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FIRM, INDUSTRY AND COUNTRY LEVEL INFLUENCES ON
JAPANESE FOREIGN INVESTMENT IN THE UNITED STATES

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The discussion of Japanese investment in the United States has tended to treat all Japanese investment equally. This is as true of the discussion of the management problems of the Japanese firm in the United States as it is of the discussion of the impact of the transfer of these resources on the national or local economy. As in many things Japanese, we have let our images of Japan determine the variables we are using to discuss the question. Just as there is some truth in the 'Japan Incorporated' model of Japanese economic policy-making, there is no denying that characteristics shared by all Japanese firms are an important aspect of both the investment decision and an influence on the impact of that investment on the host country, the United States. Yet it is the individual calculations of firms, faced with competitive threats and the opportunities of the global and the Japanese domestic marketplace, which, when summed together, determine the macroeconomic level of investment. If the analysis ignores the individual decision-making manager in the investing firm, this leads to the same assumptions--similar objectives for all the Japanese economic actors--that has plagued the discussion of Japanese economic policy. It is ironic that the change of venue from Japanese internal policy to the internationalization of the Japanese economy has allowed researchers and policymakers to slip back into a country level of discussion that would long ago have been labeled simplistic when applied to Japanese internal economic policy-making.

In this paper, I try to identify the factors at the country, industry and firm levels which are important in understanding the rationale for a given investment. The approach will necessarily be a micro-level one, giving industry and firm level variables equal billing and emphasizing the individual investment decision of a firm. In the next section, I review the factors that economists believe determine the amount of investment at the firm and at the industry level. Using that review as a base, in the following section I discuss the importance of country, industry and firm level factors for the Japanese firm considering investment in the United States. I show that country level variables are significant in determining levels of investment, and that Japanese government policy influences many of the industry and firm level variables cited. However, I argue that the individual

and industry differences in the set of Japanese potential investors require analysis of these levels as well if we are to ascertain the value of such investment for the United States as the host country and the rationale of that investment given the current strategy of the firm.

Why Do Firms Invest Internationally?

Country Differences in Cost Structures

Country level variables important for explaining why firms invest primarily relate to cost. Different factor endowments, the level of resources available to firms, lead to differences in cost of production. The low cost of some factor attracts the attention of firms not just from the local economy, but from abroad as well. Low cost energy in the Pacific Northwest attracts foreign chemical and aluminum firms. The 'waste' from french fry production attracts a Japanese firm, which uses this low cost raw material to make feed for Japanese livestock.

Since foreign firms are at some disadvantage, they must bring some complementary factor which makes better use of that abundant resource possible (Casson, 1979). Specific chemical technology or financing for a major aluminum plant expansion could be those complementary factors for the Japanese investment mentioned above. Access to Japanese agricultural users and knowledge of their preferences are the complementary factors in the second case. Without such a complementary factor, local firms in the U.S. would be able to produce more inexpensively using the same local resources. Without the locally inexpensive factor, trade would be preferable, since it avoids the extra management costs. In each case, the Japanese firm brings an asset not available or available only at higher cost in the U.S. due to the Japanese firm's previous investment to develop its assets within the firm.

Country governments can change the relative prices through tariffs or through changes in foreign exchange rates not compensated for by inflation. They can set certain prices that might make investment attractive. Examples might include export processing zones or local government incentives for new Japanese investment. Policy changes and other economic effects can change

the price differentials and make the previous investment decisions more or less favorable after the fact. Honda's investment payoff for its auto plant in Ohio changed substantially when the orderly marketing agreement in effect put an infinite price--no more may be imported at any price-- on cars imported over its OMA share. This uncertainty may require firms which do not prefer to assume such policy risk to diversify their investments, even across countries which currently have similar relative price differentials when compared with the firm's home country. This diversification would help to explain the decision of a firm like Matsushita to invest in a large number of countries, and for the continuing interest in siting plants both in Canada and the United States by auto manufacturers, even with the U.S. Canada Free Trade Agreement seemingly in place.

Relative price differentials between countries may not remain stable over time. Not only exchange rates, but also changes in productivity changes will have that effect. Firms may invest in anticipation of that change, or to build up new assets to respond to that change, as I show in later sections.

Industry Level Influences on Investment

Industry level factors mostly relate to the demand side, as opposed to the cost side in country level factors. Competitive conditions between large firms in the product markets may drive firms to invest overseas. With only a few firms in one isolated local market, it might be possible through government sponsored agreements such as cartels to divide up the market and peacefully coexist. Without such a system to regulate competitive threats, however, all market participants must be concerned about letting their competitors have a comfortable market in which to reap higher profits and build competitive strength.

A local market with no international player creates just such a dangerous competitive situation for outsiders. Early discussions of this competitive incentive for foreign investment (Hymer) focused on the necessity to deny a protected home market to a foreign rival. With the strength developed in the comfortable home market environment, the firm could develop its own

asset base and financial strength, and then attack aggressively the competitive position of other firms on international markets. The isolated Japanese domestic market base of television sales enabled the Japanese competitors of Zenith to gain experience which later was used to aggressively penetrate the American television market. While Zenith was not able to enter to challenge this isolated market, this same analysis would explain cross investment between countries such as the American investment in Japanese semiconductor capacity at the same time that Japanese semiconductor firms invest in the United States. This could take place even when the factor costs of production are quite similar, as they seem to be in semiconductors. Firms on either side of the Pacific could not afford to permit a protected local market for a major competitor. Note that in this case the semiconductor agreement provides a degree of 'protected market' status for the American firms, so that both sides have incentives to challenge the other country firms on their home ground.

Some writers reintroduce cost factors into the discussion of this competition between large firms (Helpman), so that the cost disadvantage is less. Helpman argues that the scale economies from single sources of production have diminished, so that firms can now consider sourcing subgroups of products in a particular category from different country plants. While the Helpman analysis focuses on the macroeconomic level of trade flows between similar countries, the effect on firm level strategy, with foreign investment as the vehicle, is clear as well. Small copiers and large copiers from the same firm can cross the Pacific in different directions given the larger demand for large copiers in the U.S. and smaller copiers in Japan. Even without differences in preferences, common parts for autos can be shipped to various world-wide points for final assembly.

The competition need not be only between multinational firms of different countries, as Hymer had modelled. Recent papers have shown that there is an incentive to follow the investment into third countries by firms from the same country or competing countries (Ito and Yu, Ohmae). The rationale is the same: to assure that a single firm does not gain the advantage from a market in which there is less competition than in the overall global marketplace. This rationale,

which leads to follow the leader investment, will be shown to be especially important in the Japanese case (e.g. autos), given the nature of competition in the Japanese domestic market. Note that it need not be international demand that drives such a competitive investment, since the ability to serve the domestic market from various supply sources has value in this type of model. A Japanese firm making an early investment in standardized electronics production in other Asian countries can use that production base to attack an established domestic rival in Japan. Similarly, a Japanese beverage firm making sake can attack a domestic rival with the low cost California rice as a competitive weapon.

Up to this point, the discussion has only considered how to gain, through foreign investment, the most benefit from the firm's existing competitive position in world markets. This narrow definition of benefits from foreign investment neglects the ability of firms to build up their own competitive position over time through participation in international markets. By participation in a wide variety of world markets, the firm is assured of insights into the emerging trends in technology and customer desires (Bartlett). Japanese department store investments in Paris shops and buying offices is a good example. The Japanese department store, Kintetsu, will handle brand name product from Macys in Japan, gaining Macys insights into emerging fashion trends in the U.S. The investment in small U.S. software companies in Silicon Valley by firms as seemingly unrelated as the equipment manufacturer Kubota show the same objective. The investment of Merck in a uncompetitive Japanese pharmaceutical firm, Banyu, is in a similar vein. The access for Merck to distribution channels and Japanese research labs can form the basis for future strategic initiatives.

By operating in the leading markets of the world, firms are pressured into developing the products which customers demand (Johansson and Roehl). U.S. semiconductor firms, heavily dependent on defense orders in their home market, develop stronger competitive positions in consumer applications through their investments in Japan. With this more realistic specification of market competition, industry level competition is more than a battle for the share of current market

position. It now includes competition for access to new technology and competition for access to consumers, even as the firms strive to maintain their current market position.

In a rapidly evolving, dynamic market which forces firms to develop new assets to respond to these changes, attaining full value of the firm's competitive position need not come at the expense of customers; exploitation need not occur. If participation in these markets and in these technologies leads to constant change in the marketplace conditions, then there is also less worry about the loss of consumer sovereignty in these markets. Not only are there more participants as a result of the foreign investment, but the pressure to serve consumer changing desires provides an additional benefit.

Firm Level Variables

How does the firm get the highest value for the assets it controls? This question drives the discussion of the firm level incentives for foreign investment. While the Japanese auto firm could license GM to produce cars in the U.S., that Japanese firm may feel this alternative would not generate as high a return on the Japanese firm's assets as building a plant in the U.S. The skills controlled by the Japanese firm, in this case the production technology, would be hard to value in advance by the U.S. firm. Without the experience of the NUMMI joint venture with Toyota, how could General Motors know what would be an appropriate price to pay for the management assistance Toyota might transfer? General Motors would likely underbid what Toyota thought the skills were worth.

Writers have tried to build a theory of foreign investment on just such failures of markets to provide the full value for the assets of multinational firms. Note that in place of the industry level emphasis on product markets, it is the failure of markets for the exchange of assets owned by the firm. It is a failure of these factor markets that leads to this incentive for foreign investment (Dunning). Instead of selling or renting the assets in the market, firms choose to use the assets internally, thus the term 'internalization' (Rugman).

A firm must decide what assets it has of value that are not also in the asset portfolio of other firms in its industry or country (firm-specific advantages). In the initial stage of development of just-in-time production systems, Kanban was just such an asset for Toyota. The firm must then decide whether it would be better off using the assets in the home country and exporting the output, or using it in a foreign location (location-specific advantages). Having chosen the location, the firm must finally decide what institutional or transactional relationship will maximize the value of the asset (internalization). For the auto firm mentioned above, the firm-specific advantage is the production expertise; the location-specific advantage, the lower tariff and access to increased volume from U.S. production and maybe lower labor cost; and the internalization advantage, the process techniques which are hard to transfer.

Firm-specific advantages are not static, but can be strengthened or can deteriorate over time as a result of strategic decisions. Macro-level discussions of effective trade policy have recently emphasized the importance of experience in attaining long-term competitive strengths by a country in an industry (Krugman). For example, in semiconductors, the experience of Japanese firms in earlier generations of memory chips enables the industry in that country to more easily develop future generation of such chips. These same factors are important on the firm level. Writers (Itami with Roehl) have suggested that the strategy chosen by a firm has an effect beyond the returns earned on the asset; strategy has a significant effect on the firm's asset base as well. Foreign investment can build that asset base through contact with technology, experience with customers or from the pressure of intense competition that might be lacking in the domestic market. In each of these examples, the assets that are developed as a result of foreign investment may not be easily duplicated by competitors. Kao, the Japanese soap company, learns about American consumers through its purchase of Jergens. Seiko Epson stays close to its main customer base in IBM PC's through a research center in California. Yamanouchi Pharmaceutical, in a very regulated market at home, obtains experience in very competitive consumer markets by buying Shaklee's cosmetics business. Even though cosmetics is quite different from pharmaceuticals, the

consumer market skills are important additions to its firm-specific asset portfolio. Each of these firm assets can not be purchased in the Japanese market by any of the firms which compete with Kao, Epson and Yamanouchi. Nor can a Japanese competing auto firm purchase in the market Honda's grasp of the U.S. customer tastes.

The assets developed internationally, if chosen correctly, can have multiple use, both in the domestic market and in the country of the investment. Honda can use its brand name to sell lawnmowers as well as cars in the U.S.; its success in the U.S. market feeds back to improve its image in Japan as well. Yamanouchi, expecting to see increased competitive pressure in the domestic market, may be able to use the U.S. experience to be better prepared as the domestic drug market is deregulated.

Use of the firm's assets may further develop them rather than merely depreciating them. Foreign investment, as one way to further develop these intangible or 'invisible' assets, thus becomes a central part of emerging strategy rather than just a way to exploit an existing advantage.

Firms do not have only a single asset. Yet this internalization approach identifies the seeking of full return on an asset as the source of the foreign investment incentive. In reality firms have a portfolio of strengths and weaknesses which will have to be deployed together if the investment is made. A small parts supply firm that wants to protect its ties to an auto firm by investing may find that it lacks other assets necessary to carry out the investment effectively. The most obvious example is international management skills. Since these issues are addressed by other papers in the volume, however, I need only note the point here. Academic economists can isolate the individual asset and hold other effects constant by suggesting that there are extra costs of managing abroad or of marketing abroad (Hirsch). While logically true, this approach does not help us understand the impact of these management factors on the investment decision, since everything gets dumped into the black box of management costs (or marketing costs if you choose not to serve the market locally).

The next section of the paper applies these principles to a discussion of Japanese investment in the United States. To help the reader keep track of the variables, the discussion to

this point is summarized in the following table.

Table One
Factors Influencing Foreign Investment

<u>Level of Analysis</u>	<u>Main Factors</u>	<u>Focus</u>
Country Level	Relative Prices of Factors of Production	The Supply Curve
Industry Level	Competition Between Large Firms	Demand Conditions
Firm Level	Invisible Assets of the Firm	Full Return on Assets & Efficient Building of New Assets

Japanese Investment: What are the Important Differences in Variables

While Japanese investors consider the same set of variables other firms evaluate when they invest overseas, the relative importance of each variable is influenced by the country environment within Japan, the industry environment in Japan and the firm's experience in Japan. Without an understanding of the differing importance of the variables, the rationale of an investment is difficult to evaluate. To understand the value of a U.S. investment in the overall strategy of the Japanese firm or to estimate the potential value over time to the host community, information about the country, industry and firm level factors faced by the Japanese firm are essential.

Country Level Variables: What Japanese Prices are Significant?

Price differences between the local market and foreign locations are the source of most country level differences, as I have said above. These differentials between local and world market prices are not the same for Japanese as for American firms, and this variation will generate a different pattern of investment incentives.

Even though the Japanese economy is always said to be dependent on trade, statistics show

that the country has a relatively low level of dependence on international trade as measured by percentage of GNP. This however fails to address the equally important question raised above: what is the cost of losing access to markets for both raw materials and final products. If the difference between domestic prices of raw materials and world market prices are substantially greater for one country than for another, investment decisions should not be the same in both. The price differentials between the world market price and the price Japanese would have to pay if the product were produced locally are on average far greater for Japan than for many other countries. For example, both the United States and Japan might find it more attractive to import copper, since the local price is higher in both cases. Japanese firms, however, would be more interested in securing supplies from the world market, since the local market price is much higher. The U.S. alternative is closed mines in the United States that could be reopened; there are none in Japan. Concern about access to those materials on world market will naturally be higher in Japan, even if Japan's dependence on trade remains relatively low. The investment of a Japanese trading firm, Mitsui and Company, in aluminum smelter capacity in the United States is certainly based on lower U.S. energy costs, but it is also premised on assuring aluminum supplies from sources it can control, sources not vulnerable to discrimination against buyers in Japan by the large multinational integrated aluminum firms.

This might not always lead to investment, but rather to long-term contracts for supply of raw materials (Smith, 1976). Japanese contracts for coal from Canada and for sugar from Australia are examples where foreign firms made the investment to serve Japanese demand through long-term contracts. Still, the worry over the loss of this access is an important stimulus for overseas investment. Witness the Japanese investment in U.S. beef feedlots and wine grape acreage as it became clear that further imports of these products would be permitted in the 1990's. This is an investment stimulus that would not be shared by firms whose domestic market provides substitutes at a relatively low premium for foreign supplies that might be cut off.

The same argument can be said for access to final product markets. Suppose the relative

profitability of firms is dependent on access to world markets. This is a reasonable assumption for many of the key industries in Japan. Even if the relative weight of the foreign market sales are not overwhelming, the profitability of the firm and its continued health may depend on continued access to the foreign markets. Japanese firm investments in technology in both the automobile and semiconductor industry, while premised on a secure local market, depend on such an assumption of market access.

Not all the factor prices move the Japanese firms toward a greater level of foreign investment. Most analyses of factor prices at the national level assume that those prices are given to the firm. Unfortunately, if firms make long-term business relationships with other firms, and if they make long-term labor contracts with their employees, they may create cost structures which are quite different from other firms in the same national market. that face arms length market exchanges of these factors of production

Suppose a firm has made employment contracts with its workers in anticipation of the continued export of products from its Japanese manufacturing operations. If the relative prices change to favor foreign operations, theory would predict that the firm would shift operations abroad, especially if the change in prices were thought to be permanent. For the Japanese firm having long-term labor contracts, however, that shift might be substantially delayed.

The marginal cost of labor in some large Japanese companies may well be close to zero for the purpose of a foreign investment decision. The workers will have to be kept, or their contracts bought out, if the firm chooses to transfer production. It is no accident that the smaller firms in Japan, with no permanent employment contracts, were some of the earliest firms to move abroad to low wage countries in Asia. Honda, the earliest auto maker to invest abroad, found itself in a position where it had to add additional capacity, so that all its current workers were fully utilized at that time. With its current labor contracts secure, it could more easily make the commitment to foreign production capacity at that point in time. Firms with fast-growing sales are less constrained by these labor contracts, since they are both able to protect the current contracts (they

face labor costs which approximate market rates for new hires) and also invest abroad. Firms in more slow growing markets, markets that are losing competitiveness, face a situation where labor contract commitments reduce their labor 'costs.' Since they have excess manpower, the opportunity cost of using the employees in Japan are quite low. This can sometimes delay what economists would predict as the proper strategy, movement abroad to take advantage of lower labor or other factor costs.

These same permanent employment contracts may push the Japanese firm into a different type of foreign investment, however. Suppose a firm's core business does not provide as many employment opportunities as expected, so that the firm has excess technically trained people to whom it has committed to permanent employment contracts. It may resort to unrelated diversification in an attempt to find new arenas for growth. A current Sumitomo Metals recruitment film mentions steel only tangentially, with the emphasis on using the technology developed in steel in high technology areas such as production process control and semiconductors. Often the sources of resources necessary for this diversification are closely controlled by established Japanese players in the home market. In most cases, the skills, especially labor, necessary for such diversification have to be developed internally, not being available for purchase on the market in Japan.

Some skills may be totally unavailable without active foreign market participation. Trading companies wanting to extend their information-based assets to data base services could initially find no Japanese sources for the necessary expertise, and had to tie up with foreign firms to develop those skills. The combination of under-utilized skilled labor and the lack of available complementary resources in Japan would encourage foreign investment in new or high technology areas. The investment of the equipment manufacturer Kubota in a semiconductor company, Nippon Mining's investment in Gould and that of steel firm Nippon Kokan's proposed investment in silicon facilities all are of this type. Note that in this case green field investments may be less common than either takeovers or joint ventures with a foreign firm, since either of these alternatives speeds the process of acquisition of the skills which is the primary objective of the

investment. It may seem that the use of takeovers would enable the Japanese firm to utilize the more open market for resources in the United States, but in such areas as financial services, Japanese firms have found that the very openness of the labor market has enabled skilled workers and managers from the firms to desert it after the takeover. After Fuji Bank purchased the financial services firm Walter Heller, many of the management left. Again, the ability to retain and effectively manage foreign workers, the question discussed in most of the other papers in this volume, becomes important in assessing the value of a given investment.

The long-term parts supply commitments that many Japanese firms develop also change the relative prices of domestic and foreign parts production (Roehl, 1989). If the production system of a firm is predicated on quick supply response (JIT systems) and information exchange systems for rapid product development, it will take more than a marginal advantage in factor prices to move the firm toward foreign production. Even new domestic supplier relationships seem hard to develop under these circumstances. Since the 'costs' of foreign production include the duplication of this system of parts flow and information exchange with the foreign suppliers, foreign investment might be delayed for these types of firms.

Even for raw material supplies, where exchanges of information and product might not be as significant, long-term contracts may present Japanese firms with prices that do not reflect current market prices, thus limiting flexibility. As Ben Smith documents, the desire for resource security has driven Japanese firms to commit to long-term contracts that may be based on long-term average prices rather than current market prices. Here again, the Japanese firm may find itself protected from increases, or forced to share losses due to price fluctuations. This has led to some celebrated cases of disputes with suppliers, as when sugar prices dropped soon after the Japanese signed a long-term contract with Australian suppliers. Thus, the prices faced by a Japanese firm with such a long-term contract will be different from that faced by its domestic competitor who has negotiated such a contract on different terms, and certainly different from the prices faced by non-Japanese firms buying at current market prices.

An obvious country level variable is the value of the yen. At the same time that the increase in the value of the yen makes it more difficult to sell abroad products produced in Japan, the increase reduces the cost of acquiring or building facilities in the United States. This incentive is shared by all Japanese firms. Of course, all countries share this same risk. Given the increased politicization of the exchange rate process, there may be greater uncertainty in the future price of the country's currency than before. Japan's currency recently seems to be a target of international policy, such as the intervention recently seen by the Group of Seven finance ministers. Thus, there may be more policy uncertainty for Japanese firms than for those of other countries. With accurate forecasting becoming increasingly difficult, diversification of sources, along with more flexible manufacturing operations that permit quick modification of product output according to the value of the currency, may be appropriate. Honda's ability to serve the Japanese market to a small degree with its Honda Accord Coupe is but one example of that flexibility.

Government policy actions are another country level source of investment incentives. Some might argue that the U.S. government actions are the most important reason for Japanese investment. Areas with strict import limits like autos and televisions find major U.S. investment positions taken by the major Japanese firms.

While these actions were sector-specific, the cumulative result of such U.S. government actions by a purportedly free trade administration will force all Japanese firms to expect some non-zero risk of intervention in trade in their industry as well. While hard to document, this may well be a rationale for investment in a much wider set of industries.

Suppose, as a manager, you were worried that restrictions might influence your industry at some point in the future. You could easily observe that firms with some foreign production experience that helped them deal with the U.S. market were able to adjust much faster when trade restrictions were imposed. Honda moved faster than other manufacturers to adjust to the OMA limits on auto exports to the United States. Risk averse firms might invest to be prepared, as Honda was, especially if their profitability were heavily dependent on the U.S. market.

Japanese government policy toward investment, on the other hand, no longer is a major factor in the investment decision of Japanese firms. Of course, for most of the postwar period, Japanese government policy was firmly opposed to foreign investments. The only exception was what Kojima (1982) has called trade-promoting investment such as that for distribution and services. Foreign exchange controls directly limited the access to funds for such investment until the mid-1960's. Until the new foreign exchange control law in the early 1980's, firms could still not be confident of the free flow of financial assets necessary for effective investment abroad.

There is another more basic way in which Japanese government policy still does influence investment incentives for Japanese firms. Japanese government policy has created an economic and competitive environment in which firms must consider long term growth as well as profitability in choosing their corporate strategy. This policy had an effect on two levels. First, overall tax policy encouraged growth, while monetary policy generally provided sufficient funds. Those funds, until the early 1970's, were provided at below market real rates of interest. Again, until the early 1970's, government spending was kept low to make sure there was no crowding out of investment by the private sector.

The second effect was a series of policies which, taken together, rewarded firms which grew faster than the competition. Cartels in many industries protected firms in downturns from severe domestic price competition. This encouraged investment, but also encouraged firms to grow faster than their competition. Recession shares were assigned based on performance in previous business cycles, so a firm which did not grow was punished not just in the current period, but also in future downturns. Banks also were assigned borrowings from the Bank of Japan based on their performance in generating loans in previous periods. As a result, they too were concerned about identifying and assisting firms which were growing and thus able to generate the loan volume that the government policy used as a criteria for access to central bank financing.

Thus Japanese internal economic policy helped to shape a corporate culture that differs

substantially from the American model. Government policy has given most Japanese firms strong incentives to put a higher priority on long-term growth in their overall strategy. If a market is growing fast, even with no government incentives, it usually pays for firms to trade off short-term profits to gain the expected future growth through a long-term perspective. Japanese economic policy has reinforced that growth expectation. While the absolute level of growth has been lowered in the last decade, Japanese firms have continued to expect higher relative growth than their competitors in other developed countries.

This expected growth has several implications for foreign investment. With expectations of future growth set, and the government policy encouraging the long-term perspective, managers logically felt that market share had to be developed and protected. Investment abroad could be seen as aiding in that market share development. This was especially true when the market access was challenged via trade policies. In fact, the imposition of trade barriers has an ironic side effect: it may open up an opportunity to redistribute market share via investment, since the other Japanese firms are not easily able to counter-attack from their Japanese manufacturing base.

If the investment by one firm caused a threat of market share loss, this mentality could easily lead to copycat investment to make sure that no firm will be left at a disadvantage. Note that if all Japanese firms misread the environment for foreign investment, and there is excessive investment, there would be less likelihood of major changes in relative market share. Thus, this growth bias can often lead to excessive investment abroad, just as it sometimes led to excessive investment in the domestic market. Witness the six U.S. investments in the forklift industry.

Factor prices and government policy are thus influences that are shared by all Japanese firms. It is important to remember that these factors interact with industry and firm level factors which are not the same for all Japanese firms, however, and it is to these effects that I now turn.

Industry Level Variables: Long Term Growth and Market Share

The industry level influences presented above related to competition between firms in global markets. To understand the industry level variables which drive Japanese **foreign**

investment, it seems ironic that one must start with the domestic market, but this approach is essential to understand the pattern of investment in many industries. Competition between Japanese domestic rivals is at least as important for Japanese firms as global competition. Attaining the competitive edge against Japanese domestic competition still drives most strategic decisions in Japanese firms. This is analytically the same as the factors driving the oligopolistic competition Hymer modelled, where firms are investing to make sure that large firm rivals do not have a comfortable market in which to build a competitive edge, but the argument is in a sense turned on its head, since it is the competition between large rivals in the **domestic Japanese**, not the international market, that often forces the investment.

Why is the influence of foreign investment on this domestic market position a more important consideration for Japanese firms? This is because the domestic market is important for all the Japanese players. The market is large, and is a major portion of sales for almost all Japanese firms, even those that are active in the export market like consumer electronics and autos. That market has seen relative growth higher than other world markets for most of the post-war period, and currently shows the highest growth of any OECD country. That growth permits economies of scale to be realized in more conventional industries like steel, and permits the experience to be gained in the fast-changing, high technology industries like semiconductors. Those characteristics would cause any profit-maximizing business person to focus on the home market.

That domestic market, while often protected from new foreign and domestic entrants, still is extremely competitive among the existing players. This is exactly the story that Hymer depicts in his model: rivalry between a number of large firms. Abegglen has stressed the quick response of competitors in such a market, and the fragile nature of any competitive advantage. No firm can expect that a single period success, no matter how striking, can be long sustainable. Each manager must expect that there will be quick response by the competitors. At a minimum they will match the current strategy if it is successful. A comment by Mr. Yoshihiko Miyauchi, the

president of ORIX, the leading leasing firm in Japan, illustrates the mind set. In leasing, you necessarily show all the characteristics of a new leasing instrument the minute it is marketed. You sign a contract and everyone knows all the new tricks you have thought up. He envied the easy life of his friends in the camera business, who have the luxury of having a three to six months monopoly on new ideas before their competitors match a new product. SONY's competitive position has always been based on being the first out in new electronics products, from one gun TV to VCR's, the Walkman and CD players. Japanese analysts often are skeptical of the long-term viability of such a strategy, citing the quick deterioration in price that follows as rivals pick up any new trend SONY identifies. This problem is always present, but the criticism of SONY shows how the nature of competition in the Japanese market makes the effect much more significant.

With the period for excess returns from innovation so severely limited in the domestic market, the importance of foreign markets as a location to get full value for innovation is understandable. Firms with strong market presence in the foreign markets may be able to use that presence to increase the return from the innovation. This is more true in industries where innovations developed in and for Japan are still able to present opportunities in other markets (Johansson / Roehl). SONY, if it can get its CD player onto the U.S. and European markets at the same time it is introduced in Japan, can have two more markets in which to achieve any short-term returns from its innovation. Toshiba, trying to stage a comeback in the semiconductor industry in 1 MB memory chips, would want to be ready to send product into the U.S. as well as Japanese markets. For these types of industries, the establishment and maintenance of market share in foreign markets will be more important, with foreign investment more likely when those positions are challenged.

The worldwide presence can also become part of the competitive challenge itself, as will be shown below in the firm strategy section. Firms can attack the domestic market position of established firms not only by quick response, but by introducing products based on different factor costs (Matasushita's electric fans from the NIES) or tastes (Mitsukoshi's new fashions from

Europe) that upset the competitive positions of competitor firms based only in the domestic market.

This domestic market focus puts the Japanese firm at a disadvantage in carrying out a foreign investment strategy. One of the key factors in foreign investment, the management resources necessary to carry out such a strategy, are less available to Japanese firms than to firms with more international experience. If domestic markets are key, why would you as a manager, assign some of your best up and coming managers to international posts? This reinforces a point C.K. Prahalad has made elsewhere in this volume from a rather different perspective: a very successful domestic strategy may limit the ability of firms to develop the resources necessary to becoming multinational. I am adding the additional factor of fast industry growth in the domestic market that creates a competitive environment that reinforces such an inward-looking strategy.

This focus on domestic market share does not always mean that foreign investment will not be attractive, however. As noted in the above section on country level variables, changing factor prices may force all firms in an industry to consider alternative sources outside of the Japan in order to serve a segment of the Japanese market. Each firm finds its market share position threatened if it does not provide a stable source of product from a foreign source, and almost simultaneous investment follows from all the major players wanting to maintain their market share. The high cost of energy after the first oil crisis forced all the Japanese aluminum firms to look for secure, low cost alternative sources of supply outside of Japan. Within a decade, all local manufacturing capacity was scrapped, and each firm has new sources of supply via investment abroad (Goto). No aluminum firm could afford to be a laggard in this process. In the U.S. this phenomenon has been seen in many raw materials and agricultural industries. Japanese textile manufacturing investment in Asia shows the same pattern (Tran).

The emphasis on market share in the domestic market has another influence that may increase foreign investment. If domestic market share in a growing domestic market is as predominant as it is in many Japanese industries, that emphasis on share may carry over into overseas markets. Even if the growth and competitive environment assumptions are less likely to

hold in these foreign markets, the industry and corporate culture of market growth may be so strong that it spills over into markets. Even if they themselves believe the assumption inappropriate, they may feel other firms in their industry will act according to that approach, forcing their hand. There is substantial evidence (Jacque, 1989) that Japanese firms do not pass on via price increases the full value of exchange rate differences, due to the fear that other Japanese competitors will choose to use the situation as an opportunity to increase share.

This situation of low-margin exporting from Japan is not tenable in the longer term. Thus the move to foreign investment to replace this Japan-based supply flow is a natural evolution of this strategy if local production cost is indeed lower. With market share at risk, no firm can easily ignore the competitive challenge of local production. This is especially true if limits on exports exacerbate the exchange rate or factor price changes. Thus, firms with little previous intent to invest abroad might feel compelled to respond to the competitive market share challenge with investment of their own.

Many analysts explain Toyota's late entry into the U.S. according to this model. With competitive advantage based on a close-knit supplier network using low inventory production methods, Toyota was naturally hesitant to begin local production, since it had higher costs of adjusting its manufacturing process than other firms. Faced with the success of Honda's investment in increasing share in the United States market, however, it quickly expanded its conservative joint venture strategy with General Motors, adding production of its own at the NUMMI plant as well as developing its own production facility.

As Abegglen notes, it is often the firms that are not the strongest in the domestic market that make these types of investment. Even in more standardized industries, the investment in steel facilities in the United States was not led by the most profitable firms in the market, Sumitomo Metals and Nippon Steel. Instead it was companies looking to improve their competitive position, Nippon Kokan (50% of National Steel) and Kawasaki Steel, that made the initial moves.

The pressure of competitive challenge from other Japanese firms requires the individual

Japanese firm to look for sustainable advantages in all possible areas, including advantages from foreign market participation. To understand why certain Japanese firms invest, the analysis must consider what assets the individual Japanese firms have to carry out a successful investment. This alone is not sufficient, however. Analysts must also look at the potential change in the value of the overall portfolio of assets of the firm as a result of the investment. Investment, as suggested in the literature review above, both increases the return on current assets and builds new assets. How will the portfolio of assets available to the firm for deployment in U.S. and Japanese domestic competition be enhanced by the decision to invest? Surely the national and industry competitive factors faced by a firm will be major factors in investment decisions. Yet, the individual firm strategy decisions to deploy its assets for investment and to build new assets into its portfolio via investment will be crucial in shaping the characteristics of the investment and in deciding which investments will be ultimately judged to be successful. This is the subject of the next section of the paper.

Firm Level Variables: Finding Ways to Build New Assets Abroad

With the strong pressures of country and industry level variables described above, there is a tendency to think that Japanese firms share similar strategies. Systematic questionnaire studies (Kagono et al) show that even in the same industries, there are several types of strategies chosen by Japanese firms. Books rich in case studies of Japanese firm strategy (Abegglen; Itami with Roehl) also document that this deterministic view is clearly too simplistic. Firms that choose distinctive strategies not consistent with conventional wisdom in their industry are often able to build an asset base that is not easily assailed by competitors. Kao Corporation's wholly-owned distribution channel for its soap and other consumer products set it apart from Lion, its main Japanese competitor in these products. Even in an industry as seemingly homogeneous as consumer electronics, three successful firms show very different strategies: SONY depends on

product innovation; Matsushita depends on a quick response to innovation and distribution control to succeed; and Sharp's manufacturing technology gives it the ability to maintain competitiveness even without major production innovations or strong distribution channel control. In each case, the set of company resources, its invisible assets, is quite different. Yet all are labelled successful. Each should have different reasons for foreign investment reflecting the different firm-specific assets for which it desires full value.

The development of new invisible assets for world-wide or Japanese domestic market deployment can be an important objective for Japanese foreign investment as well. Remembering that firms in the Japanese market will often try to immediately copy competitive challenges from other firms in their industry, assets developed abroad become valuable for two reasons. Not only can they be used to challenge existing positions, but they also are less vulnerable to counterattack. These assets may be in many areas. They can be based on technology. The cooperative ventures of Japanese pharmaceutical firms with small American biotech firms enable the Japanese firms to obtain technology in this very competitive industry in Japan. At the same time that they provide the manufacturing facilities and financing to small U.S. firms who themselves are worried about domestic competition in United States.

Supplier relationships can also be the source of new competitive assets. The buying offices that some superstores have set up to find attractive foreign products to sell back into the Japanese market both assure them of supplies and provide the ability to tailor product to Japanese tastes rather than buy off the shelf as a Japanese domestic food wholesaler might. The assets can be in the more conventional world-wide manufacturing network such as that of a Matsushita: a strategy that can take advantage of unexpected changes in exchange rates by adjusting its mix of production globally.

In each of these cases, a competitor is not able to quickly announce a similar strategy to counter a strategic move that builds on this foreign invisible asset base. SONY, with its more conventional base of technological innovation found vulnerable, is moving to redefine competition

in the electronics industry by meshing the software of CBS Records and Columbia Pictures with its still substantial skills in hardware innovation. Assets not easily obtained by competitors thus form the basis for a more sustainable market position in both the U.S. and the Japanese market for these firms.

If a firm carefully chooses the assets it develops via its foreign investment, it will take competitors longer to respond if they have not matched the international deployment of assets of these firms. Often it is the competitor which feels most vulnerable in the Japanese domestic market which makes the earlier move to international markets. Honda in autos, Epson in personal computer products and Shinetsu Chemical in semiconductor wafer production each found themselves with competitive technology, but with too little power in the domestic market relative to competitors to rely solely on purely domestic corporate asset portfolios. With foreign production facilities and the accompanying information about these overseas markets, the firms were able to successfully challenge much stronger domestic competitors.

At first, the challenge was in foreign markets, but in each case the firms brought back the assets developed to Japan as well. Honda now sells product produced in the United States to Japan, even keeping the steering wheel on the 'wrong' side for cache. Epson used its experience in dealing with the legal aspects of making a PC compatible clone to good advantage when it was the first to attempt to challenge NEC's monopoly in top-of-the-line personal computers in Japan with the first successful NEC clone. Shinetsu Chemical's knowledge of the developments in semiconductor use, built up through the close contact with United States customers, helped them to stay on top in an industry in Japan that has attracted many of the large metal firms seeking diversification.

Technology and production facilities are the common assets that come to mind from foreign investment, but access to customers, especially leading market customers, can be just as important in the expected return from foreign investment. Long-standing business relationships may cut off a new entrant from necessary complementary technology needed for entry. A new entrant in Japan is as much of an outsider as the foreign firm we read about. The domestic leading customers

may be too closely tied to existing suppliers or purchasers (e.g. the NTT family of suppliers or a *keiretsu* industrial group membership). Alternatively, as in the case of financial markets customers, the Japanese customer may not be permitted to deal with your firm at the present time. Japan's barriers between securities firms and banks are still more rigid than in the United States.

The established shares and relationships in the Japanese domestic market are not easily challenged. For those Japanese firms who are newcomers to a given market, the potential value from exposure to leading market customers in foreign markets is strong. Note that you need not be a small firm to seek these benefits. Many older heavy industry firms in Japan seek diversification which puts them in the same category as a newcomer in the market. While in some markets the leading market customers are no longer only in the United States, Von Hippel's work (1988) shows a significant contribution to innovation to industrial product suppliers from their close contact with U.S. customers. The innovations are often first suggested by the customers in the industries he studies. U.S. financial market innovation is clearly drawing Japanese firms to U.S. investment.

Just as Von Hippel shows that industrial customers create new products, close interaction with American financial customers used to a wider variety of financial products can develop new assets for Japanese financial firms. This is the rationale for the joint venture by ORIX, the leasing firm, in a venture capital firm, the Daiichi Kangyo Bank's investment in CIT to gain experience in middle market lending, and Nomura Securities support for a new mergers and acquisitions firm.

Even if there are leading customers in Japan, the tastes of foreign customers may be different (Bartlett), challenging the firm to understand different tastes that might appear in other markets as well. Once identified and catered to, these new customer desires might enable the firm to challenge the established shares in domestic Japanese markets as well.

Honda's design of a CIVIC station wagon specifically for the U.S. market--this would be a 'truck' in Japan and have different uses--should enable it to respond to the potential leisure vehicle

market in Japan. The design team for the new Accord station wagon is entirely based in the United States. The interaction between American and Japanese designers on the team will not only assure good communication in the design process; the Japanese designers will return with an increased understanding of the U.S. consumer. With Honda's reputation as an innovative auto designer being increasingly challenged in the home market, the outside sources of innovation may prove valuable.

In the financial services area as well, the conditions mentioned by Bartlett are important. With Japanese bank lending to large firms at a plateau, banks are looking to develop new markets internal to Japan. With little experience with such alternatives as middle market customers, an investment in a U.S. firm builds management assets for potential use in the domestic market. Rather than full line investments, many Japanese bank investments have targeted special niches which build such assets. Mitsubishi Bank bought Bank of California, a bank with a portfolio of many middle market firms.

If assets developed in foreign markets are to be effectively utilized, there must be an effective system to channel information received and knowledge generated to the appropriate part of the organization world-wide. Supply of products will not be sufficient. These information channels themselves can be labelled one of the invisible assets of the firm.

These information channels, as shown in several other papers in this volume, are potentially one of the most difficult of assets for Japanese firms to build from a foreign investment. Accurate calculation of the returns on foreign investment, as well as the effect on the portfolio of assets of the investing firms depend on the success of these organizational systems. It is the industry and country variables emphasized above that make this asset so difficult to develop. If Japanese domestic strategic considerations predominate, it takes a very daring manager to divert resources to slowly and systematically develop such an information system through small investments and other international experiences, experiences that will have little initial effect on the Japanese firm's domestic competitive position. Again, the weaker firms in the domestic market

have more incentives to develop such a system. SONY's early cooperative venture with CBS Records and Honda's long-unprofitable motorcycle plant in Europe in the early 1970's provided the necessary vehicles to develop the pool of international managers and the international information channels necessary for their more aggressive investments of the 1980's.

It is tempting to argue that experience in other fast-changing markets will permit firms to overcome this lack of international experience, but the evidence cited elsewhere in the volume argues that this invisible asset can not be so easily transferred. Fruinn's comments on the difficulties of transplanting the success of the 'development factory' making copiers in Japan to the creation of a new plant with its own copier design in the U.S. illustrates the problem. Experience in other parts of the company, gained from the production of laptop computers in the United States, was not used by the copier division when it planned its own investment in the United States. An extremely responsive organization for new product design had developed in the copier division, and such close ties to other units in organizational proximity meant they had difficulty dealing with a uncertain environment for investment abroad, even though access to some more organizationally distant units of the company (laptop production) would seem to be possible. Here, as in the Toyota production system example, an organizational response to uncertainty and change requires commitments to assets that can not be easily transferred to the international arena. As C. K. Prahalad stated in different words elsewhere in the volume, strong sets of individual firm assets may limit the ability of firms to develop the new set of invisible assets necessary to take full advantage of the international information and knowledge exchange.

While all Japanese firms may find increased incentives to invest in the U.S. to maintain their competitive position in world and Japanese competitive markets, this section on individual firm strategy has shown that there will likely be substantial variety in the types of investment undertaken, and quite probably substantial variation in the performance of those subsidiaries. While this variation will have an effect on the strategies of the firm, the variation will also have an effect on the economy of the United States, and on the economies of the communities which accept

the investment. The final section of the paper examines the lessons of this investment discussion for the U.S. policymakers who must set their own strategy to regulate this investment.

Implications For Policymakers

National Level

Any regulation proposed for Japanese investment will have to consider how best to deal with the variation in value of Japanese investment. Overall quantity limits, just like quotas, have greater costs. Just as quotas may close off the low cost producer who may have no quota rights, an overall limit may encourage all firms, even those which have only a limited benefit from investment, to try to jump the barrier and achieve any monopoly power that might accrue.

The alternative of very detailed specification of a 'good' investment introduces regulatory complexity, as the Canadian government has found with its FIRA (Globerrman, 1983). Political intrusion into the process, especially by the communities which will gain from a particular investment, will be hard to avoid. Yet to set only an overall limit will have greater loss in discrimination between poor and good investment candidates, given the facts presented above.

At the national level, the increased complexity of the evaluation of costs and benefits of Japanese investment may make it efficient to provide some basic information to all communities to reduce the cost of this process for all players.

Local Level

At the local level, the above discussion demands a greater sophistication in the analysis of the potential benefits of individual Japanese investments. Not all the firms, even in the same industry, will give the same stream of net benefits for the community. There will be winners and losers among the Japanese, and the community will share in that competitive fate. Even if the average Japanese firm is a better bet for the community, the nature of competition among Japanese firms may mean that the losers in that competitive race are substantially less beneficial to the local community.

Communities, as well as firms, have a set of assets they can offer to firms. Choice of a proper portfolio of firms in a community will enable the community to develop its own set of assets, especially the invisible ones of technology, management and skilled workforce. Choice of a Japanese firm will surely consider the current level of these assets. There will certainly be communities where any current employment, no matter what its future potential, is welcomed. For most, however, the development of the assets of the community over time will be just as important. In choosing the Japanese firms to attract, the community should choose companies that will develop the invisible asset skills of the community. Just as the Japanese firm does not expect its level of invisible assets to remain stagnant, the community, in competition for jobs within its own 'industry' of competing towns, should be equally concerned with the dynamic nature of competition for jobs.

Given the nature of the competition in Japanese industry, there is another difference between investment by a local firm and that of a Japanese one. As I noted above, Japanese deal with risk organizationally, so that when a town attracts a Japanese firm, it buys into a set of business relationships to a much greater extent than if the new factory was an American one. This introduces additional considerations, both positive and negative, into the community's calculation of the value of the investment. On the negative side, existing business relationships will likely be maintained. A new entrant into the system, whether a foreign firm or even a Japanese one, will not be able to immediately expect the same treatment as a member in long standing of the organization. This might also delay any expected benefits from the further development of the skills of local workers or the expertise of local firms that want to supply the firm.

These same situations can, however, provide potential for growth in a community as well. If the firm has success in finding local suppliers (again, the set of resources in the community must match the firm's desires), then it is likely that the new production systems utilized by many Japanese firms will offer an opportunity to upgrade the skills of the workers. If the Japanese firm

has a product line with rapid turnover, the firm that successfully meets the tight time schedule for parts development has an asset that is not likely to be matched by its American competitors in other cities. Again, the positive benefits are only available if the community sees the investment not as a cash cow, but as a source of additional resources to be developed as its people enters the business organization of the new firm.

Applying the idea of 'invisible assets' to the community only makes this argument stronger. Not only do the visible assets of the community (e.g. tax subsidies; infrastructure) have alternative uses, but the invisible assets (skilled labor; technology of the area) of the community will tend to be drawn to the Japanese firms, especially in this period where the image of Japanese firm is strongly positive and Japanese firms have the visible assets of capital and new jobs to offer. A community that fails to pick winners has failed to give local assets the opportunity to grow over time, providing the basis of support for not just growth in Japanese firms, but for the entire community.

The intra-industry competition among Japanese firms also requires an adjustment in the evaluation process for the local community. Initial levels of jobs may be less important in judging the potential benefits than the growth over time in the activities of the firm at home in Japan and in the foreign country. That growth is not entirely under the control of the firm, but depends on the industry competitive condition and the strategies of competitors. While this may be less concrete, the long run potential for the firm to contribute to the community will be based as much on these patterns of growth as the initial level of investment by the Japanese firm.

The community should not fear Japanese investment; it should fear bad investments of any nationality that use up its precious resources that it not just shares with the firms it attracts, but develops in consort with the firms that share its community. Given the greater difficulty in evaluating the benefits of the Japanese investments, however, a community must carefully evaluate the industry level and firm level factors, rather than depending on a country level proxy to help it decide what firms will develop their own and the community's invisible assets.

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