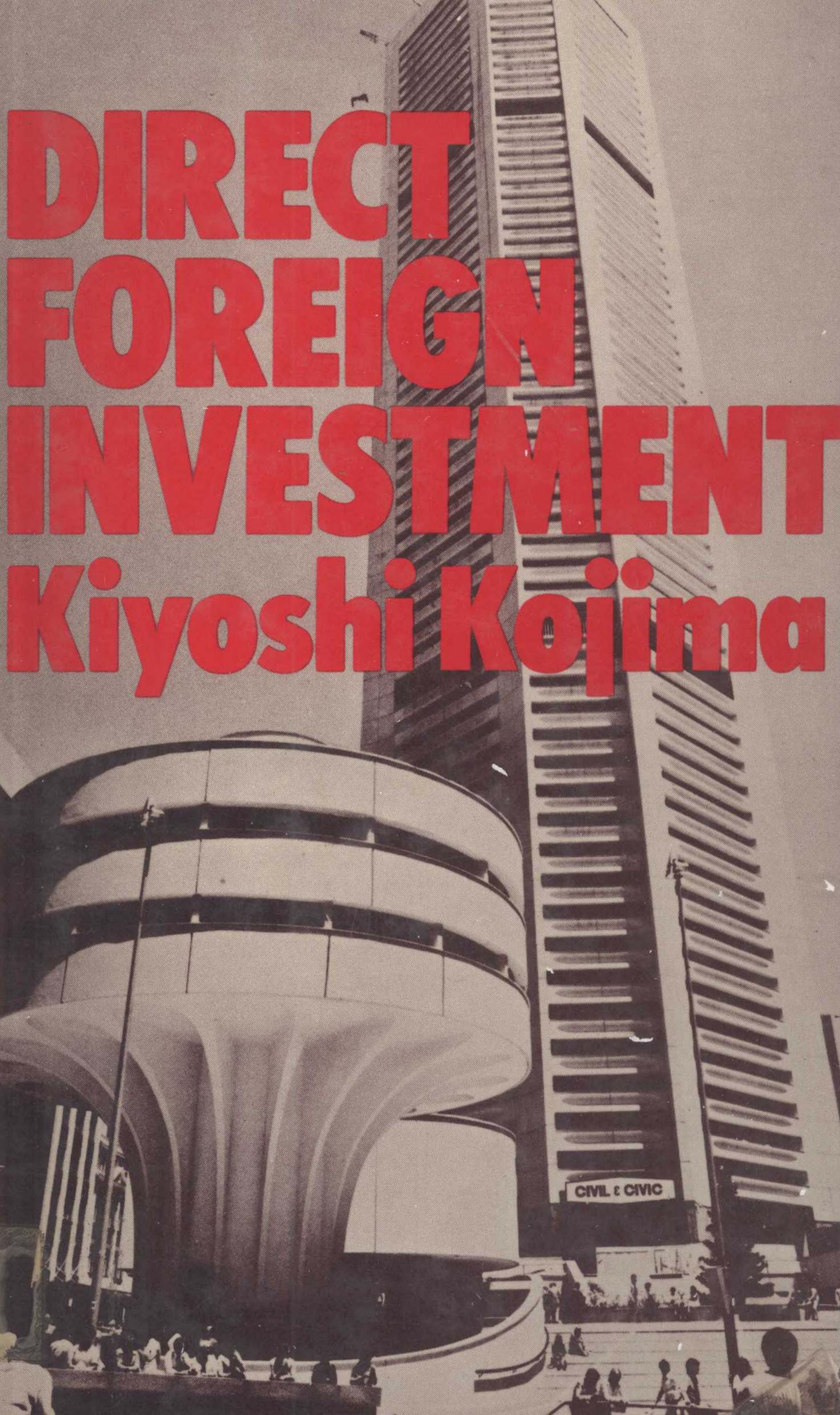
DIRECT FOREIGN INVESTMENT

Kiyoshi Kojima



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A JAPANESE MODEL OF MULTINATIONAL BUSINESS OPERATIONS

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PREFACE

Direct foreign investment and the activities of multinational corporations are new dynamic elements in the international economy. The emphasis on the growth of firms has resulted in the justification of oligopolistic direct foreign investment which may be called 'American-type' or 'anti-trade-oriented', and the justification for the domination of world production by giant multinationals of oils, copper and other primary products and sophisticated manufactured goods as well. The micro-economic, business administration approach which has been the most prominent method of analysis used in the study of multinationals has entirely neglected macro-economic theory, especially the theory of international division of labour.

In many situations, host countries lack sufficient capital, technology or management resources to realise the potential comparative advantage in international trade. Thus, foreign direct investment is effective in supplementing these factors of production, thus making the industry internationally competitive. Therefore, if direct foreign investment is undertaken along the line of comparative advantage, it contributes harmoniously both to the steady industrialisation and economic development of the host country on the one hand, and, on the other, to a lower-cost foreign supply for the investing country. Thus direct foreign investment works to complement, instead of substituting for, international trade, and both will grow *pari passu*, bringing about prosperity of the international economy. This is what I want to call the 'Japanese type' or 'trade-oriented' direct foreign investment.

In this volume an attempt is made to identify, theoretically and practically, those two types of direct foreign investment. This dichotomy will cast light on important policy implications and recommendations about: (1) direct foreign investments for developing countries; (2) investment by an advanced industrialised country in another advanced country; (3) investments in resource security; and (4) on the code of conduct of multinational corporations.

The book, it is hoped, will add to our knowledge of the multinational corporation by, first, developing a macro-economic approach to direct foreign investment instead of the prevalent explanation from the viewpoint of business administration and industrial organisation; secondly, by endeavouring to bridge the gap of separated treatments between international trade and foreign investment, searching for an integrated theory from the viewpoint of a dynamic reorganisation in the international division of labour; and thirdly, by developing a model of Japanese direct foreign investment which follows the integrated theory.

We have added two introductory surveys on the theory of international division of labour and that of foreign investments with a hope that the book might be useful as a textbook of international economics.

I am especially grateful to those eminent scholars who provided me with valuable comments and suggestions to earlier Japanese and English drafts; The late Kaname Akamatsu, H.W. Arndt, Jagdish Bhagwati, Ekkehard Bechler, Fred Bergsten, Richard Cooper, W.M. Corden, Sir John Crawford, William Diebold, Jr., Peter Drysdale, Shigeru Fujii, Koichi Hamada, G.C. Hufbauer, Kiyoshi Ikemoto, the late Harry G. Johnson, Nobuo Minabe, Lennart Ohlsson, Terutomo Ozawa, John E. Roemer, Ben Smith, Yoshi Tsurumi, Raymond Vernon and Taro Watanabe. All contributed to the clarification of my ideas.

I am also deeply indebted, in this context, to Mr Chris Findlay of the Australian National University for devoting his time to going over my English text, and to Dr Makoto Ikema, Dr Kazutaka Kunimoto, Mr Tom Roehl, Dr Norihiko Suzuki, Mrs Hatsuho Kuwayama and Miss Mariko Ono for preparing the text at various stages.

Hitotsubashi University, Tokyo January 1978

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1 ISSUES OF DIRECT FOREIGN INVESTMENT

The importance of direct foreign investment and multinational corporations (MNC) has significantly increased since the Second World War but, at the same time, the corporations' activities have created conflicts between international trade and investment and complaints and antagonism from host countries. While the conflicts and criticisms reflect the reality of MNC operations, it is not clear that the corporations must necessarily be condemned. Specifically, the criticisms levied against the institution are based on *micro*-economic, business administration conceptions which entirely neglect the *macro*-economic theory of the international division of labour. Through the use of both international trade theory and investment theory, can we not attempt to find types of MNC and direct foreign investment which minimise the host country complaints and which eliminate the conflict between trade and investment? A satisfactory answer is given by an enquiry into 'Japanese-type' direct foreign investments with which both trade and investment develop *pari passu* along the line of comparative advantage, the core of the theory of international trade. This is a central issue which I try to explore throughout the present volume. The plan of the book is presented in the last section of this chapter.

1. Importance of Direct Foreign Investment

The following statistics emphasise the importance of the problem under study. The US cumulative foreign investment at the end of 1975 amounted to \$133.2 billion, a figure equal to 8.8 per cent of the GNP in that year of the US. Investment *per capita* was \$623. It was very remarkable that US cumulative foreign investment exceeded US exports by 1.2 times. This fact suggests that the US evaluates her direct foreign investment as more important than her foreign trade, letting the former substitute for the latter.

Compared with the case of the US, the amount of Japanese direct foreign investment is still very limited: the cumulative total of Japanese foreign investment by the end of 1975 was \$15.0 billion, which is about a ninth of US investment. It was only 3.1 per cent of the Japanese GNP. Investment *per capita* was \$135. Exports are still much more important to Japan than direct foreign investment; foreign investment was only 27 per cent of exports. But the rate of increase of Japan's direct foreign investment was remarkably high. The reason was that during the three years from 1970 to 1973, there was a rush of investment abroad because of Japan's favourable balance of payments. Although such a rush might have been temporary, the rate of increase rose to 31.4 per cent for the period of 1967 to 1974. This rate was considerably higher than the increase of US investment, which has been around 10 per cent. In contrast, the rate of increase of Germany's direct foreign investment rose to 26.1 per cent in the same period.

According to the first forecast the Council for Industrial Structure[1] presented, Japanese foreign investment would reach the level of $100 billion by 1985, that is, Japan's investment abroad would become as high as the US investment at present. This would be a formidable amount. Among more recent forecasts, the Council for Industrial Structure, the Industrial Bank of Japan, Japan Economic Research Center and Nikko Research Center[2] each forecast Japanese foreign investment in the future up to 1980 as $40.9, $42.5, $38.5 and $37.4 billion respectively. It must be questioned whether such an enormous amount of direct foreign investment could happen, and what kind of contribution it would make for both Japan and host countries.

Stephen Hymer, a radical economist, presented a surprising forecast for the foreign investment activities of the world's multinational corporations (most of which are American).[3] The production by the multinational corporations has already occupied a quarter of world production. If this were to continue, Hymer states, a half of world production by 2005 and 80 per cent by 2040 would be performed by one or two hundred multinational corporations. This is an astonishing prediction, although I assume it would be unlikely, because many countervailing powers such as opposition from developing countries or resistance of labour unions would arise. Whatever one may think of Professor Hymer's conclusions, his discussion indicates the importance of foreign investment in the post-war world. The future of the world economy, economic development and the welfare of all the developed, developing and socialist countries may well depend greatly or even critically upon how the direct foreign investments of a few multinationals are going to perform.

As can be seen in the above prediction of Hymer, there is a view that several big multinationals' oligopolistic activities over the world might dominate the world economy by establishing an 'invisible empire'. I fear that while it is feasible for such an advanced nation as Japan to counter the activities of the multinationals, developing countries are in danger of not only being charged an exorbitant price for unnecessary beverages or expensive pharmaceuticals, but the countries are also in danger of surrendering all their important production activities to the multinationals. As the multinationals are efficient, they will be able to supply 80 per cent of the world production employing, say, 20 per cent of the total labour force. How can the remaining 80 per cent of the world labour force that are not employed by the multinationals find a job to survive? Hymer continues: 'Multinational corporations, like pine trees, spread their cones on the ground, so that nothing else will grow.'[4]

It is also noteworthy that Hymer, in another paper,[5] and other American economists as D.R. Sherk[6] and J.E. Roemer,[7] are interested in the competition between the USA and Japan in the Pacific and they consider foreign investment as a struggle for obtaining control of economic and political power. They assume that Japanese enterprises will also be multinationalised as predicted by Vernon's 'product cycle' theory, creating its own product cycle with newly developed products.

It is also the general opinion of Japanese economists[8] that Japan ought to take this course. Japanese multinational enterprises will in due course either compete or collude, if necessary, with American multinationals in the Asian-Pacific area. It is the dominant opinion of American entrepreneurs, economists and policy-makers that the multinational corporation activities should be protected and supported as they admit, either explicitly or implicitly, that direct foreign investment gives the USA economic and political power.[9] So the theory of direct foreign investment justifying this opinion has been energetically developed. This is the theory of what I call 'American-type or anti-trade-oriented' direct foreign investment. Unfortunately it has been widely believed in Japan that this is the only legitimate theory of direct foreign investment.

The dominant theories of direct foreign investment and multinational corporations in the US seldom integrate the idea that direct foreign investment should complement and support the step-by-step and well balanced economic development of host countries, especially that of developing countries. This neglect cannot be condoned. Direct foreign investment should be of use to economic development of both the investing and host countries, promoting diversification and the upgrading of their industrial structure, aiming at mutual prosperity. In order to support this kind of foreign investment, another theory of direct foreign investment different from the dominant theory of 'American-type' foreign investment is needed. It is this theory of the 'Japanese-type or trade-oriented' direct investment, based upon the principle of international division of labour, which I am trying to establish in this book.

2. International Trade versus Foreign Investment: A Theoretical Divergence

In order to establish an appropriate economic policy for direct foreign investment and multinational corporation activities, we must have an adequate theory which is rigorously tested. I am convinced that this economic theory would eventually cast light upon, and help in finding answers to, the issues of direct foreign investment and multinational corporations. To my regret, conditions in foreign investment and MNCs have been changing so rapidly that reliable economic theory has not been able to keep pace, and an appropriate theory has not yet been fully developed.

One issue which we consider central to the discussion is whether direct foreign investment complements trade, or substitutes for it. In other words, it is the question of what should be the role of direct foreign investment. We must examine the role of direct foreign investment and its relationships with trade, having in mind both investing and host countries.

Another issue is the importance of the direct foreign investment to Japan. Is Japanese trade going to decrease relatively, to be replaced by foreign investment as in the case of the USA? Will Japan survive by depending upon the returns from investment abroad? Japan's investment has already been criticised in Asia for its 'over-presence'. In spite of that, is it possible for Japan to increase investment? If so, should she increase it? There is growing opinion that Japan should increase investment in such advanced countries as the US and Europe. Will investment in a country where the wage level is higher than in Japan be profitable?

A controversial point in considering these problems is whether or not international trade and direct foreign investment each belong to a different theoretical framework. I think that an integrated theory of international trade and direct investment is missing, since each is separately treated.

The following are a few examples of disintegration of the theory of trade and investment or of inconsistencies between the two. First, such countries as the US consider direct foreign investment to be more important than trade. So they say their government should extensively support the activities of multinational corporations and the government and the multinationals maintain close ties. Thus the US government, for example, has urged Japan to liberalise the introduction of direct investment by foreign firms. In a more extreme example, it is well known that ITT caused trouble in Chile. This is one of the examples of putting great emphasis on direct foreign investment, so that direct investment policy takes precedence over trade policy.

Secondly, the US labour unions, on the other hand, fear the continually increasing outflow of funds to foreign investment projects. Their protest derives from the fact that workers are not able to move freely between countries and, therefore, economic development and welfare have to be considered within the framework of a national economy and an international division of labour. Once investment and corporations are regarded without respect to national boundary, activity is undertaken wherever it can gain the greater profit. The more US investment flows abroad, the less the employment opportunity within the USA would be at fixed wage rates. This is why the labour unions object to direct foreign investment which eventually results in the 'export of employment', and I think it is very reasonable for them to be against it.

Thirdly, the US urged liberalisation of capital inflow into Japan. On the other hand, the US has been intensifying her own protectionism to restrict imports, using balance of payments problems and increased unemployment as the justification. This argument is inconsistent. The reason for this contradiction is that a theoretical analysis dealing with trade and investment is lacking.

Fourthly, when a certain country imposes tariffs on imports other countries attempt to get behind the tariff barriers through direct foreign investment rather than promote exports. Yet this only results in the shrinking of the scale of the home country operation, since without the barrier, the same goods would be exported. For these reasons, to overcome the tariff barriers is one of the biggest motivations to invest abroad. The most typical example was the investment rush by American enterprises to the EEC to get behind its common tariff wall.

The US urged Japan to eliminate limitations on the inflow of direct investment and thus IBM invested in Japan. On the other hand, the US hoped to increase export of computers to Japan, and so requested that Japan abolish quota restrictions and tariffs on computers. This means that the US would like to increase direct investment as well as exports of the same products. These two requests are incompatible with each other. There is also the following contradiction: if Japan should eliminate tariffs, there would probably be no reason for the US to undertake direct investment to Japan.

Nevertheless, many do not realise the seriousness of contradictions.

This, too, we can attribute to a lack of an integrated theory of trade and investment.

We consider the role of direct foreign investment as follows. A primary objective is to continue attempts to extend free trade all over the world. Free trade means that each country, on the premise that neither labour force nor capital is transferred internationally, promotes international divisions of labour along the line of comparative costs. That is to say, the principle of trade tells us how each country can develop in the international economy. Direct foreign investment should then complement the lack of capital or management skills of the host country. The cheap production which was not possible previously because of the lack of these elements is then possible. So, based on the new comparative costs, harmonious trade can grow. The role of direct investment, as it promotes the structural adjustment, is to establish this harmonious trade.

In order to examine the role of direct investment in this scenario, we should first go back to the theory of international division of labour based on the principle of comparative costs and then use that theory to understand and analyse trade and investment comprehensively.

Scholars of business administration have therefore been justifying and supporting multinational corporation activities from the point of view of the growth of an enterprise. The deficiencies of their view result from the complete disregard for policy implications inferred from international economics. The theory of international division of labour assures that while one country takes an advantage of specialised production and export of one commodity, it provides the opportunity for the partner country to produce and export another commodity for its own advantage, whatever difference in size, stage of development and tastes of demand may exist between the two economies. Therefore, the theory provides a sound basis for the interdependence and prosperity of trading countries. Thus, multinational corporation activities should also be reconsidered in the theory of international division of labour.

Secondly, direct foreign investment is a prerequisite for expanding free trade, that is, to establish in the host country a new industry that produces at low cost. We should look at the relationship between direct foreign investment and comparative cost. Direct foreign investment that is released from a comparatively disadvantageous industry in the investing country and finds its way into the industry with overt or potential comparative advantage in the host country will harmoniously promote an upgrading of industrial structure on both sides and thus speed up the expansion of trade between the two countries. This is what I call 'Japanese-type' (in contrast to 'American-type') direct foreign investment. The detailed analysis of this 'Japanese-type' direct foreign investment is the core of this book.

Thirdly, since a comparison of profit rates in the two countries is an appropriate yardstick in a foreign investment decision, I have tried to demonstrate that there is a one-to-one correspondence between comparative costs and comparative profit rates. As a precise explanation is needed to demonstrate the connection, I cannot summarise it here and the reader will have to wait until Chapter 5. Once the relationship is demonstrated, it is possible to find the right direction for international trade as well as for direct foreign investment, judging the situation either by comparative costs or comparative profit rates.

3. A Japanese Direct Foreign Investment Model

What is the core of my analysis of 'Japanese-type, trade-oriented' direct foreign investment? The answer is simple. The comparative costs in Japan and the host country should be considered. Japan should undertake direct foreign investment in an industry becoming *comparatively disadvantageous in Japan which at the same time has* the potential of becoming comparatively advantageous in the host country. If an industry of the host country having potential comparative advantage, which has not been able to achieve its comparative advantage with cheap costs as it lacks technology, capital and management skill, were to become an industry of comparative advantage, it would develop as a new export industry in the host country. In response to this, Japan should enlarge another industry in which it has comparative advantage so that the capital and labour force of the industry which undertook direct investment abroad are transferred to this promising industry. This adjustment would upgrade the industrial structures of both Japan and the host country and could enlarge harmonious trade between them. Direct foreign investment of this type would create more complementary and more profitable trade than if no direct foreign investment took place. This is 'Japanese-type, trade-oriented direct foreign investment'.

Conversely, there is a tendency in some investing countries, as in the US, to invest abroad starting from the industry in which it has the largest comparative advantage (computers, for example). In this case, the consequence would be the reverse. I have named this kind of direct foreign investment 'American-type, anti-trade-oriented'. In this case, where the country has the largest comparative advantage, the export of its product should be promoted. Direct foreign investment negates this export effort. 'Japanese-type' direct foreign investment, on the other hand, is complementary with trade. Consequently the two types of direct foreign investment will bring about very different results.

Perhaps a few examples of 'Japanese-type' foreign investment will help the reader appreciate the differences between the two types presented above. The first example pertains to national resources. Japan possesses hardly any oil. It is said that there does exist a little oil on the Japan Sea coast, but to extract it would be prohibitively expensive. So Japan's oil extraction is comparatively disadvantaged. On the other hand, Indonesian oil deposits are abundant, but they would not be an object of trade if left untouched. It is not until a country such as Japan or the US makes an investment that the extracting of oil becomes Indonesia's comparatively advantageous industry. New trade is created. This tendency for Japan to invest in development and then import the products back to Japan is evident not only in oils, but also in other resources – fuel, agricultural raw materials and foods. Development followed by import is an investment to complement Japan's comparative disadvantage and is a typical example of 'Japanese-type' direct foreign investment.

The second one concerns labour-intensive manufactures such as textiles. As the economic growth in Japan accelerated, wages increased. This made it more costly to produce labour-intensive commodities. Therefore, since the wage rate in Korea, for instance, is one-third or even a quarter of that in Japan and labour efficiency is high, Japanese capital, superior technology and management skill entered Korea to create a textile industry, by establishing joint ventures. As Korea was originally abundant in cheap labour, it potentially possessed comparative advantage in the production of such labour-intensive manufactures. If there was no direct foreign investment, Korea could not have taken advantage of this potential comparative advantage.

As a third example, there are cases that transfer a labour-intensive production process to a country where labour costs are less expensive. The most typical example can be seen in the assembly of cars and electric equipment and appliances. Only the assembly process is transferred to such countries as Korea and Taiwan. Furthermore, if the production of a certain part and component requires a highly labour-intensive method, the process in question is undertaken in places where labour cost is saved. This is also a kind of 'Japanese-type' direct foreign investment, for it moves the production process with comparative disadvantage to a host country which has a comparative advantage in that process.

'Japanese-type' direct foreign investment plays the role of initiator