

## Determinants of Japanese Direct Investment in Central and Eastern Europe

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Our study investigates the attractiveness of Central and East European countries (CEECs) to Japanese investors in the 1990s. With many CEECs set to join the European Union over the next few years, understanding foreign direct investment (FDI) flows from non-EU countries is of particular importance to policy makers wishing to attract such investment. An interesting puzzle exists in regard to Japanese FDI into the region in general, and Poland in particular. During the 1990s, Poland became one of the most attractive investment locations in Europe (11<sup>th</sup> in European OECD FDI inflows, 15<sup>th</sup> in overall OECD FDI inflows). However, Japan (6<sup>th</sup> largest in OECD FDI outflows) was only the 12<sup>th</sup> largest foreign investor in Poland. By contrast, Korea (15<sup>th</sup> largest in OECD FDI outflows) is the 5<sup>th</sup> largest investor in Poland. Similar scenarios describe Japanese FDI to many of the other CEECs as well.

Empirical evidence on FDI inflows into Central and Eastern Europe still remains scarce. In particular, formal quantitative studies on Japanese direct investment in the region have been virtually non-existent. Morita (*J. East-West Business, 1998*) adapts Smoker's directional trade ratio to macro-level FDI flows to find that Japanese FDI into Poland is not relatively weaker than its trade position in Poland. More recently, Brenton and DiMauro (*J. Econ. Integration, 1999*) concentrate on the more general issue of whether FDI flows into the CEECs are smaller as compared to other recipient countries. Their attention is primarily focused on West European investors, with recipient countries grouped rather than considered individually. Controlling for the level of income, market size and proximity, they find that the amount of FDI into Central and Eastern Europe positively depends on the progress of economic reforms. Finally, Resmini (*Economics of Transition, 2000*) investigates EU FDI into the CEECs at the manufacturing sector level. She stresses the importance of sector-specific effects in the determination of FDI location choice across individual hosts.

Our study is intended to characterize Japanese firm-level investment flows into the CEECs as well as determine how Japanese investment into these countries differs from that of the EU for both manufacturing and service FDI. A gravity-type model is used to evaluate the relative importance of various factors affecting the location choice both at country and sectoral levels. The firm-level panel data set employed in this study allows us to focus on individual host-country characteristics as potential FDI determinants. Sector-specific effects are also analyzed. In contrast to previous studies we consider both manufacturing and service FDI (wholesale/retail, business service, financial service) into the region throughout the 1990s to provide a more complete description of how Japanese firms service these markets. Our study contributes thus to the better understanding of how and why Japanese investors are attracted to the CEECs.

**JEL Classification Codes:** *F23, P33*

**Keywords:** *Central and Eastern Europe, Japanese Direct Investment, Location Choice*

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