3 Exchange Rate Fluctuations and Internationalization Strategies of Multinational Companies

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Introduction

While traditional theories of the multinational firm explain Foreign Direct Investment (FDI) as a result of oligopolistic structures, by eclectic 'approaches', technology and lower transportation costs and by Porter's diamond,[1] the role of exchange rate fluctuations in the decision to internationalize multinational enterprises has been widely neglected in recent years. Although some analysis of the impact of exchange rate fluctuations on Foreign Direct Investment (FDI) was carried out in the 1980s, academic discussion in the 1990s focused more on European monetary integration and its economic appropriateness (Klein and Rosengren 1994; Sung and Lapan 2000).

In the following, it is argued that the change from Bretton Wood's fixed-rate system to floating exchange rates has in the long run influenced companies' internationalization strategies. Dramatic and unforeseeable fluctuations in exchange rates between the USD, European (DEM-based) currencies, and the JPY forced Japanese and European companies to replace their export-oriented internationalization with FDI in order to reduce their exchange rate risks. The sharp falls in the USD after the collapse of the Bretton Woods system in 1973 and after the Plaza Accord in 1985 in particular had a long-term impact on internationalization strategies and market entry modes of Japanese and European companies.

It will be shown that although multinational companies (MNCs) are capable of reducing the short-term 'transaction risk' of exchange rate fluctuations with modern hedging instruments ranging from forward contracts to multinational corporate finance, the only choice they have to reduce the long-term 'economic risk' of losing market shares caused by changes in exchange rates is FDI.

In the Asia-Pacific context, the relatively low-level of economic integration in the region and the weak role of the JPY – in comparison to the

[1] For an overview of these theories see Ietto-Gillies (1992).

role of the USD in the Americas and the EUR in Europe – has implications for investment flows which in the long run may lead to a re-definition of Asian core and hinterland markets with modified roles for the economies of Japan and China.

Internationalization Patterns under the Bretton Woods System
The World Economic Order after 1945

The Western allies' decision to create a world economic order which would liberalize world trade provided the framework for the tremendous internationalization of Western enterprises after World War II. This decision was based on the theories of Ricardo and Heckscher-Ohlin which both explained that free trade leads to higher world production than does protectionism. Moreover, it reflected a political consensus that, even though the Great Depression itself was caused by 'Black Friday', the decision of national governments to stop imports by raising tariffs and establishing prohibitive import quota and, moreover, to devaluate their currencies in order to increase their countries' price competitiveness had worsened the situation significantly.

The post-war world economic order aimed at preventing national governments from repeating this mistake:

- The General Agreement on Tariffs and Trade (GATT) obliged all signing countries to reduce tariffs and other import restrictions.
- A system of fixed exchange rates was implemented, in which 35 USD equalled one ounce of gold – with all other currencies pegged to the USD – and the International Monetary Fund (IMF) was established as a control body to prevent countries from manipulating currencies unilaterally.

In general, the GATT was a success story: With the application of the Most Favoured Nation (MFN) principle and after several multilateral negotiation rounds tariffs were lowered from an average of over 40 per cent in the late 1940s to around 3 per cent in 2000 and a number of Non-Tariff-Barriers (NTB) to trade were reduced or even eliminated. World trade grew dramatically.

In the first two post-war decades, the Bretton Woods fixed-rate system also contributed to the growth of world trade as tight government control of financial markets and cross-border financial flows kept the exchange rates stable so that exporters and importers had no exchange rate risk to bear.

The major weakness of the system, however, was the fact that realignments were only possible in the case of 'fundamental' disequilibria with

at least one country facing extreme balance-of-payment (BoP) problems. 'In the Bretton Woods system, … currency devaluation was considered undesirable because it seemed to indicate a failure of domestic policies and a loss of international prestige. Conversely, revaluations were unacceptable to exporters, whose livelihoods were vulnerable to such policies' (Carbaugh 2000, p. 495).

In the late 1960s, the problem became virulent. Although export prices in the US rose by 15 per cent between 1963 and 1969 but only half that fast in France and by a third or less in Germany, Italy, and Japan, the US government refused to devalue the USD (Eichengreen 2000, p. 18). As a consequence, the DEM and JPY were undervalued in the 1960s, the USD correspondingly overvalued.

Export-oriented Internationalization of German and Japanese Companies

With the DEM and the JPY undervalued, products manufactured in Germany and Japan were cheaper on the world markets (where goods were paid for in USD) than products manufactured in the USD zone. Many German and Japanese companies, therefore, pursued an export-oriented approach to internationalization (Eichengreen 2000, p. 35). Production was concentrated in the home country; sales departments, in contrast, internationalized heavily.

Daimler-Benz AG and BMW AG may serve as German examples: up to the end of the 1980s, around 90 per cent of their passenger cars were produced in Germany. Other manufacturing industries followed the same pattern, especially Germany's major export sector, the machinery and equipment industry.

The impact on business organization and labour force was obvious: While material supply, production, finance, and human resource management remained embedded in their national environment, companies – often enough even small and medium-sized ones – established export departments with specially trained managers and staff. These employees were the only ones who needed to speak English and probably other foreign languages, who had to know about legal and cultural differences between their own country and the target markets and, moreover, had to travel abroad.

In Germany's vocational training system, three year training programs served the staffing needs of these departments qualifying the participants as 'Export Managers' and secretaries with specialization in foreign languages. In academic education, degree courses with interna-

tional content were created in 'Export Management' and 'Export Marketing' whereas studies in mechanical and electrical engineering – the technical basis of Germany's export industries – did not and still hardly ever include lectures or seminars which prepare participants for international business contacts.

In Japan, the situation was not very different. Japanese companies also realized an export-oriented internationalization strategy. Even though many Japanese companies sold a considerable proportion of their products overseas, the company management remained completely Japanese for a long time. It became the task of export specialists to penetrate foreign markets. Sony, for example, started around 1960 to market their Japanese-made products systematically in the United States. Yamazaki Mazak, nowadays one of the world's leading machine tool manufacturers, sold the first 30 machines to the US in 1963 (Kuba 1989, p. 93). In the 1950s and 1960s however, many Japanese manufacturers, used the existing *sōgō shōsha* to export their products (El-Agraa 1995). Thus, only very few employees ever came into contact with foreign customers. Even in the 1990s, many Japanese executives were not able to communicate in any language other than Japanese.

Later, the Japanese 'economic miracle' was seen as a blueprint for economic development in Pacific Asia and copied by many newly industrializing economies (NIEs). The Korean *'chaebol'* structure, for example, also consisted of industrial conglomerations which were allowed to benefit from centralized export service functions, even though they did not play such a prominent role as the *sōgō shōsha* did within the Japanese '*keiretsu*' structure. Governments promoted exports with a variety of instruments ranging from loans at low interest rates to exporters to the establishment of export-processing zones (World Bank 1993, pp. 123–47). In contrast to Japan, however, inward FDI was seen as a means of increasing productivity and exports.

Whereas the JPY and DEM were undervalued because realignment had not taken place, the export push on the part of Taiwan and South Korea were accompanied by deliberate exchange rate policies, even to some extent using multiple exchange rates. These exchange rate manipulations were even continued at the end of the 1980s. Taiwan's very large trade surpluses in the 1980s, especially from 1984 to 1987 when the surpluses averaged 16 per cent of GDP, resulted at least partly from government efforts to manage the exchange rate. Korea's exchange rate protection in the late 1980s certainly helped to run an export surplus in times when the USD devaluated sharply against all other major world currencies (World Bank 1993, p. 126).

The Multinational Approach of US Firms

Confronted with an overvalued USD in the 1950s and 1960s, American companies had to opt for FDI in place of exports. Products manufactured in the USA were more expensive than Japanese or European goods. However, an overvalued USD allowed American firms to purchase and to manufacture abroad cheaply. The internationalization strategy of IBM, Hewlett-Packard, Ford and many other US companies was, therefore, to establish and buy production facilities in overseas markets. Many American firms already became multinationals in the 1950s and 1960s in this way.

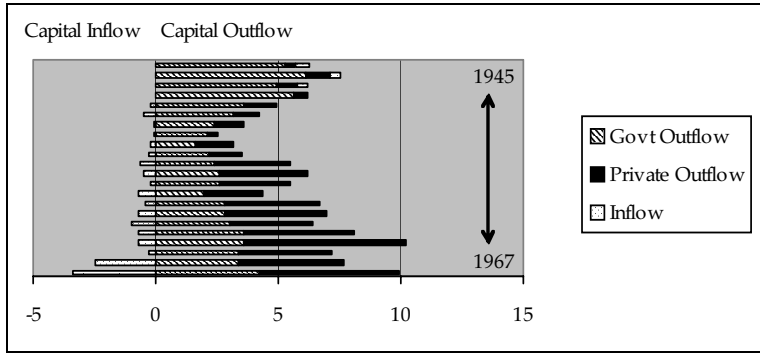
On the macroeconomic level, this business policy of American companies contributed to the net outflow of US capital during the Bretton-Woods-period. As shown in Figure 1, the United States was a permanent capital exporter from 1946 to 1968. Whereas in the first years after World War II government investment – most of it used for establishing a military presence in Europe and Asia – clearly outweighed private capital outflows, private FDI gained importance in the 1950s and became the dominant source of US capital outflows after 1955.

Of course, the USD was not the only reason for American outward FDI. Hymer, Vernon and Knickebocker (Ietto-Gillies 1992) explained how the oligopolistic structure of US consumer markets drove American companies to seek advantages through foreign investment. This was especially the case when initially innovative products became mature and their production could be standardized. Moreover, American companies were not damaged by the war in the same way as their European and Japanese competitors and were able to use a functioning financial market for their expansion whereas only little capital was available in post-war Europe and Japan. Additionally, American companies were ahead of their competitors with regard to technology, management, and marketing – a competitive advantage they had already developed (Chandler 1987, p. 434).

In contrast with export-driven European and Japanese firms, US-based multinationals transferred their company culture to their foreign subsidiaries; American expatriates and later also 'local nationals', having trained in US universities and company headquarters, formed a bridge between the American 'mother' and the subsidiaries abroad.

As the legal environment varied from country to country, the multinationals' investment policy also varied. Whereas in most Western European countries inward FDI was not restricted, France and Japan erected barriers. In Japan, for example, international investors had to form joint ventures with Japanese companies. This obligation was lifted industry by industry in the 1970s.

Figure 3.1: **US Capital Flows (USD billion) 1945–1967**



Source: Eichengreen (2000)

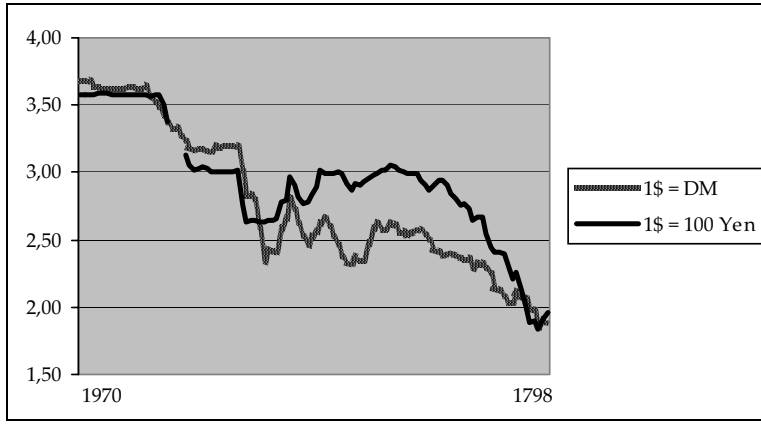
Floating Exchange Rates and First Modifications to Business Strategies

The Introduction of Floating Exchange Rates

The more the USD became overvalued in the 1960s, the more political pressure to re-align the exchange rates increased. The simplest solution – the devaluation of the USD – was turned down by the US government. One explanation is that devaluation would damage the credibility of the Bretton Woods System and, perhaps of more relevance to U.S. officials, of the Dollar itself. A government, which devaluated revealed itself to be less than fully committed to the maintenance of its currency peg. If its priorities came to be questioned, investors would run at the first sign of trouble, and trouble would proliferate (Eichengreen 2000, p. 35).

All second-best solutions such as realignments between European currencies in 1968, a revaluation of the JPY, loans for several countries and the abolishment of the US obligation to hand out gold for USD in 1971 failed. Central Banks no longer intervened to keep the USD rate stable. The Bretton-Woods system collapsed. In 1973, the JPY peg to the USD was lifted and the European countries introduced a joint float. Politicians and business representatives hoped that supply and demand on a free currency market would automatically adjust exchange rates thus reducing trade imbalances. As expected, the USD devaluated significantly throughout the 1970s (Figure 3.2).

Figure 3.2: **USD Devaluation in the 1970s**



Source: Deutsche Bundesbank, Exchange rate statistics

As the three governments and their central banks reacted differently to the oil price shocks in the 1970s, the sharp decline of the nominal USD exchange rate hit Japanese exporters more than Europeans:

While Germany managed to keep the average annual inflation rate below 5 per cent in the 1970s, Japanese monetary policy accommodated the oil price shocks. Thus, Japan's average inflation rate of the 1970s was above 9 per cent peaking at 23 per cent after the first oil price shock. In comparison, the US annual inflation rate oscillated between 3 per cent in 1972 and 11 per cent after the oil price shocks, reaching an average of 7 per cent throughout the 1970s.

Thus, inflation rate differentials indicate a moderate decline of the real USD exchange rate against the DEM and a sharp fall against the JPY. Consequently, Japanese companies have responded more actively to the new exchange rates.

The 'Triad' Approach as a Japanese Reaction

Japanese business leaders tried to cope with the rising JPY. A few started to build up production in the United States; Nissan and Yamazaki Mazak are well-known examples (Box 1).

Most of the Japanese companies, however, tried to lower average costs by transferring the labour intensive parts of production to neighbouring low-cost countries. In a first wave of investment, they moved into South Korea and Taiwan, Hong Kong and Singapore, later into Thailand, Indo-

nesia and Malaysia. They used their natural 'hinterland' in order to gain cost advantages in the fierce competition on the 'Triad' markets.

The basic idea of the Triad is simple: Three (hence Triad) huge trading blocks form the largest part of the world market: USA, Western Europe, and Japan. Around half of world trade takes place within and between these three blocks, they combine around 70 per cent of the world's purchasing power. 90 per cent of product innovations take place within the Triad. Therefore, sales efforts should be concentrated on these three markets (Ohmae 1985).

Box 1: **Nissan and Yamazaki Mazak: Early Movers**

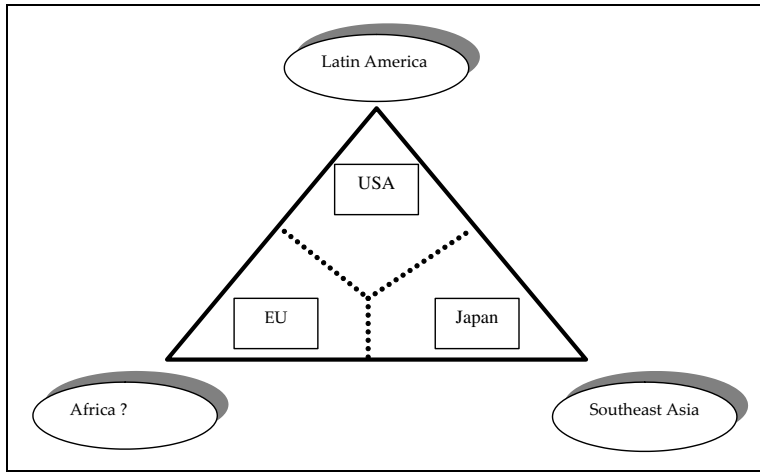
Nissan and Yamazaki Mazak both represent Japan's export industry. Both of them, the car manufacturer Nissan as well as the machine tool builder Yamazaki, started to export products made in Japan to the US in the early 1960s. Both of them reacted to the sharp increase in the value of the JPY by transferring parts of their production to the US. Neither of them invested in the Northern states which were already industrialized and unionized but in Tennessee and Kentucky respectively where no manufacturing or union history would inhibit the transfer and application of Japanese management and production style.
Nissan Motor Manufacturing Corporation was established in Smyrna, Tennessee in 1980; the first truck produced by Nissan in America rolled off the line in 1983. In order to facilitate adaptation of the product to the needs of the American consumer, a research & development centre was established in Michigan. Nissan's investment was only partly in response to the stronger JPY. Investment was also felt to be necessary as Japanese car exports to the US were facing increasing protectionist pressures from the US government.
Yamazaki Mazak's investment in Kentucky seemed to be much more closely related to the JPY appreciation of the 1970s. The company's president, Teruyuki Yamazaki, decided to 'revise radically' the export policy (Kuba 1989, p. 148). In 1974, the company started on the construction of a new plant in Florence, Kentucky and expanded it several times by the end of the 1980s. In 1982, the name of the US subsidiary was changed to MAZAK Corporation so that it would be better accepted as a local supplier. In 1987, the European plant, which had been supported by Prime Minister Margaret Thatcher, was opened in Worcester, UK. Since then, a manufacturing presence in all three triad markets has played a major role in Yamazaki Mazak's internationalization strategy.

After the GATT had opened these markets and free trade had become a reality, at least for the bulk of manufactured goods, enterprises were able to gain market shares as long as they could offer their products at the same quality as competitors but more cheaply. Japanese companies applied two management strategies in order to achieve this goal:

- Total Quality Management, a concept initially introduced in the US, was further developed and rigorously applied by Japanese companies.

- Cost Leadership: lower prices allow market shares to increase. Higher market shares allow cost reductions. Fixed costs per unit decrease with an increase in production (economies of scale); variable costs may also be lowered by learning and specialization effects (experience curve). Cost decreases can also be achieved by transferring labour intensive parts of production into the 'hinterland' while keeping the production of strategically important 'high-tech' components, R&D, marketing and logistics at the Japanese headquarters.

Figure 3.3: **The Triad**



Japanese business leaders were convinced that in the long run the most successful enterprises would be those that consistently exploited the 'hinterland' and which could therefore offer their products in the triad markets more cheaply than competitors who did not. South East Asia was seen as a 'natural hinterland' for Japanese enterprises. Although some American companies also built up production in South East Asia, Japanese firms clearly dominated there. In Thailand and Taiwan, more than 60 per cent of work places in foreign-owned companies were owned by Japanese investors; in South Korea and Hong Kong this figure was around 30 per cent (Urata 1994, p. 279).

According to this Triad Model, Latin America, especially Mexico, could serve as a natural 'hinterland' or 'backyard' for US companies. The future for Western Europe, however, was not as bright: Eastern Europe and the Soviet Union were not available, and Africa was out of the question as a production base (Ohmae 1985, p. 144).

Western Policy Responses to the 'Triad' approach

The successful Japanese export offensives clearly irritated the West. Domestic enterprises and labour unions demanded protection against their Japanese competitors. In many countries, governments reacted and satisfied the demand for a new protectionism. As existing GATT regulations prohibited the increase of import tariffs, the new protectionism consisted mainly of NTBs such as technical norms, administrative rules and 'voluntary export restraints'.

Western politics did not just react defensively but also actively copied the Japanese 'hinterland' strategy:

- The USA signed the 'North American Free Trade Agreement (NAFTA)' which enabled primarily US-American companies to transfer labour-intensive production to Mexico.
- The EU started negotiations with neighbouring countries in Central and Eastern Europe immediately after the fall of communism. As early as 1991, free trade agreements were signed with Poland, Hungary and Czechoslovakia (later integrated in the so called 'Europe Treaties') which enabled Western firms to use these countries as low-cost 'hinterland' countries. By 1995, treaties with the rest of the reforming CEE countries were signed.

Exchange Rate Fluctuations Leading to FDI
Today's World Economic Order

One of the prerequisites of the Triad model and its application was the openness of the markets. Exporters and multinationals wanted to sell their products on the rich Triad markets. Import restrictions were not in the interest of these companies. Not only Japanese and European export-oriented companies but also American multinationals were afraid of the 'New Protectionism' which threatened to hamper the effective use of their world-wide production network. IBM, for example, wanted to send electronic components and parts from South East Asia to America and Western Europe where they were used as components of IBM products, and GM-subsidiary Opel was interested in continuing to buy gearboxes in Japan.

It was therefore in the interest of these companies when the Triad countries encountered protectionist tendencies during the Uruguay round and affirmed the GATT's principles of free trade after eight years (1986–1994) of negotiation. The establishment of the WTO further strengthened free trade policies.

Exchange rate mechanisms, however, continued to represent a more problematic area in international economic policy. While the USD floated against all the major currencies, the majority of the EU countries tried to re-establish a fixed-rate system within Western Europe. On the one hand, the European Monetary system contributed a lot to the further integration of the European market, on the other hand, it went through a severe crisis in 1992 and 1993 when the de-facto anchor currency DEM faced problems due to German reunification. Since then, GBP has been floated against the DEM and, later, the EUR even though the UK is a member of the Single Market. South East Asian countries pegged their currency permanently to the USD until their currencies collapsed in the Asian financial crisis of 1997 and 1998. Japanese firms therefore faced severe price fluctuations in their trade with South Asian subsidiaries with any change in the JPY-USD exchange rate.

Exchange Rate Risks for Internationally Active Companies

In the 1970s, the introduction of floating exchange rates between the USD and other major currencies had successfully reduced its overvaluation. The JPY and DEM were revalued on the markets, the USD and GBP devalued. Floating exchange rates, however, came along with a worldwide liberalization of capital markets. Nowadays, financial institutions invest short-term money – whether capital or derivatives – across borders so that exchange rates are much more determined by short-term capital transactions than by the trade in goods.

Like all investment, cross-border portfolio investment depends more on expectations of future returns than on actual data. In the case of portfolio investment which is denominated in foreign currency, a major determinant of future returns is future exchange rate fluctuation. The expected return on an investment, therefore, depends more on expected changes in the exchange rate than on differences in interest rates, economic growth or other fundamental economic data. Exchange rate fluctuations, therefore, mainly reflect investor's expectations which are not always rational. Therefore, exchange rates tend to 'overshoot'.

Internationally active companies have to cope with these fluctuations in exchange rates. They are exposed to three different types of risk:

- Transaction risk is related to a particular transaction. When a company, for example, signs an export contract, the buyer does not pay immediately but on a given day in the future. If the price is denominated in a foreign currency, the exporter does not know how much money he will receive in his own currency because by the date of

payment the exchange rate may change. Similarly, an importer who is obliged to pay a certain amount of foreign currency at a given date in the future, does not know how much this will be in his own currency. This type of risk can easily be hedged by using forward contracts, currency options and other hedging instruments.

- Translation risk describes changes which occur while translating balance sheet figures into a consolidated balance sheet which is published in another currency. The assets of an American subsidiary which had a value of USD 10 million in both 2001 and 2002, for example, has to be translated into a consolidated European balance sheet at around EUR 11.6 million in 2001 and around EUR 9.9 million in 2002. Even though the value of the assets in the US has not changed in this example, there is considerable depreciation to be seen in the consolidated balance sheet. As these changes do not affect the company's cash flow as long as profits are not repatriated and foreign investment withdrawn, this type of risk is usually neglected by multinational companies.
- Market risk describes the long term effect of exchange rate fluctuations on market shares. It occurs when foreign competitors are able to lower prices because their currency was devalued or the prices of the own products have to be increased as the result of the revaluation of their own currency. This risk cannot be managed with the above-mentioned hedging instruments. As a result, market shares in a foreign market fluctuate with the exchange rate.

Companies are exposed to the market risk as soon as costs incur in another currency than revenues. Then, changes in the exchange rate determine either the number of goods an exporter can sell in a target market or the revenues after conversion into his own currency. 'The consequence may be that goods traders may still refrain from launching exports even if they are sufficiently competitive on the international market … For large companies, in particular, this may mean that direct investment in the target country is the preferred option' (Jepma, Jager and Kamphuis 1996, p. 271).

The long-term strategy of the company must therefore aim at a currency distribution of costs similar to that of proceeds. 'In this way they set production costs in the foreign currency against the foreign currency income. This will diminish their exchange rate exposure substantially' (Jepma, Jager and Kamphuis 1996, p. 271).

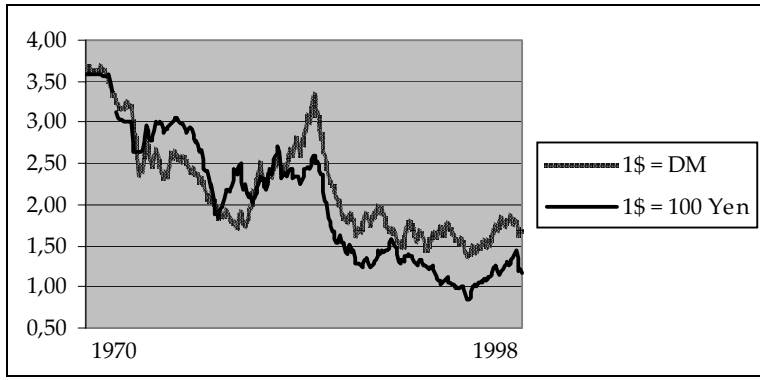
FDI as a Risk Reducing Strategy

European and Japanese companies responded to the challenge of fluctuating exchange rates and changed their internationalization strategy. European and Japanese companies invested heavily in the US particularly in response to the dramatic decline of the USD – after the 1985 Plaza accord – between 1985 and 1994, for example, the greenback devalued from its peak of DEM 3.47 in 1985 to DEM 1.36 in 1994.

The Deutsche Bundesbank pointed out in 1999 that 'serious exchange rate fluctuations have more and more motivated globally active companies to invest in countries whose currencies vary significantly towards the DM' (Deutsche Bundesbank 1999, p. 60). An appreciation of the DM in real terms led to an increase of German outward FDI of around 2.5 per cent, according to Bundesbank (1997, p. 78) estimations. Around two thirds of Germany's FDI stocks outside of the EU were invested in the US in 2000, for example (Deutsche Bundesbank 2002, pp. 16–19).

Similarly, changes in the value of the JPY have a strong influence on Japanese outward FDI. According to IMF estimations (Bayoumi and Lipworth 1998), 'a 6 per cent depreciation of the host country's currency vis-à-vis the yen would also generate an increase in FDI of roughly 10 per cent.'

Figure 3.4: **USD Fluctuations against DEM and JPY**



Source: Deutsche Bundesbank, Exchange Rate Statistics

Japanese companies strengthened the division of labour between subsidiaries in South East Asia and headquarters in Japan (Urata 1994) and, on the other hand, invested heavily in the US and Western Europe (Pohl

Box 2: **BMW – A Change in Strategy**

Over three decades, BMW's strategy remained unchanged: to manufacture high quality cars and motorbikes for a small market segment at home and abroad. Even in Japan, where all other Western competitors relied on joint ventures with Japanese car makers and dealers, BMW successfully installed its own distribution network.

In contrast to the extremely successful internationalization of sales and distribution, production maintained concentrated in a small region within upper and lower Bavaria. All plants were (and still are) highly integrated, with each factory supplying parts and components to the others. Specialization is used for productivity gains. This high level of factory integration combined with their concentration in one region allows BMW to react flexibly to changes in market demand. Components and parts, for example, are delivered from one factory to another as part of a highly sophisticated 'just-in-time' concept which allows component stocks to be reduced to a maximum of a day's production. Even the highly-skilled labour force can be moved between the factories by bus transfers according to changes in demand for various models. External suppliers have been integrated. Nearly all of them are located themselves within the region.

A major change in location strategy was announced by BMW in June 1992. BMW built the first overseas plant on a green-field site in Grier, Spartanburg, South Carolina. The initial investment was USD 400 million. The Z3 model, amongst others, was produced for the NAFTA and the world markets. Even the Z3 models sold in Germany have always been 'made in the USA'.

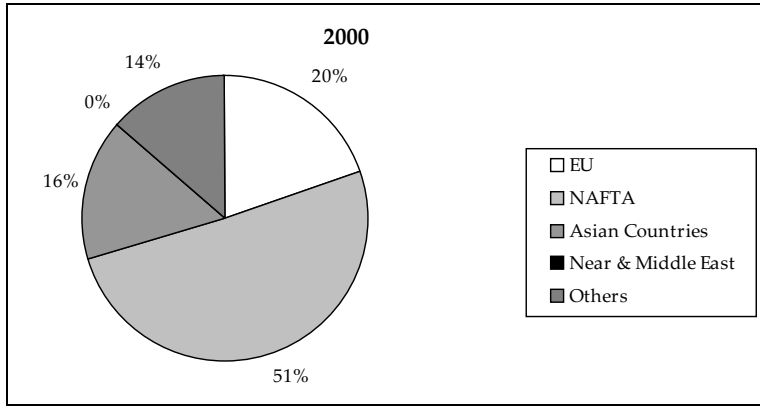
The major reasons for this change in strategy were to avoid possible trade restrictions and negative effects of exchange rate fluctuations, according to Eberhard von Kuenheim, BMW's CEO in 1992.

As BMW is too small to manufacture one type of car in different locations, the company opted for specialization: By producing a limited number of car types in South Carolina and exporting them even to Europe, the net USD exposure is reduced to the difference between the flows from Europe to the US and vice versa. From a macroeconomic viewpoint, BMW's FDI in the US has thus rather increased than reduced total exports.

1994). They 'began to escape from the disadvantages of producing at home by shifting production abroad via FDI. The high yen also subsidized this investment outflow. The upshot was a one-sided imbalance in Japan's FDI account; a huge investment outflow but a minuscule investment inflow' (Ozawa 2002, p. 5). As a consequence, South East Asia was replaced by developed countries as the main recipient of Japanese outward FDI. Their share in Japan's outward FDI increased from about a third to around 70 per cent (Kleinert 2001). The largest part was invested in the United States but European countries received a large amount of Japanese FDI as well. More than 50 per cent of Japan's outward FDI stock is located in NAFTA (Figure 3.5).

Thus, Japanese FDI outflows increased from USD 10.2 billion in 1984 to USD 67.5 billion in 1989 whereof more than USD 32 billion were invested in the United States (OECD 2003 Internet). These investments seem to have at least partly replaced Japanese exports to the USA. In 1990, Japan exported merchandise worth JPY 15 065 billion to the US, compared with more than 18 billion in 1985 (Japan Statistics Bureau 2002). Japanese investment in the EU increased from USD 2 billion (1984) to USD 14.1 billion in 1989 (OECD 2003 Internet). In the same time exports to the EU increased by around 40 per cent (Japan Statistics Bureau 2002). Obviously, Japanese companies' FDI and export activities in Europe were also encouraged by the European Single market program.

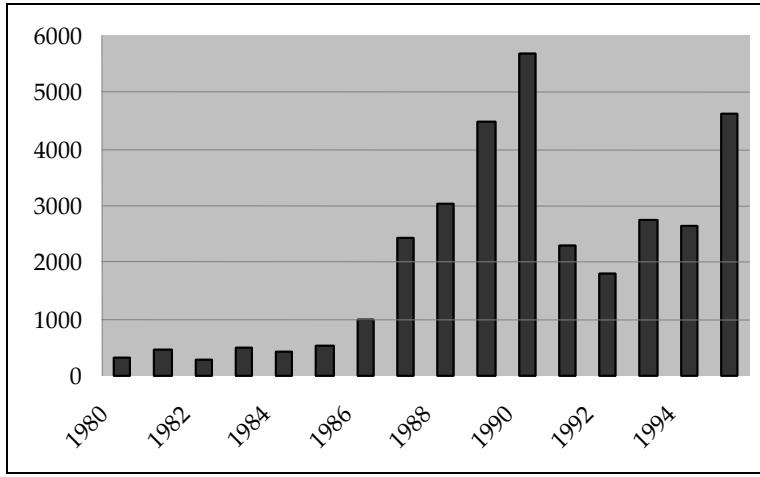
Figure 3.5: **Japan's Outward FDI Stock**



Source: OECD 2003

'The strong appreciation of the yen after the 1985 Plaza Accord encouraged Japanese companies to push for other internationalization strategies besides exports. Although trade remained dominant, foreign direct investment (FDI), the establishment of joint ventures and licensing agreements strongly gained importance' (Kleinert 2001, p. 475). Consequently, the export share in Japanese manufacturing fell from over 14 per cent in 1985 to 12 per cent in 1990 with the most dramatic decline in the car industry where the export ratio fell from 57.3 per cent in 1985 to 34.9 per cent in 1996 (Kleinert 2001, p. 479). Also the machinery and equipment sector, Japan's second largest export industry, realized a huge increase in investment outflows after the Plaza accord (Figure 3.6).

Figure 3.6: **Japan's FDI Outflow in the Machinery & Equipment Sector 1980–1995 (in millions of USD)**



Source: OECD 2003 online

While many companies built up new production sites, others entered into Triad markets by mergers and acquisitions or strategic alliances. Especially in the service sectors such as the air traffic industry or telecommunications, where liberalization and deregulation started later than in manufacturing industries, networking and M&A have played a major role in recent years.

In the long run, global players tend to place production and services in different currency areas in such a way that proceeds and costs are roughly balanced in each currency area. For them, this is the only way to govern the 'market risk' of exchange rate fluctuations in the long run.

'Integrated Currency Zones' in Order to Attract Inward FDI The Triad's 'New Face'

The strategy of global players must, therefore, not only focus on exploiting the natural 'hinterland' but also to minimize exchange rate risks by allocating production to the three key currency zones, namely the USD the EUR, and the JPY zones. 'Integrated currency zones' may constitute today's triad more than the physical openness of markets.

In this way the 'Triad' has acquired a new face. In addition to the 'natural hinterland' which is used as a low-cost site for labour-intensive

production in order to be competitive on export markets, the 'integrated currency zone' plays a major role. Thus, the role of the 'natural hinterland' will change. It will be increasingly used as a production zone for products to be sold within the triad market it is attached to.

The 'dollarization' of Latin America may, for example, help Central and South American countries to increase their attractiveness to investors into export related industries. Although the official or semi-official use of the USD has been introduced by countries like El Salvador, Ecuador and Argentina in order to fight inflation, a stable exchange rate relationship to the major export market may help to build up stable external trade and investment relations.

It is, however, counterproductive to peg the national currency to the USD when the major external trading partner's currency is continuously floating against it, as the example of Argentina shows. Although a member of a customs union with Brazil (in the framework of the 'Mercosur'), Argentina had pegged the ARS to the USD while Brazil has kept its currency, the BRL, floating against the USD. With the USD strength throughout the late nineties, Argentina's price competitiveness versus Brazil deteriorated which finally contributed to the severe BoP problems Argentina faced in 1999.

Box 3: **GBP versus EUR – Some Multinationals' Viewpoint**

Nick Reilly, American CEO of the British GM subsidiary Vauxhall, explained in a Financial Times interview: 'The UK currency's isolation outside the euro-zone has made cost-planning more difficult … Whether we add capacity here or in Spain or Germany, Vauxhall has to put in costs at current exchange rates'.
In very un-Japanese plain terms a *Toyota* representative even threatened with disinvestments: 'We are not selling (UK-made) cars in continental Europe because of the difference between the GBP and the EUR. The UK government has said it may join the EUR in five years, but we won't be around five years from now'.
Nobuyuki Idei, president of *Sony*, was reported to have warned Prime Minister Tony Blair 'that Britain's delay in committing to the EUR puts the future of the company's plants in Britain in question'.
Carlos Goshn, president of *Nissan*, told reporters at a seminar in Tokyo that if Britain did not join the EUR, Nissan would have to consider various options for making any further investment because their British subsidiary 'Sunderland is producing cars with costs in GBP and most of the revenue in EUR'.

In Europe, Lithuania was confronted with a decrease in the country's competitiveness during the rise of the USD against the EUR throughout 1999–2001 and decided to replace its peg to the USD with a peg to the

EUR in February 2002: 'The decision on the peg of the litas to the euro was taken on account of the fact that Lithuanian economy is becoming more closely integrated with the economies of the EU and EU candidate countries. With the emergence of a corresponding export structure, it has become increasingly important to reduce the fluctuations of the real exchange rate of the litas against the currencies of the main trading partners' (Ukio Bankas 2002).

Therefore, the creation of the single currency in Europe served the strategic interest of multinational companies. This might be the reason why mainly multinationals urge the British government to join the single currency (Box 3).

Consequences for Asia-Pacific?

The increasingly important role of Central and Eastern European (CEE) for American and Japanese multinational production is actively supported by the European co-ordination of monetary policy, which is aimed at the long-term accession of these countries to the single currency (Schüle 2003). However, the Asia-Pacific region seems to be far from monetary integration.

No Asian or Pacific country has ever pegged its currency to the JPY in the post-war period. In contrast, the USD has played and still plays a major role even though the financial crisis in 1997/98 demonstrated how dangerous a partial peg to the dollar in combination with high inflows of portfolio investment can be. Although there was some evidence of an increasingly important role for the JPY in the late 1980s (Frankel 1994, p. 244), Asia-Pacific is still highly influenced by the USD. In particular, China's decision to keep the RMB peg to the USD unchanged during the financial crisis seems to have weakened the role of the JPY. This might even be welcomed by several South East Asian countries whose governments have tried to avoid excessive economic dependence on Japan.

In comparison to Europe's integration, the core Triad market in Asia-Pacific has never been a common market of several states, but a single nation. For this reason, close ties to the core market have always gone hand in hand with depending on one single nation and its government, Japan. South East Asian countries were much more reluctant to tie their economies as exclusively to the core market as European accession states do.

In the long run, the economic and probably political rivalry between Japan and China over political leadership in Asia-Pacific may further weaken the role of the JPY as a potential catalyst of economic integration.

On the other hand, China still seems far from being economically strong enough to become the core market in East Asia. If China maintains its policy of keeping the RMB exchange rate towards the USD stable, the USD's role in Asia-Pacific is more likely to be strengthened throughout the current decade.

European and American multinationals will, therefore, be much less inclined to use South East Asia as a production hinterland for penetrating the Japanese market compared to the extent they use Central and Eastern Europe. If a significant risk of exchange rate fluctuations between Japan and other Pacific-Rim countries remains, there is no specific location advantage South East Asian countries might have as a hinterland over China. Companies interested in low cost production sites in Pacific Asia might then prefer investment in China where the same low cost advantages are available, but with the additional promise of a huge market developing in the decades to come. The slow process of trade liberalization within the region may further strengthen the role of China.

Conclusion

As it has been shown, the internationalization strategy of today's global players has been heavily influenced by exchange rate mechanisms and the changes made to them. As a result, European and Japanese companies switched from an export-oriented internationalization strategy to one based on FDI. Internationalization is still mainly concentrated on the Triad markets. However, not only physical barriers but also the existence of 'Integrated Currency Zones' constitute today's Triad. They serve the interest of multinationals who used FDI in order to 'hedge' or circumvent the long-term 'market risk' of floating exchange rates. The more a country's economy belongs or is attached to one of the three major consumer markets traditionally described as the Triad, the more it can increase its attractiveness for inward FDI by pegging its currency to this major market.

Therefore, the lack of currency integration in the Asia-Pacific region together with only slow progress in economic integration might in the long run weaken the role of South East Asia and strengthen the attractiveness of China as a production site. In the very long run, the extent to which China might become the core market in Asia could be discussed.

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