Board of Investment of Sri Lanka.

In Sri Lanka, at the commencement of economic reforms in 1977, the manufacturing sector was host to a total of 70 foreign firms. Since 1977 this total has increased significantly. At the end of 1994, the Board of Investment of Sri Lanka (BOI) was host to 449 commercial projects in operation with foreign capital participation, with a total foreign investment contribution of US$ 564.9 million and local investment of US$ 374.5 million. FDI in Sri Lanka is disproportionately concentrated in the garments and service sectors (Appendix Table A-6). The textile and garments industry is host to a total of 97 projects, with a foreign investment contribution of US$ 131.9 million (23.3 per cent of total FDI). The service sector has attracted a total of 138 projects and foreign investment of US$ 279.6 million (49.5 per cent of total FDI).

Looking at the country composition of FDI in Sri Lanka, it is clear that much of it originates from the East Asian economies, particularly from Hong Kong, Singapore and South Korea (Table 4). This trend is not surprising given that much of FDI in Sri Lanka has tended to be concentrated in the textile and garments sector. The imposition of stringent quotas on garments exports to the USA and European Union meant that many garments exporters from East Asian economies moved their operations overseas as a means of "jumping" quotas. Japan, on the other hand, was not a signatory to the MFA and had no reason to seek quota rents through the production of garments in Sri Lanka for the home market.

Japanese FDI in Sri Lanka accounts for around 8 per cent of Sri Lanka's total FDI. The comparable figure for Japanese FDI in Thailand on the other hand is as much as 38 per cent (US$ 16.3 billion) of total cumulative FDI, while that of Malaysia is approximately 23 per cent or US$ 2.3 billion (Table 5). Their greater success in attracting Japanese FDI relative to Sri Lanka can be argued to be a reflection of the fact that these economies have been more open to the Japanese "ingredients" approach in pursuing an export-led strategy. In an attempt to emulate Japan, Malaysia embarked on its "Look East" policy in the early 1980s, placing increasing emphasis on the development of heavy industries. Malaysia and Thailand have been able to maintain an overall economic policy stance that has been both pro-market and outward-oriented, providing an incentive regime to prioritised industries along the lines adopted by Japan and the "tiger" economies.

Table 5
Cumulative FDI in Thailand and Malaysia: 1993
(per cent)

Country	Thailand	Malaysia[a]
US	11.9	7.0
Europe	21.9	n.a.
Japan	38.1	22.7
Hong Kong	6.6	3.0
South Korea	1.5	2.9
Taiwan	9.2	22.8
Singapore	6.3	6.7
Others	4.5	35.0
Total (US$ billion)	42.9	10.1

Notes: a. FDI from Europe is included under "other".
Source: Ministry of International Trade and Industry, *White Paper on International Trade, Japan 1994*, Japan.

A breakdown of foreign investment in BOI enterprises by industrial category for some selected countries at end 1993 shows that nearly a half of foreign investors from Hong Kong and the USA have invested in garments (Table 6). The investment profiles of Japan and South Korea are the most diversified, ranging from garments to ceramics and electrical products.

Table 6
Number of Enterprises by Industrial Category for Selected Countries (in operation at end 1993)

Category	USA	UK	Germany	HK	Japan	Korea
Food			1		2	
Garments	8	6	5	17	3	12
Wood Products				2		1
Chemical Products	1		1	3	1	2
Fabricated Metal Products					2	
Jewellery	2	1			2	1
Tobacco						
Ceramics/Minerals	1			1	3	5
Toys			1		2	8
Electric/Electronic Products	1	2	1	1	2	3
Services	1	1	1	3	3	
Other	4	6	7	7	6	27
Total	18	16	17	34	26	59

Source: National Planning Department, *Sri Lanka Industrial Statistics 1993.*

Japanese FDI has played a significant role in the economic growth of the Southeast Asian countries, and, while there is an often expressed desirability for a similar role in Sri Lanka, to date the contribution of Japanese FDI towards transformation of the Sri Lankan manufacturing sector has been very limited. Table 7 gives a breakdown of cumulative Japanese FDI by sector in Sri Lanka for the years 1983, 1989 and 1995. As the figures indicate, there has been a significant increase in Japanese investment in Sri Lanka's textile and garments industry. In 1983, roughly a quarter of total Japanese investment was in this industry, but by 1995, this

Table 7
Sectoral Classification of Japanese FDI in Sri Lanka (US$ million)

	1983			1989			1995		
	No	F/I[a]	L/I[b]	No	F/I	L/I	No	F/I	L/I
Food, beverages & tobacco							3	2.1	1.3
Textile, wearing apparel & leather	1	0.2	0.2	2	0.4	0.3	7	28.0	0.6
Non-metallic mineral products	1	0.5	0.2				8	3.4	1.6
Fabricated metal, transport & machinery							4	2.2	0.4
Manufactured products (nes)	1	0.1	0.2	2	0.2	0.4	7	7.2	0.8
Services				1	18.9	6.4	8	18.7	8.4
Total	3	0.8	0.7	5	19.5	7.1	37	61.6	13.0

a. Cumulative foreign investment in US$ million.
b. Cumulative local investment in US$ million.

Source: Board of Investment of Sri Lanka.

ratio had jumped to more than 45 per cent. In the latter half of the 1980s, there has also been a noticeable increase in Japanese FDI in the services sector, although it appears to have tapered off in the 1990s. A single project in ship repair services alone accounts for US$ 15 million of the total US$ 19 million Japanese investment in the services sector. Most noticeably, Japanese FDI in assembly-type operations has been disappointingly small. This is in contrast to the experience of Southeast Asian countries. For example, Japanese FDI in the electrical machinery industry in Malaysia and Thailand accounted for approximately 28 and 18 per cent of total Japanese FDI respectively in 1993 (Table 8).

Table 8
Japan's Cumulative FDI in Selected East Asian Economies by Industry: 1993
(per cent)

Sector	Thailand	Malaysia	South Korea
Chemical	4.8	9.3	10.0
Transportation machinery	4.8	4.6	6.9
Electrical machinery	18.1	27.4	11.7
Other manufacturing	37.6	31.2	18.9
Real estate	2.9	0.3	6.1
Finance and insurance	2.3	3.7	2.2
Other non-manufacturing	29.6	23.4	44.3
Total (US$ billion)	6.2	5.0	4.8

Source: Ministry of International Trade and Industry, *White Paper on International Trade Japan 1994*, Japan.

It can be argued that the poor response to Sri Lanka's efforts to attract FDI into high-tech assembly-type production from Japan has been due to the fact that the timing of Sri Lanka's policy initiative was out of line with basic developments in the Japanese economy. The manufacturing sector was the driving force behind Japanese FDI in the 1970s (Table 9). With the liberalisation of foreign exchange controls and financial regulations in the early 1980s, Japan's finance and insurance industry began to expand overseas significantly. At the same time, the shifting export composition of Japanese manufactured goods (to high technology, high value-added products such as electronics and automobiles) prompted rapid FDI increases in related industries.

Table 9
Japanese Global FDI by Sector: 1951-93
(US$ billion)

Sector	1951-71	1972-80	1981-85	1986-90
Primary Sector	1.1	6.9	5.0	5.7
Manufacturing	1.2	11.4	11.8	57.2
Services	0.8	6.0	16.5	60.2
Finance	0.5	2.6	11.0	97.8
Others	0.8	5.2	2.9	6.4
Total	4.4	32.1	47.1	227.2

Source: Jun, K., et al, (1993)

Economic developments in Japan's Southeast Asian neighbours, on the other hand, were far more conducive to attracting FDI. As previously discussed, these economies had implemented a coherent set of policies geared towards encouraging export-oriented industrialisation well before Sri Lanka's own attempts. They were thus well placed to benefit from the rapid increase in Japanese FDI from the 1970s.

South Korea was one of the early beneficiaries of Japanese FDI. Japan has been the single largest foreign investor in South Korea during the past three decades -- accounting for 39 per cent of total foreign investment. However, Japanese investment in South Korea has dwindled since its peak around 1970. Since 1965, for example, Japanese companies have invested less in South Korea than the US$ 4.4 billion that poured into China from Japan in 1994 alone (Financial Times, 15 November 1995). There are many reasons for this. Most importantly, South Korea has among the highest wage and land costs in the Asian mainland. There continues to be an import ban on more than 250 Japanese products, imposed since the 1970s, and this has effectively deterred Japanese companies from investing.[3] The surge in the value of the yen since the mid-1980s has also meant that Japanese companies operating in South Korea have suffered shrinking profits. This has been heightened given that South Korea is still dependent on the import of expensive Japanese produced parts. Investment in South Korea's service industry, on the other hand, avoids some of these problems and continues to be more attractive to Japanese investors. Given the significant flow of Japanese tourists to South Korea, investing in the hotel industry in particular, remains an attractive alternative.

Japanese investors have therefore increasingly turned their attention to other East Asian economies. Over the last eight years, Japan has been the biggest investor in Malaysia, with

3 In an effort to improve bilateral economic cooperation, South Korea has, however, promised to halve the number of banned Japanese products by 1998.

approved Japanese investment having risen by nearly nine times since 1987 (Financial Times, 15 November 1995). While Japanese investment in Malaysia is still to regain its peak level of 1990, inflows continue to be strong. The trends in Japanese investment in Thailand best exemplifies its growing influence in the economic development of second-tier NICs, and holds important lessons for Sri Lanka. Japanese companies have been a prominent fixture in Thailand for three decades. By the 1990s, Japanese investment accounted for more than 38 per cent of total foreign investment in Thailand -- with the US lagging at 11.9 per cent (Table 5). Thailand is experiencing a resurgence of Japanese investment, strengthening its existing dominance of Thailand's manufacturing sector. Japanese companies are likely to have investment upto US$ 800 million in 1995, a half of all new investment in manufacturing industries this year (Financial Times, 15 November 1995).

The experience of Thailand is a case in point in identifying a trend in Japanese investment in the East Asian region. In the initial stages, Japanese investment tended to move cautiously into local assembly of largely imported components for export to third countries. This has generally been followed by ever-larger investments using higher proportions of locally-made components for assembly into products for the local market, exports to other Asian countries, the US and, increasingly, back to Japan. Thailand has enjoyed three waves of Japanese investment. The first was in the mid-1960s and saw the arrival of Japanese companies aiming to set up factories to assemble previously imported consumer durables for the Thai market. These included white goods and motor vehicles, using parts imported from Japan. Japanese investors also set up textile firms, diversifying away from Thailand's traditional agricultural exports base for the first time.

The second wave of Japanese investment took place during the mid to late 1980s as the Japanese yen appreciated in the wake of the Plaza Agreement. Japanese companies increased capacity in Thailand, still mostly importing parts, but this time assembling goods for export back to Japan. Japanese investment in electronics and motor vehicles also expanded with some parts beginning to be sourced locally. Given Thailand's high level of capital imports from Japan (Appendix Table A-3), sourcing parts locally and exporting back to Japan meant that some of the adverse impact on the balance of trade was mitigated.

As the yen began to surge in value in the 1990s, Thailand experienced a further renewal of Japanese investment. Moves to source more products locally further strengthened Japanese investor interest in Thailand. According to estimates by the Japanese External Trade Organisation (JETRO), 44 per cent of the parts used by Japanese companies in Thailand are

already sourced locally (Financial Times, 15 November 1995). Furthermore, 70 per cent of Japanese companies in Thailand have plans to increase local sourcing.

Japanese banks have also emerged as important participants in the off-shore lending market. They are an important source of finance underlying Japanese investment in the country. Japanese banks lend not only to clients with whom they have established relations back in Japan, but also prove to be valuable source of funds for joint-venture and supplier partners of those clients. In Thailand, Japanese banks are set to win at least three of the seven new licences to be awarded in 1996, and that will in effect allow them to open full branches in the country.

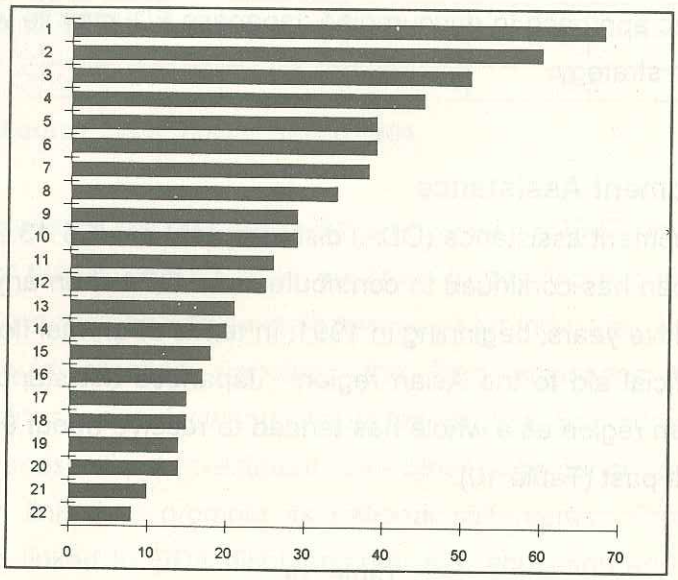
Unlike Thailand, Sri Lanka was following a policy of import restrictions and stringent foreign exchange controls for much of the 1960s and 1970s that effectively discouraged foreign investment in the country. Thus, the argument that the policy intiatives undertaken in Sri Lanka to attract FDI in 1977 was basically out of line with developments in Japan. This argument is open to debate. Athukorala (1995) for instance argues that empirical evidence relating to overall trends and geographic distribution of world wide assembly operations does not support such a hypothesis. Historically, assembly exports from developing countries are argued to have grown much faster than their total manufactured exports throughout. Nevertheless, the early entry of Japanese investors to Southeast Asia undoubtedly spurred the second and third waves. For example, the presence of Japanese investors in Thailand over a long period also meant the development of a closer affinity between the Japanese businessmen and their Thai hosts.

There is, however, little doubt that the nature of the investment climate in Sri Lanka has been the more important determinant in influencing the decisions of Japanese investors. Despite a continued commitment to attracting FDI since 1977, Sri Lanka has suffered policy and political instability for much of the ensuing years. Despite periodic political turbulence, Thailand, for example, has maintained a high level of policy continuity and this is a defining feature of most of the other Southeast Asian economies. Thailand signalled its departure from a predominant leaning towards import substitution in the 1960s by adopting a private-sector led industrial strategy and maintained an investment climate conducive for long-term investments, inspite of continual political upheavals.

The contention that a country's investment climate is the most significant factor in the minds of Japanese investors is borne out by a number of surveys carried out in Japan. Figure 4

illustrates the results of a recent survey carried out by MITI on the internationalisation of the economy of Japan. Compared with other developing countries, the attractiveness of East Asia lies more in its political stability than in its labour market. A total of 68 per cent of the respondents ranked political stability as the most attractive feature of the investment climate in Southeast Asia. Low wages ranked only eighth in importance. Other than these elements, East Asia's infrastructure such as airports, harbors and highways, and its geographical and cultural proximity to Japan are also attractive to the latter.

Figure 4
Favourable Aspects of Investing in East Asia Relative to Other LDCs
(per cent)



(1) Stable political situation
(2) Relatively good feeling toward Japan
(3) Secure living environment
(3) Secure living environment
(4) Expectation of economic development
(5) Adequate infrastructure of airports, ports and roads
(6) Elementary education accesible to all and work ethic
(7) Countries geographically close and culturally similar to Japan
(8) Relatively low wages
(9) Availability of good quality engineers and managers due to development of higher education
(10) Stable labour supply
(11) Large market scale
(12) Preferential policies toward foreign capital
(13) Easy financing due to less financial restrictions
(14) Simple export and import procedures including clearance and quarantine
(15) Rapid availability of parts and components
(16) Young people are not reluctant to work in factories and construction sites
(17) Low tax rates
(18) Relatively low land prices
(19) Equal working conditions for men and women
(20) Simple procedures for setting up companies and factories
(21) Low consumer prices
(22) Relatively low expenses for water electricity and fuel

Source: Ministry of International Trade and Industry, *White Paper on International Trade, Japan 1994.*

Heightened political uncertainty in Sri Lanka since the early 1980s has not helped the cause of attracting FDI. Japanese investors, in particular, are prone to long term investment planning. Sri Lanka's policy and political instability may also account for its less than successful attempts at achieving a more diversified FDI portfolio in manufacuturing. Foreign firms involved in vertically integrated assembly industries, unlike those involved in light consumer goods industries such as garments, are argued to view country risk and the other elements in the investment climate from a long-term perspective (Athukorala 1995). In particular, electronics is identified as being generally a mobile industry which is highly sensitive to the risk of production disruption.

Given that Sri Lanka is disadvantaged by its limited domestic market and its current investment climate, a more realistic approach to encouraging Japanese FDI may lie within the context of a concerted South Asian strategy.

5. Official Development Assistance

With an official development assistance (ODA) disbursement of US$ 13.2 billion to developing countries in 1994, Japan has continued to contribute more ODA than any other country in the world for four consecutive years, beginning in 1991. In terms of annual flows, Japan is also the largest provider of official aid to the Asian region. Japanese assistance has included ODA grants, where the Asian region as a whole has tended to receive about 90 per cent of Japan's foreign aid loans in the past (Table 10).

Table 10
Distribution of Japanese ODA Loans to Selected Asian Countries

	US$ million[a]	% share of total loans
Southeast Asia		
Malaysia	601.9	7.0
Thailand	805.5	9.3
Indonesia	1545.5	17.9
Philippines	1215.5	14.1
South Asia		
Sri Lanka	356.3	4.1
India	1230.6	14.3
Pakistan	340.7	3.9
TOTAL ASIA	7707.7	90.0

Notes: a. Cumulative total as of March 1994.
Source: OECF, Annual Report 1995.

Sri Lanka has come to depend increasingly on Japan for development assistance over the last three decades. Over this period, 20 per cent of aid received has come from international donor agencies and the remaining 80 per cent in the form of bilateral aid. Japanese aid accounts for 10 per cent of the latter. Japan's contribution to Sri Lanka's aid composition has increased from around 6 per cent in 1975 to nearly 47 per cent by 1993 (Kuruppu 1995). As evident from Table 11, Japan's share far outstrips those of other major aid donors to Sri Lanka.

Table 11
Country Share of Total Bilateral ODA Received by Sri Lanka

Country	US$ million	% share
Japan	1.8	46.6
U.S.A.	0.4	10.8
Germany	0.4	10.3
U.K.	0.3	7.8
Other	1.0	24.5

Source: JICA, Annual Report 1994.

MITI's New Asian Industries Development Plan, unveiled in 1987, involved a proposal to harmonize the need of the developing Asian countries to develop economically viable export-oriented manufacturing industries with Japan's own need for industrial restructuring. To ensure that this process could proceed smoothly, the Plan envisaged the development of internationally competitive manufacturing industries in the Southeast and South Asian countries through Japanese direct investment. Like other large donor countries, Japan's ODA programme has been linked to promote its national self-interest. Promotion of trade and investment have been linked to ODA disbursement. Aid, education and technical assistance have paved the way for the private sector to follow with corporate investment.

The on-going industrial restructuring of Japan from an economy largely based on heavy resource-processing and labour-intensive industries to one relying more and more on knowledge and high technology intensive industries has shaped Japan's aid programme. The ensuing imperative to relocate Japan's increasingly uncompetitive labour intensive industries to labour abundant and lower wage developing countries, is argued to have given rise to a "new" form of Japanese ODA (Wie 1994). In line with the industrial restructuring in Japan and the corresponding need for industrial relocation, a growing part of Japan's ODA has been increasingly directed at promoting more Japanese direct investment in the recipient developing countries. This strategy is also in line with Japan's drive to utilize more the experience, technology, and know-how of its private sector in development cooperation.

The major government agencies which administer Japan's ODA are the Overseas Economic Cooperation Fund (OECF), the Japan International Cooperation Agency (JICA), and the Export-Import Bank of Japan (EXIM Bank). The OECF is responsible for bilateral loans and has become one of the world's major development finance institutions, as well as being the principal executing agency of Japan's ODA. In addition to the loans provided by the OECF and the EXIM Bank, Japan's aid to developing countries is also channelled through JICA. While the OECF is entrusted with the implementation of bilateral loans, JICA is in charge of technical cooperation with developing countries as well as the implementation of major portions of bilateral grant aid.

Thailand, for example, has been one of the most significant beneficiaries of Japanese aid. Until 1987 it was the second largest receipient of Japanese ODA, and only then dropping to fourth place. Overall, 70 per cent of Thailand's official development assistance comes from Japan. During the 1960s and 1970s such assistance was focused on the agricultural sector. But in the 1980s, official assistance has been used almost exclusively for the development of infrastructure (Tasker and Handley 1991).

Table 12
OECF Loan Commitments to Selected Countries by Sector[a]

Sector	Sri Lanka	Malaysia	Thailand	India	Pakistan
Agriculture, forestry & fisheries	-	0.6	2.7	2.9	0.8
Mining and manufacturing	1.1	9.8	4.9	14.1	5.8
Social services	5.7	10.8	10.3	4.1	3.7
Irrigation and flood control	7.5	-	4.9	0.7	2.0
Telecommunications	11.0	1.2	9.9	6.3	3.5
Electric power and gas	13.9	57.7	19.9	47.2	20.6
Transportation	39.1	10.9	38.0	4.2	26.7
Commodity loans	21.7	-	-	11.3	34.9
Financial intermediary	-	9.0	8.9	9.3	2.0
Total (US$ million)	2974.5	5210.7	1128.3	1078.5	4875.8

Notes: a. Cumulative total as of March 1994.
Source: OECF, Annual Report 1994.

The OECF has financed about about 50 per cent of Thailand's and Malaysia's electrical capacity. The OECF has been extending loans to Sri Lanka since 1976 and since 1986 has surpassed other donor country's annual ODA commitments to Sri Lanka. Table 12 gives a sectoral breakdown of loan commitments by the OECF to some selected Asian countries. A significant share of OECF loans are concentrated in infrastructure projects. OECF assistance

for electric power and transportation has figured prominently in all cases. In the case of Sri Lanka, the largest portion of OECF loans has been for transportation. This is in keeping with OECF's goal to improve the social and economic infrastructure of developing countries in order to enhance the investment environment and to encourage the private sector to be more active.

Promoting technical cooperation is a prime area of operation for JICA in Sri Lanka. To date, it has offered technical training in Japan to nearly 3000 Sri Lankan citizens, dispatched nearly 600 technical experts from Japan, and funded over 20 studies and an equal number of projects in the country (JICA 1994). Training in human resources management, planning and administration, public utility, and agriculture have received the highest priority.

6. A Role for Japan in South Asia: Benefits for Sri Lanka

South Asia has so far been marginal to Japan's economic interests. While Japan has been an important trading partner for the South Asian economies, the region, by and large, has missed out on Japan's foreign investment boom. As an economic region, South Asia's inability and unwillingness to open their markets to foreign investment has, until very recently, been a major stumbling block. Political and civil unrest in the region, nationalistic attitudes to foreign investment and rampant bureacracy, have only served to further inhibit foreign investment in the region.

Table 13
Composition of Exports of Japan by Area and Country (per cent)

	1975	1980	1985	1990	1994
1. Developed Countries	42.0	47.1	58.3	59.2	50.9
USA	20.0	24.2	37.2	31.5	29.7
Western Europe	14.6	16.6	14.3	22.1	16.6
2. Developing Countries	49.6	45.8	32.4	37.3	43.7
Southeast Asia	22.5	23.8	18.9	28.8	35.0
Latin America	8.5	6.9	4.8	3.6	4.7
Middle East	10.9	11.1	6.9	3.4	2.8
Africa	7.3	3.8	1.4	1.2	1.0
South Asia	0.3	0.3	0.3	0.3	0.2
3. Total (US$ bn)	55.7	129.8	175.6	286.9	395.6

Source: Ministry of Finance, *Financial Statistics of Japan 1995.*

The predominant economic influence of Japan in South Asia has been in the area of trade as it continues to exert increasing economic influence through growing trade links with the region. In absolute terms, exports to South Asia increased from US$ 0.4 billion in 1980 to US$ 0.7

billion by 1994. Exports from South Asia to Japan increased from US$ 0.6 billion to US$ 1.5 billion. Japan's global trade increased much faster, from US$ 270 billion to US$ 670 billion over the same period. Japan's exports increased from US$ 129.8 billion in 1980 to US$ 395.6 billion in 1994 (Table 13). Over the same period, the share of its exports to its Southeast Asian neighbours has grown from 23.8 per cent to 35 per cent. Its exports to South Asia remained stagnant at 0.2-0.3 per cent of total exports.

More importantly, Japan's imports increased from US$ 140.5 billion in 1980 to US$ 274.7 billion in 1994 (Table 14). While imports from Southeast Asia as a percentage of Japan's total imports increased only marginally from 22.6 per cent of the total to nearly 25 per cent over that period, in nominal terms it amounted to a substantial rise (from US$ 32 billion to US$ 69 billion, or 120 per cent, when Japan's total imports did not even double). The share of the Japanese domestic market accruing to South Asian exporters has stagnated at approximately 0.5 per cent of the Japanese market. Nevertheless, Japan remains a sizeable commercial partner with each country in the region.

Table 14
Composition of Imports to Japan by Area and Country (per cent)

	1975	1980	1985	1990	1994
1. Developed Countries	41.3	35.0	41.0	50.8	48.3
USA	20.1	17.4	19.9	22.3	22.8
Western Europe	7.6	7.4	9.5	18.2	15.7
2. Developing Countries	53.5	60.3	52.4	42.0	39.6
Southeast Asia	18.3	22.6	23.4	23.3	24.7
Latin America	4.4	4.1	4.8	4.2	3.5
Middle East	28.5	31.7	23.1	13.3	10.2
Africa	1.9	1.5	0.8	0.8	0.6
South Asia	0.5	0.5	0.3	0.4	0.5
3. Total (US$ bn)	57.7	140.5	129.5	234.8	274.7

Source: Ministry of Finance, *Financial Statistics of Japan 1995.*

In terms of foreign investment, Japanese FDI involvement in South Asia has been marginal. Out of US$ 76.2 billion invested from 1951-1994 in Asia, Japan invested a meagre US$ 840 million in South Asia as a whole (Table 15). Lack of political will and stability in the region is one factor for the poor performance, but the main deterrents are the complex and restrictive foreign capital laws and the bureacratic red-tape that confronts investors in many of the South Asian countries. Such inhibiting factors, along with the relative weakness of Japan's trade links with South Asia, have inevitably worked to limit investment.

Table 15
Japanese FDI by Country

Country	1951-1994 (cumulative total)		1994	
	US$ bn.	%	US$ bn.	%
USA	194.43	41.9	17.33	42.2
Europe	89.86	19.4	6.23	15.2
Asia	76.21	16.4	9.69	23.6
Indonesia	16.98	3.7	1.76	4.3
Thailand	7.18	1.5	0.72	1.8
Malaysia	6.35	1.4	0.74	1.8
South Korea	5.26	1.1	0.40	1.0
India	0.46	0.1	0.10	0.2
Pakistan	0.23	0.1	0.80	0.2
Sri Lanka	0.15	...	0.01	...
Total (US$ bn)	463.61		41.05	

Source: Ministry of Finance, *Financial Statistics of Japan 1995.*

The initial flow of Japanese FDI in South Asia in the 1950s, mostly in India and Pakistan, was concentrated in chemical industries like glass, dyes and plastics (Abe 1996). The 1960s saw the start of automobile related investments, with India at present host to a total of 18 Japanese FDI related projects in this sector (Table 16). Japanese FDI has expanded to other South Asian countries, going into new sectors such as fish processing in Bangladesh, ceramics and cement in Sri Lanka, and tourism in Nepal.

The on-going process of economic liberalisation in the region, particularly in India, could present the region a new opportunity to attract Japanese FDI. Much will undoubtedly depend on the pace of liberalisation in India, and in particular, the government's commitment to foreign investors. On the other hand, implementing World Bank/IMF policy proposals without adequate attention to the capacity of economic agents to respond positively to the policy initiatives may not yeild the desired results. The South Asian economies should draw on the industrialisation experience of Japan and its Southeast Asian neighbours and explore more fully the option of selective intervention as a policy alternative along the lines of Japanese theorists. At the least, it would be a positive contribution to the debate on adjustment and make policymakers more aware of the weaknesses that are being pointed out in the models that are currently espoused.

Table 16
Japan's FDI to South Asian Countries by Industry (1992)

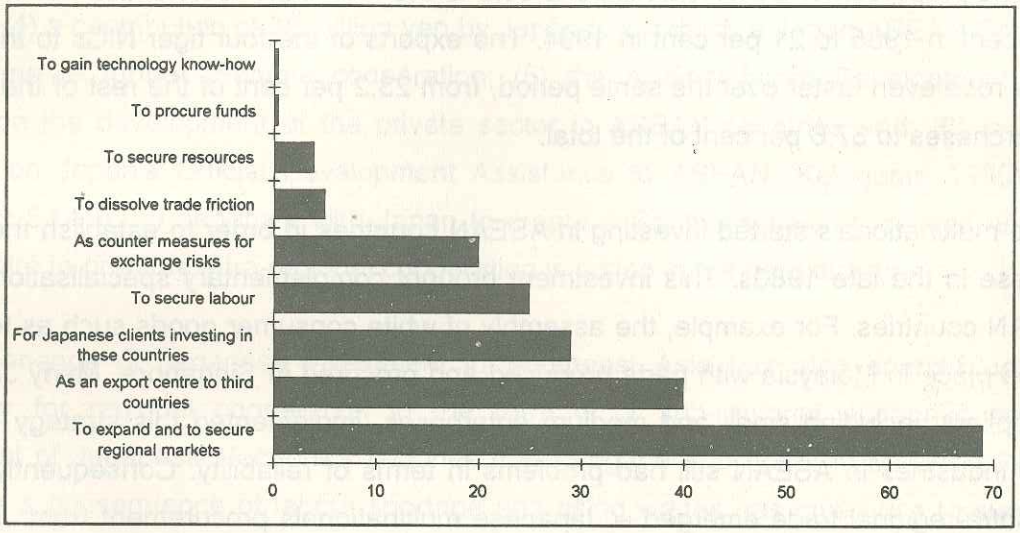
	India	Sri Lanka	Pakistan	Bangladesh	Nepal
Fishery	2			2	
Agriculture		1			
Plant/technology	1				
Food	2				
Textiles	2	1	1		
Rubber products		1			
Apparel	1	1	1		
Chemical products	5		1		
Medicines	1				
Paints and ink	2			1	
Pottery	1	1			
Porceline		2			
Glass	3				
Cement	1	1			
Steel	3	2			
Metal products	2			1	
General machinery	7				
Electric machinery	8	2	2		
Telecommunication equip	2				
Home electronics, parts	5	1			
Electronic machinery	2	1			
Transportation machinery	7	2	4		
Automobile, parts	18		5		
Shipbuilding		1		1	
Precision equip.	1				
Other manufacturing		1			
Wholesale, machines	1				
Wholesale, electronic machinery	1				
Construction		1			
Publication and printing		1			
Finance and Lease		1	2		
Shipping	1				
Hotel	1	1			3
Consultancy		1			
Management	1				
Investment			1		
Others		1			
Total	81	23	17	5	3

Source: Abe, S,. 1996

There is much to be gained by a concerted South Asian regional initiative to attract Japanese FDI. The results of a survey on investor decisions by Japanese businesses to establish plants overseas suggest that access to a regional market is a significant priority in their investment decisions (Figure 5). While Thailand has been an attractive destination for Japanese investors for a number of reasons, one of the most important is that it is regarded as the first entry point in ASEAN (Association of South East Asian Nations), a region which straddles the sea lanes on which Japan relies for its supplies of oil and other commodities. As the rest of Southeast

Asia begins to lower its tariffs, the Japanese are increasingly looking to Thailand as a base to produce for the rest of Indo-China and ASEAN. As Japanese companies move into basic industries, such as steel, iron and petrochemicals, it will forge and strengthen backward linkages for several industries. Sri Lanka is the most liberalised economy in South Asia, and its infrastructure is reasonably well developed vis-a-vis the other South Asian economies. These are positive advantages to establish Sri Lanka as an entry point to the vast regional market in South Asia.

Figure 5
Aim of Investing in East Asia (per cent)



Source: Ministry of International Trade and Industry, *White Paper on International Trade, Japan 1994.*

There are emerging problems for Japanese investors in Southeast Asia. The most significant of these relates to labour. For example, labour costs in Thailand, as in many other emerging NICs, are rising and there is little evidence of a commensurate level of productivity gains. Malaysia is increasingly facing labour scarcity, with unemployment only at 2.8 per cent in 1995. For the present, a massive influx of migrant workers from Indonesia provides relief from labour scarcity and helps maintain Malaysia's image as a competitive location for export-oriented manufacturing activities. During the initial wave of Japanese investment, given the assembly-type nature of Japanese investment, lack of skilled workers did not prove a problem, while wages for unskilled workers remained relatively low. However, these countries are increasingly facing a shortage of skilled workers, while wages for unskilled workers are also on the rise.

Rising real wage costs raise the danger for these economies of pricing themselves out of the assembly market without being able to make a complete leap into more value-added industries.

Extra-regional investment in South Asia may spur greater intra-regional trade. Japan's trade and investment with Southeast Asia has helped to push forward an even faster growth in trade and investment between the other countries of the region. In the second half of the 1980s, 60 per cent of regional investment in Southeast Asia is estimated to have originated, not from Japan, but from other East Asian economies. The "tiger" economies, as a group, were the largest investors in the region (Financial Times, 15 November 1995). Trade follows a similar pattern. The proportion of East Asian exports sold to the four "tiger" economies has risen from 15.1 per cent in 1985 to 21 per cent in 1994. The exports of the four tiger NICs to the rest of East Asia rose even faster over the same period, from 23.2 per cent of the rest of the region's export purchases to 37.6 per cent of the total.

Japanese multinationals started investing in ASEAN countries in order to establish their Asian export base in the late 1980s. This investment brought complementary specialisation among the ASEAN countries. For example, the assembly of white consumer goods such as television sets takes place in Malaysia with parts produced and procured in Singapore. Many Japanese parts suppliers, including small and medium enterprises, implemented this strategy because domestic industries in ASEAN still had problems in terms of reliability. Consequently, a new trend of intra-regional trade emerged -- Japanese multinationals procurement from Japanese local parts suppliers within the region.

The South Asian countries should also seek to encourage small Japanese businesses. Relative to large corporations, the risk factor associated with the region is heightened for smaller investors, so that the predominant source of Japanese FDI in the region, so far, has been large corporations (Abe 1996). However, in order to raise the level of investment from large corporations in promising industries, South Asian countries need to develop peripheral industries that will encourage smaller companies to invest in the region. The experience of Malaysia is noteworthy. When Malaysia first opened up to foreign investment, it was the big Japanese corporations such as Sony and Sharp that set up plants, mostly in labour-intensive assembly operations. These investors have been followed by smaller Japanese companies, typically vendor suppliers to the larger corporations. This has allowed local Japanese companies to act as autonomous units, producing their own goods and exporting to the world -- or selling them back to Japan (Financial Times, 15 November 1995).

Japanese trade and investment links in the Southeast Asian region have been instrumental in fueling intra-ASEAN economic growth. Japanese support to ASEAN has taken other forms of assistance that the South Asian Association for Regional Cooperation (SAARC) should seek to promote in the future. Some of the most notable contributions of Japanese assistance to ASEAN include: (1) The Fukuda Fund of US$ 1 billion to assist in financing ASEAN industrial projects, where about 70 per cent of the cost of the regional fertilizer project in Indonesia and Malaysia has been met by low interest loans from this Fund; (2) the ASEAN Promotion Centre on Trade, Investment and Tourism established in Tokyo to promote exports from ASEAN as well as Japanese investment and tourism in the region; (3) the establishment of projects such as the ASEAN Human Resoure Development Project and the ASEAN Regional Studies Promotion Programme, under which Japan provides funds for educational and technical training; (4) a contribution of 38 million yen by Japan to establish a Japan-ASEAN Cooperation Programme to further promote cooperation; (5) the ASEAN-Japan Development Fund to encourage the development of the private sector in ASEAN countries and; (6) low interest charges on Japan's Official Development Assistance to ASEAN (Kelegama 1995). Similar efforts by SAARC to negotiate with Japan to create a South Asia Fund, as well as a South Asia Centre to promote intra-regional cooperation is a step in the right direction.

The experience of Japanese investment in Southeast Asia has also opened up another possibility for regional cooperation in the form of a sub-regional economic zone. The movement of Japanese electronics factories from Singapore to Johor in Malaysia in the late 1980s as a consequence of labour shortage and rising wages has given rise to such a sub-region -- "SIJORI". This was the origin of the current "Growth Triangle" programmes that consist of Singapore, Johor (Malaysia) and Riau (Indonesia) to develop related industries based on the comparative advantage of the three regions. Local enterprises with adequate support from governments, in conjunction with multinationals, can create similar opportunities to expand cross-country economic activities in the South Asian region.

The South Asian region, with its surplus of low wage skilled workers and a vast market of consumers should take advantage of the renewed outflow of Japanese FDI. Despite the historically low investment linkage, Japanese FDI in the SAARC region has been steadily expanding. Japanese FDI in India in 1993 (at US$ 80 million) saw a 50 fold increase from 1990, while Japanese FDI in Bangladesh increased by 28 fold (to a total of US$ 40 million) over the same period. It is crucial that the on-going process of liberalisation in South Asia does not lose momentum and foreign investors' confidence in the investment potential in the region weakened as a result.

An expansion in Japan's trade and investment links with South Asia will be only part of its growing economic integration with the region. Japan is the largest source of foreign aid to each SAARC nation, with 37 per cent of bilateral economic assistance to the South Asian region originating in Japan. Bangladesh receives the smallest amount of economic assistance from Japan -- 19.2 per cent per capita share -- with the comparable figure for the Maldives at 74.6 per cent. The others range between 35-39 per cent. Given that the new form of Japanese ODA is directed more specifically at stimulating the flow of Japanese private investment, South Asian countries should pursue a vigorous approach to attracting Japanese FDI. If the South Asian nations pursue sound macro-economic policies in particular, the opportunity for facilitating further Japanese ODA and FDI in the region exist, and should be seized upon.

7. Conclusion

Sri Lanka, and the South Asian region in general, has been less than successful in exacting the maximum benefits from Japanese trade and investment flows to Asia over the last four decades. The lessons of the Japanese experience of industrialisation have, by and large, by-passed Sri Lanka. When most Southeast Asian nations were emulating the Japanese model in the 1960s and 1970s, Sri Lanka was following a stringent import substituting strategy of industrialisation. Even with economic liberalisation and a move towards an export-oriented strategy from 1977, there was a lack of a coherent industrial strategy to promote industrial growth along the lines adopted by Japan and its Southeast Asian neighbours in their drive for rapid industrialisation.

The shortcomings identified by critics of World Bank structural adjustment programmes highlights the inadequacies of Sri Lanka's own industrial strategy. Industrial growth was left very much in the realm of trade and exchange liberalisation, with little or no attempt made to promote a shift to capital-intensive industries after the initial surge in relatively low value-added labour-intensive industries. While the private sector was deemed the "engine of growth", the policy of generalised promotion of manufacturing activities failed to take account of the ability of the private sector to respond to the incentive regime in an increasingly competitive international market. Inadequate attention to infrastructural needs and skill development further hampered the drive for industrialisation.

Thus, despite the emphasis on export-oriented growth, Sri Lanka's policy environment was not overly conducive to attracting Japanese FDI. The situation was obviously exacerbated by the climate of political unrest in the country. A concerted South Asian strategy to attract Japanese

FDI appears to be a more optimistic goal for Sri Lanka. The on-going liberalisation in India will be vital for the success of such a strategy. Sri Lanka should increasingly look to encouraging joint-venture projects within the South Asian region with Japanese investment. Sri Lanka has the advantage of a demonstrated commitment to economic liberalisation that should be exploited to attract more Japanese trade and FDI to the region.

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Appendix

Table A-1
Effective Rates of Protection in Japanese Manufacturing (per cent)

Industry	1963	1968	1972
Manufacturing	32.3	24.2	14.4
Textiles	54.3	28.2	18.6
Spinning	27.1	12.5	15.0
Weaving	44.6	30.5	15.5
Products	72.8	32.8	22.4
Wood products	14.0	25.6	16.1
paper and Pulp	9.7	18.0	11.0
Publishing	-16.7	1.0	-0.9
Leather and Rubber products	30.9	21.8	12.3
Chemicals	33.4	17.7	8.8
Petroleum and coal products	19.5	14.5	7.1
Non metallic minerals	22.2	15.7	8.1
Iron an steel	30.1	30.0	17.1
non ferrous metals	30.4	34.1	22.1
Metal products	13.8	19.9	9.9
Machinery	36.7	20.0	7.7
General machinery	23.0	14.5	8.7
Electrical machinery	30.9	16.5	5.4
Transport equipment	61.5	31.0	9.2
Precision instruments	34.9	22.9	10.4

Source: World Bank, 1993

Table A-2
Japan's Exports by Country and Commodity: 1994 (per cent)

	Thailand	Malaysia	India	Pakistan
1.Foodstuff	0.8	0.3	0.0	0.7
2. Textiles	1.6	1.3	2.5	6.7
3. Chemicals	8.0	6.4	11.8	11.3
Fertilizers	0.1	0.1	0.0	0.0
Plastics	2.8	2.5	2.9	3.1
4. Non-metallic mineral products	1.6	2.1	2.0	0.6
5. Metal products	13.4	9.4	11.6	9.9
Iron and steel	9.3	5.7	8.5	7.5
Non-ferrous metals	1.4	1.9	1.2	0.5
Metal products	2.7	1.8	1.9	1.9
6. Machinery and equipment	68.8	75.6	61.3	65.2
Power generating machinery	3.8	1.8	10.6	7.3
Metal working machinery	2.2	1.5	1.2	0.3
Textile machines	1.3	0.5	4.0	5.1
Electric power machinery	2.3	2.4	5.7	3.6
Motor vehicles	9.0	4.7	0.3	23.6
Scientific & optical equip.	2.0	2.2	2.1	1.1
7. Others	5.8	4.8	10.7	5.5
Rubber tyres and tubes	0.2	0.1	0.2	0.9
Total (US$ million)	14.7	12.3	2.0	0.9

Source: Ministry of Finance, *Financial Statistics of Japan 1995.*

Table A-3
Japan's Imports by Country and Commodity: 1994 (per cent)

	hailand	alaysia	India	Pakistan
1. Foodstuff	35.0	2.3	25.9	6.2
Fish and shellfish	16.5	1.7	20.3	6.0
Sugar	2.6	0.0	0.0	0.0
2. Textile materials	0.5	0.3	0.5	1.1
Raw Cotton	0.0	0.0	0.5	1.0
3. Metal ores and scrap	0.3	1.4	14.2	0.4
Iron ore	0.1	0.0	13.4	0.0
4. Raw materials (nes)	9.1	24.3	4.8	3.5
Natural rubber	6.2	0.7	0.0	0.0
Wood	0.6	19.8	0.1	0.0
Non-metallic mineral ores	1.1	0.1	2.6	0.0
5. Mineral fuels	0.1	23.8	5.5	2.2
Crude oil	0.1	6.7	0.0	0.0
Petroleum products	0.0	1.8	5.5	2.2
6. Chemicals	2.3	3.6	2.3	0.7
7. Machinery and equipment	26.1	29.4	0.3	0.3
Office machinery	6.4	4.0	0.0	0.0
Precision instruments	4.3	5.6	0.0	0.3
8. Others	26.6	14.9	46.4	85.5
Iron and steel products	0.7	0.1	3.9	0.0
Textiles	6.3	2.2	11.2	80.6
Non-ferrous metals	0.2	0.8	0.4	0.0
Total (US$ million)	8.2	8.2	2.6	0.5

Source: Ministry of Finance, *Financial Statistics of Japan 1995.*

Table A-4
Major Export Markets of Sri Lanka
(% share in total exports)

DESTINATION	1980	1985	1990	1994
USA	10.94	21.24	25.75	34.76
Japan	3.15	4.91	5.35	5.15
South Korea	0.02	0.04	0.26	1.21
EEC	20.56	19.64	25.66	30.94
ASEAN	1.90	4.41	4.06	3.93
Singapore	1.12	3.29	2.59	2.38
Thailand	0.01	0.10	1.13	0.97
Malaysia	0.44	0.88	0.13	0.18
Middle East	n.a.	21.93	17.47	8.73
USSR and Eastern Europe	3.20	3.06	2.36	1.20
SAARC	6.97	4.08	3.71	2.71
India	3.25	0.51	1.08	0.74
Pakistan	3.23	2.07	1.70	1.35

Source: Central Bank of Sri Lanka

Table A-5
Source of Imports to Sri Lanka
(% share in total imports)

DESTINATION	1980	1985	1990	1994
USA	4.40	6.31	7.73	5.96
Japan	12.68	13.81	12.11	11.02
South Korea	1.72	2.25	4.76	6.83
EEC	21.72	13.89	14.03	15.88
ASEAN	6.29	6.67	12.84	13.15
Malaysia	0.58	1.39	4.26	3.79
Singapore	4.48	3.61	3.82	4.90
Thailand	0.48	1.05	3.17	2.56
Middle East	n.a.	18.27	11.28	5.06
USSR and Eastern Europe	0.94	0.64	0.46	0.38
SAARC	6.44	5.75	6.85	10.24
India	4.70	3.65	4.40	8.46
Pakistan	1.46	1.66	1.89	1.27

Source: Central Bank of Sri Lanka

Table A-6
Sectoral Classification of Actual Investment in Sri Lanka (end 1994)

Categories	No. of Enterprises	FI (US$ mn.)[a]	LI (US$ mn.)[b]
1. Food, beverages and tobacco	29	7.94	17.55
2. Textile, wearing apparel and leather	97	131.91	164.22
3. Wood and wood products	11	6.62	7.12
4. Paper and paper products	7	3.42	4.50
5. Chemical, petroleum, rubber, plastic	47	77.75	92.19
6. Non-metallic mineral	37	17.25	43.82
7. Fabricated metal, machinery, transport equipment	15	5.90	9.04
8. Manufacturing (n.e.s)	68	34.57	45.44
9. Services	138	279.61	555.66
TOTAL	449	564.98	939.55

Notes: a. Foreign Investment in US$ million.
b. Local Investment in US$ million.

Source: Central Bank of Sri Lanka

Stock Verification

Year	Verified
2015	
2020	
2025	