CORPORATE GOVERNANCE IN THE TEN NEW EU MEMBER STATES (EU-10) AS A DETERMINANT OF JAPANESE FDI

Alina Nona Petric

1. Introduction

One of the major aspects of transition was the entrance of foreign goods and services either through trade or direct investments. Foreign direct investments (FDI) became the most important source of capital for the transition economies in Europe mainly due to their difficulty to access external loans and as a result of insufficient development of their financial markets before 1990. The ten new European Union member states (EU-10) expected to attract high foreign investments immediately after the collapse of the socialist economy, but at the same time investors viewed with scepticism the health of their economic environment. Some countries managed to attract higher inflows than others; at present the EU-10 economies are competing to attract more FDI since they have outgrown the privatisation-led type. In order to attract higher inflows they need to either offer new attractive determinants or develop existing ones.

The aim of this paper is to support the hypothesis that good corporate governance principles attract Japanese FDI in the EU-10 countries; corporate governance matters for foreign investors, especially for the Japanese investors who take into careful consideration a number of determinants before entering new markets.

The literature review highlights the most relevant academic work on
FDI in the EU-10, corporate governance and Japanese investments. The theoretical consideration provides the definitions and theory applied in this paper. The focus is on the Japanese investments and the type of investments in the EU-10. The empirical analysis details the correlation between corporate governance and Japanese FDI to the EU-10. The conclusion emphasises the fact that the EU-10 economies in the future need to perfect their macro corporate governance in order to continue to attract foreign investments, and specifically Japanese investments.

2. Literature review

The topic of FDI in transition economies has received massive attention since it is an important source of attracting capital. The Central European countries are better studied than the South East ones or the Baltic States due to being receivers of higher FDI based on the fact that they are considered ‘fast reformers’. The large majority of studies on the EU-10 either analyse countries separately or are aggregate area studies. To the author’s knowledge, there is no study examining Japanese FDI flows to the EU-10 correlating investments to corporate governance.

The literature on FDI in EU-10 can be divided into three main categories: studies that focus on the theory of FDI, studies that focus on the impact of FDI on economic growth and studies that explain the determinants of FDI.

The first category of research is represented by Meyer and Peng (2005) who review organizational economic theories, resource-based theories and institutional theories and their impact on the entry and strategies of foreign investors, restructuring of domestic enterprises and the growth strategies of entrepreneurs. The second category of research finds that FDI had a positive effect on growth; Campos and Kinoshita (2002) highlight that FDI was pure technology transfer and ultimately, FDI was a tool that enabled the EU candidate countries to introduce managerial
and technological techniques (Barrel and Holland, 2000). In the case of foreign ownership there is a positive impact on growth through and indirect measure reflecting the transfer of technology and knowledge by foreign firms (Djankov and Hoekman, 2000). The third category of research focuses on a multitude of determinants of FDI and their relevance in attracting higher inflows of capital. Bevan and Estrin (2004) examine the relationship between FDI and the openness of the economy and as expected find them to be positively related because the FDI is encouraged if the trade regime of the host economy is liberal. Christie (2003) examines whether horizontal or vertical FDI is predominant in the region and reports that in Central European economies horizontal FDI is prevalent but that the evidence for South East European countries is inconclusive.

Among the determinants of FDI recently corporate governance variables have been added to analyses. Corporate governance is supposed to boost the development process in less developed countries in two ways: by raising the degree of transparency of internal financial markets and by increasing the country’s political credibility abroad making it attractive to FDI. Case studies (Oman, 2001) suggest that an appropriate system of corporate governance helps increase the flow of financial capital to firms. Evidence (Prasad et al., 2003) exists to support the hypothesis that financial markets develop best in the presence of legal codes that provide protection to shareholders’ rights (in particular minority shareholders’ rights), definition of ownership (inside-ownership versus outside-ownership) and regulation of the banking sector. Stein and Daude (2001) find that the quality of institutions has a positive effect on foreign direct investment flows.

A number of descriptive studies focus on Japanese investments in the EU-10. Yoshii (2002) highlights the importance of incentives that the Southeastern countries need to offer in order to compete with the Central economies in attracting FDI. Morita (2000a, 2000b) accentuates that the
European markets are highly divided and not sufficiently attractive to giant Japanese companies which are primarily interested in scale merit; only Japanese companies which have their own European strategies have come to Central Europe motivated to be strong competitors in Europe. Ikemoto (2005) highlights the benefits of joining the EU for the Czech Republic and consequences on FDI. Taguchi (2002) presents the approach of the Japanese government and guidance for transition and developing economies. Empirical studies reveal that there is robust evidence that Japanese aid promotes FDI from Japan, while having no impact on FDI from other countries (Kimura and Todo, 2007).

3. Theoretical Considerations

Before the collapse of communism net capital flows into the EU–10 were largely in the form of commercial bank loans and trade finance to state-owned foreign trade banks subject to sovereign guarantee. The shift to market economy resulted in inflows of capital from developed economies, especially from the EU developed nations.

The general accepted definition for FDI is the one in the Balance of Payment Manual (IMF, 1993; p. 86): ‘Direct investment is a category of international investment made by a resident entity in one economy [home country] (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy [host country] other than that of the investor (direct investment enterprise). ‘Lasting interest’ implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.’

Throughout economic history FDI has been largely studied and several
Theories have been formulated. This paper applies the theory based on internalization, Dunning’s OLI paradigm (1979; 1993). His approach explains the existence, activities and strategies of multinational enterprises through the synthesis of macro and micro-economic determinants of FDI flows; it integrates industrial economics and location theory within the broader framework of the theories of international trade and investment. The OLI framework identifies three sources of advantage that are preconditions for firms to engage in international production, i.e., to become multinational corporations: ownership (O), location (L), and internalization (I). FDI enters through specific forms — wholly owned subsidiaries, joint ventures, Greenfield investments, Brownfield investments, acquisitions of existing companies, and mergers and acquisitions (M & A).

Most of the definitions found in international and national codes link corporate governance to the control of the company, to corporate management, or to managerial conduct. The cornerstone definition for corporate governance has been provided by the Cadbury Report (1992); a more comprehensive and recent definition was offered by Sir Adrian Cadbury in 2003: ‘In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, of corporations and of society. The incentives to corporations and those who own and manage them to adopt internationally accepted governance standards is that these standards will assist them to achieve their aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen their economies and encourage business probity’.

Corporate governance contributes to increased transparency in the financial market especially through the fact that companies should be in a higher degree accountable to society and investors; all EU-10 economies
are dominated by large foreign companies and domestic companies characterised by concentrated ownership. Foreign companies play key roles in employment, production and trade; even more important, the financial sector is also dominated by foreign capital through the high concentration of foreign assets in the banking sector. Up to the completion of privatisation FDI was easily attracted by the EU-10 markets dominated by profitable assets to be privatised, tax incentives, a labour force skilled and at lower prices compared to Western Europe, close proximity to Western Europe (excellent option for relocation) and good infrastructure. At present the privatisation process is complete (or almost complete) in all economies, and EU membership means compliance with the EU tax policy, corporate governance is signalled out as an important factor in attracting and contributing to FDI flows.

4. Japanese FDI to the EU-10

At the start of transition in 1990 there were high expectations from the EU-10 countries to attract Japanese FDI. However, the reality did not match expectations. Japanese investments did enter the market, but not in the high inflows as it was desired at the time due to a series of factors and the investments are certainly low in comparison to Japan’s economic power (as can be observed in Figures 4.1 and 4.2). There are three recipient groups among the EU-10 countries: major recipients with investments up to US$ 5 billion (the Czech Republic, Hungary and Poland), middle recipients with investments up to US$ 500 million (Bulgaria, Romania and Slovenia) and minor recipients with investments up to US$ 50 million (Estonia, Latvia, Lithuania and the Slovak Republic), as can be observed in Figure 4.2. An important observation is that Japan’s investments in Europe overall are not high due to the fact that European markets are highly divided and not sufficient attractive to the Japanese corporations that are interested in scale merit (Morita, 2000a...
However, Japanese companies in the automobile, machine tools and electronic products have high sales in Europe, from 10 trillion yen in 2000 to 17 trillion yen in 2005, a faster growth rate (10 percent) than in the US (5.1 percent) and Japan (0.4 percent), and second only to the Asian market (JETRO, 2005). One of the difficulties in analyzing data on

\[22\] and \[23\].
Japanese FDI in Europe comes from the fact that each recipient country has its own methods of computing data and most do not differentiate between investments and re-investments. The Japanese data provided by the Bank of Japan, Ministry of Trade and Industry, JETRO, JBIC and JOI at times is aggregate data since the outflows are not significant enough to be considered separately. For the sake of consistency this analysis applies the data available from the Japanese side, meaning that the overall figures are lower than those presented by the national banks and development agencies of the EU-10 countries.

From a temporal point of view, the first Japanese investments in the early 1990s targeted Hungary, and Poland followed as main destination after 1995; after 2000 the top recipient was the Czech Republic (as can be observed in Figure 4.3). After 2003 investments were spread in the other EU-10 countries mainly due to increasing wages in the top three destinations.

The main reason behind this division in destinations was due to the perception of the countries in Japan: Hungary was seen as flexible in negotiations and more willing to accommodate the demands of investors; Poland was associated with unions, labour struggles and debt-cancellations and in the Czech Republic strong national pride prevailed.
making negotiations inflexible (Morita, 2000a). Besides the advantages the three countries offered, it is also obvious that they were the leaders of reforms in the region and were most successful in the transition to market economy.

Most of the FDI inflows in the EU-10 occurred during the privatisation process, but Japanese investments stand out due to the fact that they are Greenfield investments. Japanese companies had several reasons for not participating in the privatisation programs of the EU-10; mainly they centre on the idea that they did not trust the consultancy companies demanding high fees in return for information on the operations of the companies to be privatised. Japanese FDI in the EU-10 was managed through a general trade company, ‘sogoshosha’. By the time Japanese investments entered the EU-10 market, they had to take into account the existing corporate governance structures and business environment, and it was not a question of influencing the corporate governance but rather of choosing the countries with better practices.

The main reason for Japanese investments was to move (or establish) production bases to locations where costs are lower, but there were also key factors that attracted Japanese investments in the EU-10 countries. Some of the features that attracted Japanese investments in the EU-10:

(i) a tradition of manufacturing – all countries had stable and old history in manufacturing;
(ii) good quality of labour force, especially skilled production managers;
(iii) low wages compared to developed Western markets;
(iv) advantageous geographical location for the EU market-
connections to Western Europe and Russia, and after the EU-10 signed accession treaties with the EU, the flow of people, goods and capital between Eastern and Western Europe became easier through the nine pan-European corridors created;
(v) relatively good infrastructure (roads, railways, electric power, telecommunications etc.);
(vi) FDI incentive programs (several years’ tax holidays, duty free import of equipment, job creation grants, site development support, et.) — mostly before the acces-
The shift of production, distribution and warehousing operations to the EU-10 from Western Europe to avoid the high costs of the mature (Western European) markets to achieve cost reductions occurred in the case of Suzuki in Hungary and Matsushita in the Czech Republic. Suzuki moved its production base from Spain to Hungary and Matsushita moved part of its production line from the UK to the Czech Republic. Shifts of production were easy for the big companies and their move attracted smaller and medium companies which are subcontractors for the corporations. In this case, risks are eliminated for the smaller Japanese companies that want to enter European markets. This is the explanation for the high Japanese inflows to the Czech Republic, Hungary and Poland; along with the corporations came smaller companies. Japanese FDI in the Czech Republic increased significantly due to the large number of subcontractors that Matsushita brought along. The countries that have low Japanese investments have not attracted any corporation to their market, Japanese investments are only in the retail sector operated by small companies (especially the Baltic republics where direct investment is in the form of restaurants or other small business, all in the retail sector).

Since the EU-10 countries do not benefit from large natural resources, Japanese investments are directed to the manufacturing industries, with automobile-related and electric/electronic sectors most significant. The Czech Republic, Hungary and Poland are top recipients of Japanese FDI for automobile manufacturing in the EU-10. The automotive industry is divided between car assembly (Suzuki in Hungary for Splash, Swift and SX4, and Toyota in the Czech Republic for Aygo), and production of car parts (most significantly in Poland, car parts for Isuzu and Toyota—diesel engines, transmissions and engines).

The history of Japanese direct investments in Western Europe points to the fact that the first investments were in the sales sector, followed by manufacturing sector and R & D. However, in the EU-10 countries,
Japanese investments started in the manufacturing sector (mainly through the transportation and machinery parts industry followed by electric and electronic parts industry), followed by the non-manufacturing sector, as observed in Table 4.1. This is highly beneficial for the EU–10 countries as it is accompanies by transfers of technology and management know-how.

The most successful Japanese investment in the EU–10 occurred in 2001, when Toyota Motor Corporation and PSA Peugeot Citroen established the Toyota Peugeot Citroen Automobile project in the Czech Republic. They established a joint factory that manufactured a new class of passenger cars (Toyota Aygo, Peugeot 107 and Citroen C1) for the European markets and started production in February 2002. The project itself was evaluated at €1.3 billion and created over 3,000 new jobs and reached full line utilization in 2008.

From the point of view of inflows, from 1989 up to the present approximately US$10 billion have been invested in the EU–10 with the Czech Republic, Poland and Hungary as top recipients of FDI. Looking at a short-term future, direct investments from Japan in the area are expected to fall due to the slowdown in the Japanese economy and the

\[
\text{Table 4.1: Japanese Investments by Industry in Europe}
\]

<table>
<thead>
<tr>
<th>Industry</th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
<th>4th</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>19.9%</td>
<td>11.3%</td>
<td>10.8%</td>
<td>10.8%</td>
</tr>
<tr>
<td>Transportation machinery parts</td>
<td>19.9%</td>
<td>11.3%</td>
<td>10.8%</td>
<td>10.8%</td>
</tr>
<tr>
<td>Chemical and petrochemical</td>
<td>13.4%</td>
<td>11.6%</td>
<td>10.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Electric and electronic</td>
<td>14.9%</td>
<td>10.9%</td>
<td>6.9%</td>
<td></td>
</tr>
<tr>
<td>Electric and electronic parts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General machinery</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other manufacturing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU-10</td>
<td>42.5%</td>
<td>14.9%</td>
<td>10.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Transportation machinery parts</td>
<td>42.5%</td>
<td>14.9%</td>
<td>10.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Chemical and petrochemical</td>
<td>13.4%</td>
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<td>6.9%</td>
</tr>
<tr>
<td>Electric and electronic</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Electric and electronic parts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General machinery</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: JETRO Brussels website (www.jetro.be).
world financial crisis. According to the corporate questionnaire survey of the Nihon KeizaiShimbun from April 25/2008, Japanese direct investment in the EU is expected to maintain momentum in spite of the financial crisis.

In order to remain an attractive destination for investors and even more in the case of Japanese investors, the EU-10 must strive to improve their business environment and achieve a good and efficient macro corporate governance. An investment climate that leads to significant FDI inflows goes beyond macro-economic stability and the non-discriminatory treatment of foreign investors; FDI requires an ability to exercise corporate governance without arbitrary bureaucratic interference and a transparent and fair regulatory and legal environment.

5. Hypothesis and model development

The hypothesis of this study states that Japanese FDI inflow in the EU-10 countries is influenced by the quality of macro corporate governance. In other words, if the EU-10 countries achieve a good quality of macro corporate governance they can attract more Japanese investors and higher FDI inflows.

Data for the ten countries is employed for the period 2000-2007, as well as Japanese direct investment in the EU-10 countries. In order to maintain consistency regarding the data and avoid the different methods for compiling country statistics, data is collected from EBRD, the World Bank and UNCTAD. The Japanese inflows are collected according to the balance of payments of the Bank of Japan and JETRO. The study employs Ordinary Least Squares pooled regression and controls through a series of dummies; we control fixed effects for reform and region as separate models by using dummies relating to these variables. The model is constructed as following:
Japanese Direct Investment = f(Corporate Governance Index, GDP per capita, Trade Openness, Unemployment, Inflation, Wage, Industry, dummies)

Dependent variable is Japanese FDI and independent variables are the Corporate Governance Index, GDP per capita, Trade Openness, Unemployment, Inflation, Wage, Industry, and dummy variables. As a measure of Trade Openness we take the share of trade in GDP since it reflects the international trade of the economy — because we deal with small countries surrounded by neighbours with open trade regimes, international trade tends to be more relevant. Unemployment rate is preferred in the case of the EU-10 as besides the data on labour force without employment, it also reflects the privatisation and reform process. Inflation rate besides reflecting the economic conditions also reflects the financial policies of the national banks of the EU-10 countries. The Wage variable indicates the gross average monthly earnings in an annual average-percentage change, and the Industry variable refers to the share of industry in national GDP. The Wage and Industry variables are selected due to the fact that they constitute attraction features in the case of Japanese investments as mentioned above; the Wage indicates that Japanese investments were attracted by the low wages in the EU-10 economies, and the Industry emphasises the fact that the countries have a tradition in manufacturing, as it has been pointed out. The source of variables and expected results are presented in Table 5.1.

The Corporate Governance Index is created from indices provided by EBRD:

Corporate Governance Index = (Quality of corporate governance laws, Index of privatisation, Index of banking sector reform)

The EBRD constructs its ‘Quality of corporate governance laws index’
as a measure of the level of compliance of corporate governance laws with international standards (especially the OECD’s). The ‘Index of privatisation’ compiles the two indices provided by EBRD for ‘large scale privatisation index’ and ‘small scale privatisation index’. The ‘Index of banking sector reform’ provides insight of the banking sector overall.

The results of the privatisation process in the case of the EU-10 economies is relevant both for FDI and the quality of corporate governance; privatisation not only denotes the type of ownership that resulted (concentrated ownership) but also enables governments to have control over capital movements through investment opportunities. Privatisation by itself is not sufficient, it needs the creation of effective systems in order to improve enterprise performance (Estrin, 2002; McCarthy and Puffer, 2003). Corporate governance is a relatively new concept for the former planned economies; since 1990 societies had to learn the rules of private ownership. There is no specific and particular measure for macro corporate governance and the stock markets are underdeveloped since they have functioned only since mid-1990s in most EU-10 countries. Therefore, to have an accurate measure of corporate governance the most relevant indicators for corporate governance are—from an economic point of view—privatisation (large scale and small scale) and the banking sector reform. Through the entrance of foreign banking, on one hand ownership concentration occurred, but on the other hand, banks imported good principles of corporate governance from Western developed economies. The banking sector reform also contains the issue of credit granted to the private sector and it is an accurate measure both for the reform of the banking sector and growth of the private sector. From the legal point of view the most significant indicator for corporate governance is the quality of corporate governance laws. The corporate governance laws are benchmarked against the OECD’s good principles of corporate governance since 1999 and especially after 2004; after 2000 the legal systems of the EU-10 matured and became stable—this is the reason behind the decision to
Table 5.1: Description of variables

<table>
<thead>
<tr>
<th>Variable Name</th>
<th>Description and Source</th>
<th>Expected result</th>
</tr>
</thead>
<tbody>
<tr>
<td>CGI</td>
<td>Independent variable. Constructed from EBRD indices as explained above from the EBRD Transition Reports. The values are between 1 to +4.</td>
<td>+</td>
</tr>
<tr>
<td>GDPPC (ln)</td>
<td>Independent variable. Gross Domestic Product per capita in US dollars. Log transformed to conform to normal distribution. Obtained from EBRD Transition Reports.</td>
<td>+</td>
</tr>
<tr>
<td>TROP</td>
<td>Independent variable. Trade Openness represents the share of trade in GDP in percentage. Obtained from EBRD Transition Reports.</td>
<td>+</td>
</tr>
<tr>
<td>UNMP</td>
<td>Independent variable. Rate of unemployment. Obtained from the International Organisation of Labour.</td>
<td>−</td>
</tr>
<tr>
<td>INFL</td>
<td>Independent variable. Rate of inflation obtained from UN Database (<a href="http://www.data.un.org">www.data.un.org</a>)</td>
<td>−</td>
</tr>
<tr>
<td>WAGE</td>
<td>Independent variable. The wage variable indicates the gross average monthly earnings in an annual average-percentage change. Source: EBRD Transition Reports.</td>
<td>−</td>
</tr>
<tr>
<td>INDST</td>
<td>Independent variable. Industry variable refers to the share of industry in the national GDP. Source: EBRD Transition Reports.</td>
<td>+</td>
</tr>
<tr>
<td>Reform dummy</td>
<td>The EU-10 were labelled by the IMF and World Bank as ‘fast reform countries’ and ‘slow reform countries’: the fast reform countries are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia. The slow reform countries are Bulgaria and Romania.</td>
<td>+/−</td>
</tr>
<tr>
<td>Region dummy</td>
<td>EU-10 countries are divided into three regions: Central, North East and South East Europe; Japanese investments are insignificant in the Baltic economies.</td>
<td>+/−</td>
</tr>
</tbody>
</table>
use a sample only from 2000 onwards.

The benchmark equation based on the model suggested can be built as following:

\[ JDI(\ln)_{it} = \beta_0 + \beta_1 \text{CGI}_{it} + \beta_2 \text{GDPPC}(\ln)_{it} + \beta_3 \text{TROP}_{it} + \beta_4 \text{UNMP}_{it} \]
\[ + \beta_5 \text{INFL}_{it} + \beta_6 \text{WAGE}_{it} + \beta_7 \text{INDST}_{it} + \varepsilon_{it} \]

Where i is the country subscript, t is the time (year) subscript, \( \beta \) are the unknown parameters to be estimated, and \( \varepsilon \) is the usual random disturbance term. Only the Japanese direct investments and GDP per capita are used in logarithm form. The main interest of this empirical study is the sign and the magnitude of \( \beta_1 \) (that is, the marginal effect of corporate governance on the Japanese direct investment inflows), while the effects of the control variables are of a secondary interest.

6. Results

We construct four variation of the suggested model. As we can observe in Table 6.1, Model (1) contains all the variables presented above and we do not employ dummy variables; Model (2) eliminates the Industry variable in order to observe the significance of the model without the attraction for the manufacturing tradition of the EU-10 economies and we controls for the regional aspects -the region dummy controls for the regional choice of Japanese investments within the EU-10 economies. In Model (3) the variable Wage is eliminated in order to observe the significance of the model without the low wage attraction factor; the region dummy controls the regional preference. Model (4) is the complete model suggested, with the two dummy variables, the control for reform and region.

In the analysis of all four models we can observe that the proxy for market size (GDP per capita) has a positive significance given by the t-
ratio values. FDI flows are interested by economies with well functioning markets; Japanese investments are attracted by large well functioning markets and in the case of the small EU−10 markets, they need to compensate for the small market size through attractiveness of determinants.

Since the EU−10 economies before 1990 traded mainly within the

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**Table 6.1: Regression results**

<table>
<thead>
<tr>
<th></th>
<th>Model(1)</th>
<th>Model(2)</th>
<th>Model(3)</th>
<th>Model(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>−13.597***</td>
<td>−8.110***</td>
<td>−12.1054***</td>
<td>−7.6281***</td>
</tr>
<tr>
<td></td>
<td>(−2.929)</td>
<td>(−1.8105)</td>
<td>(−3.222)</td>
<td>(−1.6778)</td>
</tr>
<tr>
<td>CGI</td>
<td>1.464***</td>
<td>1.9576***</td>
<td>2.0529***</td>
<td>2.0353***</td>
</tr>
<tr>
<td></td>
<td>(2.118)</td>
<td>(2.84)</td>
<td>(3.662)</td>
<td>(3.5842)</td>
</tr>
<tr>
<td>GDPPC (ln)</td>
<td>0.7549***</td>
<td>0.6188***</td>
<td>0.4439*</td>
<td>0.049**</td>
</tr>
<tr>
<td></td>
<td>(1.7141)</td>
<td>(1.426)</td>
<td>(1.2365)</td>
<td>(0.1068)</td>
</tr>
<tr>
<td>TROP</td>
<td>0.0195***</td>
<td>0.0227***</td>
<td>0.0239***</td>
<td>0.0247***</td>
</tr>
<tr>
<td></td>
<td>(2.3448)</td>
<td>(2.7697)</td>
<td>(3.5034)</td>
<td>(3.7145)</td>
</tr>
<tr>
<td>UNMP</td>
<td>−0.0156*</td>
<td>−0.0487</td>
<td>−0.0109</td>
<td>−0.0697*</td>
</tr>
<tr>
<td></td>
<td>(−0.261)</td>
<td>(−0.8324)</td>
<td>(−0.3473)</td>
<td>(−1.3056)</td>
</tr>
<tr>
<td>INFL</td>
<td>0.1709***</td>
<td>0.0175</td>
<td>−0.0199</td>
<td>0.0485</td>
</tr>
<tr>
<td></td>
<td>(2.5363)</td>
<td>(0.2549)</td>
<td>(−0.3475)</td>
<td>(0.8598)</td>
</tr>
<tr>
<td>WAGE</td>
<td>−0.1376***</td>
<td>−0.0487*</td>
<td>−0.053***</td>
<td>−0.053***</td>
</tr>
<tr>
<td></td>
<td>(−2.5715)</td>
<td>(−0.871)</td>
<td>(−1.1948)</td>
<td></td>
</tr>
<tr>
<td>INDST</td>
<td>0.2804***</td>
<td>0.1928***</td>
<td>0.185***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(7.5728)</td>
<td>(5.9034)</td>
<td>(5.6541)</td>
<td></td>
</tr>
<tr>
<td>Reform dummy</td>
<td></td>
<td></td>
<td>1.0162***</td>
<td>(1.6788)</td>
</tr>
<tr>
<td>Region dummy</td>
<td>3.3163***</td>
<td>2.5393***</td>
<td>2.7597***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(7.9384)</td>
<td>(6.9648)</td>
<td>(6.4568)</td>
<td></td>
</tr>
<tr>
<td>R square</td>
<td>0.5381</td>
<td>0.5575</td>
<td>0.6987</td>
<td>0.7188</td>
</tr>
<tr>
<td>Adjusted R square</td>
<td>0.4932</td>
<td>0.5145</td>
<td>0.6694</td>
<td>0.6826</td>
</tr>
</tbody>
</table>

Note: t-statistic values are presented in the parentheses; p-values are noted as ‘***’ for p<0.01, ‘**’ for p<0.05 and ‘*’ for p<0.1.
COMECON, international trade gained a major relevance after the collapse of the planned economy. Although the values for the TROP variable are not impressive, nonetheless, in all four models we observe a positive association between Japanese investment and the share of trade in GDP at the 0.00 significance levels in all four models.

The EU-10 economies before 1990 functioned with employment on the job; reform brought along high levels of unemployment, inexperienced previously. The negative association between Japanese investments and the unemployment rate in all models supports the idea that investments concentrate on markets capable of high consumption and confirms the traditional approaches that higher FDI inflows reduce unemployment.

High inflation along with unemployment are common phenomena during economic reforms; high inflation promotes FDI and there should be a positive association between high inflation and FDI; however, very high inflation rates can be considered an impediment to FDI since it implies macroeconomic instability. In models (1), (2) and (4) inflation contributes to attracting Japanese inflows, but except for model (1) its significance is relative. In model (3) the association between Japanese investments and inflation is negative with a t-value of −0.34.

All three models which employ the gross average monthly earnings variable reveal a negative significance enforcing the attraction for Japanese investments due to low labour costs in the EU-10 economies; along with location factors the low wages are the top attraction features. Due to its profound effects on production costs, investment depends on wage levels. The relocation of the large Japanese manufacturing lines (Matsushita and Suzuki) as mentioned previously occurred due to the skilled workforce and low wages especially in the automobile industry.

The strong positive association between the industry share in GDP and Japanese investments reflected in the three t-values (7.5728, 5.9034 and 5.6541) all with p-value significance 0.00, confirm the importance of the industry sector and good quality of labour force skills.
Both dummies employed have a positive significance, signalling that reform factors and regional choice have contributed so far to the Japanese inflows to the EU–10 economies are reflected in the choice of investment.

The corporate governance index created from the EBRD indices reveals in all four models a significant positive association to Japanese direct investments. Corporate governance quality matters to Japanese investors as reflected by the t-values of 2.11, 2.84, 3.662 and 3.58, all with p-value significance 0.00. The markets that do follow good principles of corporate governance can attract higher Japanese investment flows. The European Bank for Reconstruction and Development has carried out assessments related to corporate governance in the EU–10 and the results have shown that some countries perform better than others; the top recipient countries of FDI inflows are also rated best regarding corporate governance aspects. The same situation applies to Japanese investments; the top three recipients of Japanese direct investments are rated best regarding corporate governance aspects.

The regression results show that there is variability between 53 and 71 percent in corporate governance captured by the variability of Japanese direct investments in all four models suggested.

7. Conclusion

The EU–10 countries are without doubt interesting to study for economists and not only. In spite of the difficulties and at times criticism towards the reforms implemented, it is impressive how a new market economy has been created in roughly 15 years after almost 50 of communism. The strategies to become attractive markets for investors have been different within the EU–10 economies and for at least the first ten years of transition they resulted in large decreases of output, high inflation, unemployment from restructuring of former state-owned enterprises, trade collapse and scandals of corruption.
Compared to Japan’s economic power, Japanese investments in the EU-10 are very low. The Czech Republic, Poland and Hungary are top recipients, with the Czech Republic receiving almost US$6 billion. The lower recipients are the Baltic economies where investments are only in the non-manufacturing (retail sector). Significant investments are in the automobile industry, with car production and car parts spread over seven out of the EU-10 countries, which contributed to establishing the area in Europe as the hub for automobile industry. Most of the car production factories were relocations from Western Europe, but the corporations brought smaller contractors and subcontractors, which had a positive impact on inflows.

The results of the empirical analysis show that corporate governance matters in attracting Japanese direct investments; there is a positive association between corporate governance and Japanese direct investments.

The EU-10 economies have undergone a radical transformation over the past twenty years. Some of the difficulties have been predictable but others arose as the reform process was ongoing. However, there is no map or previous experience with such a radical transformation and even though there is still a long way to achieve a constant growth and development along with perfecting corporate governance, the EU-10 countries have the potential and the instruments to become strong market economies.

1）PhD Candidate, Kobe University, Graduate School of International Cooperation Studies.
2）The EU-10 countries are: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.
In the late 1970s the socialist governments embarked on international borrowing programmes; these were part of efforts to sustain consumption in the face of ever-increasing investment targets as the productivity of capital continued its decades-long decline. The USSR, Poland, Yugoslavia and Hungary, and later Bulgaria approached the syndicated loan market, generally through their foreign export credit and short-term trade finance. Net medium to long-term capital flows into the region averaged US$ 1.2


22) Morita, as cited in note 12.


24) Morita, as cited in note 12.

25) The sogo shosha have traditionally played a key role in Japan’s domestic and international trade. There are more than 11,000 trading companies in Japan, but only seven are classified as sogo shosha. They have contributed significantly to the development of Japan’s trade, particularly that of corporate groups (keiretsu). But they have also helped other Japanese firms, especially small and medium-sized enterprises, to penetrate international markets and integrate into global production chains (UNCTAD (2005) Information Note 002/2005, United Nations Conference on Trade and Development, New York, UNCTAD).

26) From the survey conducted by Mitsubishi Research Institute in 1991 sponsored by MITI on 572 samples, all industries; new established sales facilities started operating in the 1960s and decreased after the late 1970s, while investments in manufacturing started in early 1960s and accelerated in 1980s. R & D investments started in late 1970s.


28) The information referring to the rating of indices is provided by the EBRD Methodological Notes published at the end of each EBRD Transition Report.

29) The quality of corporate governance laws has five levels: very high, high, medium, low
and very low.

30) The large-scale privatisation index has a rating system between 1 (little progress) and 4+ (standards and performance typical of advanced industrial economies; more than 75 percent of enterprise assets in private ownership with effective corporate governance).

31) The small-scale privatisation index has a rating system between 1 (little progress) and 4+ (standards and performance typical of advanced industrial economies; no state ownership of small enterprises; effective tradability of land).

32) The index of banking sector reform has a rating system between 1 (little progress beyond the establishment of a two-tier system) and 4+ (standards and performance typical of advanced industrial economies; full convergence of banking laws and regulations with the Bank of International Settlements standards; provisions of a full set of competitive banking services).


36) The COMECON or CMEA was founded in 1949 as the trade and payments system of the socialist countries. Its European members were the U.S.S.R., Poland, the German Democratic Republic, Czechoslovakia, Hungary, Romania, and Bulgaria ('the Six'). Mongolia, Cuba, and Vietnam were non-European members of the Council; Yugoslavia was an associate member. The trade pattern in CMEA was specific to planned economies; the practice of having trade managed by a few large Foreign Trade Organisations and excluding thereby the export producing and import receiving firms, had a number of undesirable consequences for the trade structure. The generation and exchange of product information was suppressed, making CMEA trade informationally inefficient. It was impossible for enterprises to develop an export-marketing infrastructure. Because exports were guaranteed and underwritten by bilateral treaties-and this was particularly the case with bilateral specialization agreements-monopolies were created which gave export producers no incentive to be concerned with product standards, delivery terms, and customer satisfaction, when combined with sellers' market conditions. The practice of trade planning and reliance on detailed bilateral protocols also tended to restrict changes in the composition of trade to incremental adjustments in past negotiated quantities and prices; this limited trade-expansion opportunities from product development (World Bank (1992) World Development Report 1992, World Bank, Washington DC, WB).

37) EBRD (2004), Securities Markets Legislation Assessment Project, European Bank for
Reconstruction and Development, London, EBRD.

The European Bank for Reconstruction and Development has performed a comprehensive analysis of the legal framework in the EU-10 countries through two indicators ‘extensiveness’ (or law on the books) and ‘effectiveness’ (or law in practice). The extensiveness assessment was performed in 2004 and it measured to what extent the legislation compiled with the OECD Principles of Corporate Governance. Rated with ‘High Compliance’ were Hungary, Latvia, Lithuania and Poland. With ‘Medium Compliance’ were Bulgaria, the Czech Republic, Estonia, the Slovak Republic and Slovenia. Romania was rated with ‘Low Compliance’; an update has been conducted in 2007 but results have not been made public.


In 2005 was conducted a Legal Indicator Survey on the effectiveness of corporate governance taking the perspective of a minority shareholder trying to find out whether the controlling shareholder had abused its power. The results revealed that the countries that offer an institutional framework providing minority shareholders with effective mechanisms to obtain disclosure are only a few; in most countries minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders. A reasonable level of effectiveness was found in the Czech Republic, Lithuania and Slovenia with problems in Estonia and Poland. Romania had a relative effective framework for disclosure.

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