

Foreign Direct Investment

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Only in recent years has the U.S. Government become concerned with the ways that foreign-based multinational enterprises (NINEs) affect the national interest. The main stimulus for this new interest has been the extraordinary economic achievements of large Japanese firms and their pervasive penetration of U.S. markets, particularly in industries such as automobiles, electronics, and banking. The apparent inability of U.S.-based MNEs to invest on a comparable scale in Japan has magnified this concern. Other, less dramatic policy asymmetries exist between the United States and Europe. Therefore, this chapter considers two issues: 1) the existing government rules and private sector practices governing foreign direct investment (FDI) in the United States, Europe, and Japan; and 2) the role of major foreign multinational enterprises—from Europe as well as Japan—in the U.S. economy.

The chapter examines the U.S. policy environment for FDI and compares it to the policy regimes of other major trading nations. Ideally, the United States wants FDI to provide well-paid, skilled jobs, responsible corporate citizenship, and enhancement of the Nation's industrial and technology base. Clearly, it makes sense to object to the presence of foreign firms in the U.S. economy only to the degree to which they do undesirable things. If they provide good jobs, add value to U.S. products, and contribute to the U.S. technology base, they should be encouraged. There may, however, be grounds to object if America's leading trade partners do not reciprocate in providing U.S.-based MNEs with similar opportunities to invest overseas and derive the benefits from those investments.

The chapter reviews the benefits and problems associated with foreign direct investment in the United States (FDIUS). It

elaborates on many themes initially examined in OTA's report, *Competing Economies*,¹ and discusses the findings presented below. The analysis suggests that rather than encouraging or discouraging FDIUS indiscriminately, it would be more productive to develop an approach that benefits foreign investors and maintains technological development and high value-added jobs in the American economy.

CHAPTER FINDINGS

1. The significant expansion of FDIUS in the 1980s brought a number of benefits to the Nation. The first major benefit was macroeconomic: the influx of FDIUS helped compensate for the low rate of domestic savings that had adversely affected domestic investment rates.² Foreign investors stimulated the U.S. economy, first by providing liquidity to the financial system through large purchases, and second by constructing greenfield wholesaling operations and manufacturing plants. The second major benefit was microeconomic: foreign investors, often Japanese-based MNEs in the manufacturing sector, introduced innovative managerial and organizational techniques to their U.S. competitors, joint venture partners, and suppliers. Consumers subsequently benefited from improved products and services.
2. The lack of more than minimal provisions regarding the foreign acquisition of U.S. high-technology firms in contrast to the restrictive rules and private sector practices governing foreign acquisitions in some European Community (EC) countries and Japan—may have major implications for the U.S. technology base. Acquisition of U.S. high-technology firms has helped improve the competitiveness of the manufacturing affiliates of foreign producers in the United States and/or their parent producers in Japan or Europe. At the same time, it may have increased reliance on foreign-owned sources of technologies critical to the sustained success of many domestic manufacturing firms. In many industries, technological diffusion has not been reciprocal.³
3. At present, U.S. Government policy cannot distinguish between questionable FDI and that which clearly benefits the national interest. Current policy allows foreign-based MNEs to implement strategies based on rational and intelligent business practices, whether or not they benefit the U.S. economy. Foreign-based MNEs cannot be faulted for acting in their own interests. Fault may lie instead in the lack of clear national goals expressed through flexible but explicit legislation.
4. FDI may be becoming less important to MNEs relative to strategic alliances. Statistical data provide ample evidence that the rates of growth in both global FDI and FDIUS have fallen significantly since 1990, as demonstrated in table 3-1 and figure 3-1.⁴ It is unclear whether this tendency will reverse course in the near term. While no thorough, accurate data exist to estimate the amount invested by MNEs in

¹ U.S. Congress, **Office of Technology Assessment**, *Competing Economies: America, Europe, and the Pacific Rim*, OTA-ITE-498 (Washington, DC: U.S. Government printing Office, October 1991), See especially ch. 3.

² Edward M. Graham, "Foreign Direct Investment in the United States and U.S. Interests," *Science*, vol. 254, Dec. 20, 1992, pp. 1740-1745.

³ For data on technology trade among the United States, Japan, and the EC see "Major Indices of Japanese R&D Activity," JPRS-JSP-73-O03, Jan, 21, 1993, pp. 40-53. See also General Accounting Office, *U.S. Business Access to Certain Foreign State-of-the-Art Technology*, September 1991.

⁴ John Rutter, "Recent Trends in Foreign Direct Investment in the United States: The Boom of the 80s Vanishes," Department of Commerce, International Trade Administration, December 1992. However, it should be noted that more recent reports suggest, for example, that there has been a net disinvestment during 1992. See "Japan Keeps Cash at Home," *Financial Times*, June 15, 1993, p. 4; as taken from Bank for International Settlements, *63rd Annual Report* (Basle, Switzerland: BIS, 1993); see also U.S. Department of Commerce, Bureau of Economic Analysis, "Net International Investment Position, 1992," press release, June 30, 1993.

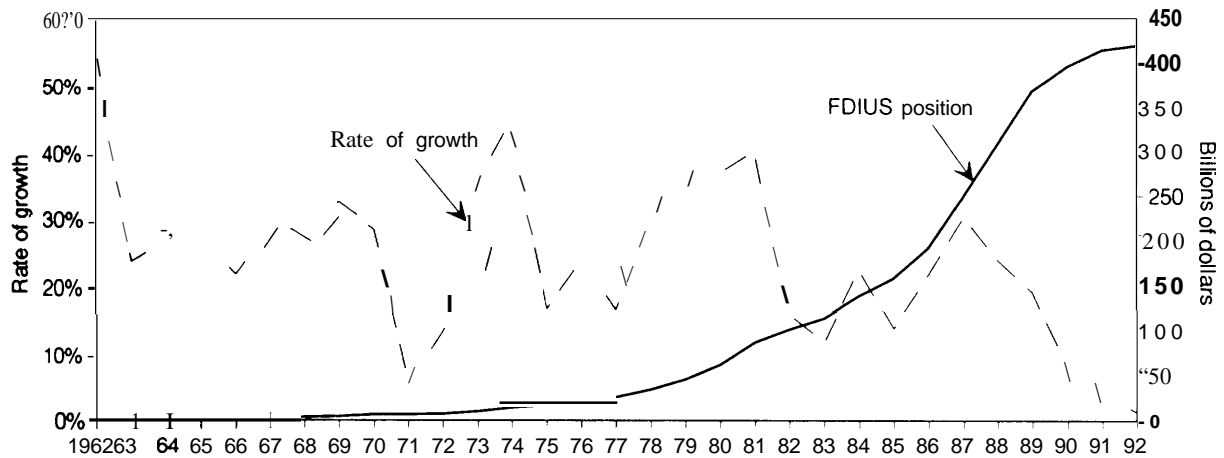
Table 3-1-inward Flows of Foreign Direct Investment, by Host Country per Annum, 1981-1992 (in billions of dollars)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
United States	25.2	13.8	11.9	25.4	19.0	34.1	58.1	59.4	69.0	46.1	12.6	3.9
United Kingdom	5.9	5.3	5.1	-0.2	5.0	7.3	13.9	18.2	30.4	33.1	21.1	19.1
Netherlands	1.5	1.0	0.8	0.6	0.6	1.9	2.3	4.1	6.4	8.7	5.1	5.2
(West Germany	0.3	0.8	1.8	0.6	0.6	1.2	1.9	1.2	7.0	2.3	2.9	3.0
Japan	0.2	0.4	0.4	0.0	0.6	0.2	1.2	-0.5	-1.1	1.8	1.4	2.7
France	2.4	1.6	1.6	2.2	2.2	2.8	4.6	7.2	9.6	9.2	11.1	16.3

NOTE: All figures are calculated on historical cost basis and are not adjusted for inflation.

SOURCE: Organization for Economic Co-operation and Development (OECD), "Inward Direct Investment Flows," *International Direct Investment Policies and Trends in the 1980s* (Paris: OECD, 1992), table 3; OECD, *Financial Market & Trends*, June 1993, table 1.

Figure 3-1—Foreign Direct Investment in the U.S., Annual Growth Rate and Position, 1962-1992



NOTES: All data are calculated on historical cost basis and are not adjusted for inflation. Differences in data and calculation may account for disparities between Department of Commerce and organization for Economic Cooperation and Development (OECD) statistics.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Business Statistics, 1963-97* (Washington, DC: U.S. Government Printing office, June 1992), p. A-120; U.S. Department of Commerce, Bureau of Economic Analysis, "Net Investment Position, 1992," press release, June 30, 1993.

that MNEs increasingly prefer strategic alliances because they allow greater flexibility and less commitment than strategies associated with FDI.

5. A discrepancy exists between the comparatively open-door, national treatment policy towards foreign multinational corporate investment adopted by the United States and the United Kingdom and those policies adopted by other major trading nations. Only the United Kingdom (since the early 20th century) and the United States (in the post-WWII period) have applied free trade principles to the inward and outward flow of investment capital. U.S. policy has actively encouraged such practices.⁵ As table 3-1 indicates, from 1986 to 1990, FDI into the United States and the United Kingdom increased to record levels. During the same

period, FDI into Germany and Japan remained low; for Japan, in 1988 and 1989 (the peak years for FDI in the United States), net inward investment was negative.

6. Since the 1970s, some Organization for Economic Cooperation and Development (OECD) countries have liberalized their rules on the outflow of investment capital; during the same period, there has been an increased inflow of FDI in some countries. But historically this inflow has been regulated to provide limited market access for foreign producers, sometimes in exchange for the transfer of proprietary technology. It remains small relative to outflows. In some European states (e.g., France and Italy) government policies on inward FDI have been consistently restrictive. The constraints in Japan are more systematic; they are

⁵ For a comparative historical analysis of FDI in Europe, Japan, and the United States, see Simon Reich, *The Fruits of Fascism: Postwar Prosperity in Historical Perspective* (Ithaca, NY: Cornell, 1990). As an illustration of these policies in practice see, for example, Mira Wilkins and Frank E. Hill, *American Business Abroad: Ford On Six Continents* (Detroit, MI: Wayne State University Press, 1964); for the case of policy in Japan, see Mark Mason, *American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1992). For a European assessment of the constraints on FDI in the United States, see Services of the Commission of the European Communities, *Report on United States Trade and Investment Barriers: Problems of Doing Business With the U.S.* (Mussels, Belgium: Commission Services, April 1993), pp. 82-90.

also more often a product of private sector initiatives.⁶

7. MNEs based in countries with restrictive FDI policies may enjoy strategic advantages over their U.S. competitors. These advantages are associated with the generation of artificial profits in home markets⁷ and the capacity to reach economies of scale. Senior officers of major American companies told OTA that such advantages threaten the degree of competitiveness and even the continued existence of some large-scale U.S.-based MNEs.
8. Japanese and European policymakers have concluded that they must maintain a domestic presence in some sectors even when it seems expensive in the short run. These governments have reached an understanding with their MNEs; business has agreed to sustain some production that may be unprofitable in the short term but that is essential to the productivity of several crucial sectors. Furthermore, MNEs in these countries have agreed to maintain as much high value-added production in their home base as possible. Some governments among the OECD nations have instituted a variety of subsidies and structural adjustment policies to assist their own MNEs.⁸

FDI IN THE UNITED STATES

I What is Foreign Direct Investment?

There are two types of private overseas investment, portfolio investment and foreign direct

investment. Portfolio investment involves the purchase of bonds of U.S. firms or the U.S. Government, or holdings in U.S. banks. Portfolio investment accounts for more than 60 percent of transaction flows into and out of the United States.

According to the International Monetary Fund:

Direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.⁹

Foreign direct investment in the United States, however, has a more specific legal and statistical definition. The *International Investment and Trade in Services Survey Act* says it is the ownership by a foreign person or corporation of 10 percent or more of the voting equity of a firm located in the United States. Such an investment is considered evidence of a long-term interest in, and a reflection of influence over, a company's affairs.¹⁰ This definition has advantages and disadvantages, and is open to a variety of exceptions. An individual or company owning less than 10 percent might still be the largest and most influential shareholder; one owning more may remain a passive investor. Either way, the behavior of the company or its strategic significance might remain unaffected by a change in ownership of this type.

This report is less concerned with the formal definition of FDI than the influence that foreign

⁶ See Office of the United States Trade Representative, 1993 *National Trade Estimate Report on Foreign Trade Barriers* (Washington DC: 1993), pp. 79-94, 143-170; for a Japanese perspective in support of this finding, see The Report of the Ad-Hoc Committee on Foreign Direct Investment in Japan, Keidanren Committee on International Industrial Cooperation, Committee on Foreign Affiliated Corporations, *Improvement of the Investment Climate and Promotion of Foreign Direct Investment into Japan*; see also House Wednesday Group, *Beyond Revisionism: Towards a New U. S.-Japan Policy for the Post-Cold War Era* (Washington DC: Congress of the United States, March 1993).

⁷ House Wednesday Group, *ibid.*, p. 18.

⁸ For related discussion, see Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High Technology Industries* (Washington DC: International Institute for Economics, 1992).

⁹ IMF definition cited in DeAnne Julius, *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (London: Royal Institute of International Affairs, 1990), p. 15.

¹⁰ See U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, 1987 Benchmark Survey, Final Results* (Washington, DC: U.S. Government Printing Office, August 1990).

direct investors exert on the behavior of corporations. Such influence can alter a firm's standard practices relative to other companies in a particular industry. Moreover, foreign ownership can have major strategic implications for the welfare of the U.S. economy, in terms of technological development, balance of trade flows, employment training and practices, and national security requirements.¹¹

Foreign direct investment includes the purchase of resources, such as knowledge, managerial expertise, plant facilities, or real estate, and the building of greenfield plants. FDI is not defined by the source of the capital used, but rather by ownership, even if foreign persons or corporations used domestic sources to finance their transactions. Although FDI accounts for less than 25 percent of all investment flows, it can be of strategic importance to the U.S. economy because of the types of jobs it generates, its impact on domestic industry, and its effect on the balance of trade, especially in industries like autos and computers.

With some exceptions, the United States has generally applied national treatment to foreign investors.¹² National treatment articulates the principle that foreign investors, whatever form their investment takes, should be treated as if they were domestic investors. This approach encourages the influx of FDI. The U.S. Government approach to FDI comes much closer to the position of the advocates of FDIUS than that of its critics, as was clearly articulated in 1991 by the Bush administration:

The Administration supports maintaining an open foreign investment policy, with limited exceptions related to national security. This policy produces the greatest possible national benefits from all investments made in the U.S. economy. The United States has long recognized that unhindered international investment is beneficial to all nations, that it is a "positive sum" game.¹³

Prior to the mid- 1970s, the principle of national treatment had little practical consequence in the United States. The inflow of investment funds was minimal, largely because other industrial powers lacked the necessary capital. A second important barrier to entry was the peculiarity of U.S. markets, for example, until the first gas crisis American consumers were uniquely unconcerned with fuel economy and preferred large, comfortable automobiles. Most U.S.-based MNEs did not face serious competition from foreign-based MNEs, either through the import of finished products or through foreign investment.

U.S.-based MNEs therefore prospered in relatively insulated consumer markets. This insularity lent itself to the development of historically unparalleled wealth and strength. The surplus was so large that U.S. citizens enjoyed the highest per capita income in the world, while its corporations benefited from technological leadership and economies of scale. Together, these factors afforded many domestic firms the capacity to build or acquire overseas facilities, and thus produced many multinational enterprises.¹⁴ The high value of the dollar made U.S. real estate expensive, and meant there were significant disincentives to

¹¹ Julius, op. cit., footnote 9, p. 14.

¹² See Edward M. Graham and Paul R. Krugman, *Foreign Direct Investment in the United States* (Washington, DC: Institute for International Economics, 1989), pp. 95-109. Critics contend that existing laws and the proposed NAFTA Agreement Annexes provide a legal framework that could support a decision by the U.S. Government to implement policies that moved away from national treatment of FDI. For example, see Edward M. Graham and Christopher Wilkie, "Multinationals and the Investment Provision of the NAFTA," to appear in *The International Trade Journal*, vol. 8, No. 3 (winter 1993-1994). However, there is no evidence to date that the U.S. Government intends to do so.

¹³ E. M. R. of the president, Transmitted to Congress, February 1991, together with the Annual Report of the Council of Economic Advisors (Washington, DC: U.S. Government Printing Office, 1991), p. 262.

¹⁴ Raymond Vernon, "International Investment and International Trade in the Product Cycle," *The Quarterly Journal of Economics*, May 1990, No. 2, pp. 190-207.

manufacturing, wholesaling, or real estate investments by foreign-based MNEs. This approximated the conditions for a sanctuary market; accordingly, some people contend that U.S. criticism of Japan for having a comparable situation today is inappropriate. But, if the United States did indeed enjoy a sanctuary market, it was by force of circumstance, not by the design of the public or private sector, as is the case in Japan.¹⁵

The issue of national treatment started to assume importance in the 1970s. The U.S. Government responded to the influx of FDI favorably, with only nominal institutional constraints on investment flows. At the Federal level, the institution directly responsible for addressing issues relating to FDIUS is the Committee on Foreign Investment in the United States (CFIUS). Created by President Gerald Ford in 1975 as an oversight body, CFIUS monitors and regulates FDIUS from the standpoint of protecting the national security. It is an interagency body composed of officials from the Departments of State, Commerce, Defense, and Justice, the Office of the United States Trade Representative, the Office of Management and Budget, and the Council of Economic Advisers; it is usually chaired by a Treasury official.

Most CFIUS authority comes from the Exon-Florio provision in the *Omnibus Trade and Competitiveness Act of 1988*, which empowers the President to veto any takeover of a U.S. firm on national security grounds. Agency officials see

the mandate of CFIUS as being consistent with a broader U.S. policy “to welcome direct investment and to support free and open foreign direct investment among all nations.”¹⁶ They have stated that the Exon-Florio Provision is a statute that protects national security without compromising an open investment policy.¹⁷

The Treasury officials who have headed the agency have adopted a narrow position in defining threats to national security.¹⁸ One prominent **critic**, for example, noted in a 1992 congressional hearing that U.S. foreign direct investment policy does not distinguish between purchases made by foreign investors from the private sector and those made by foreign governments, whose motives might not be ‘market-driven. She recommended that the U.S. Government routinely examine all prospective purchases involving foreign governments. She also suggested that the definition of national security be clarified to include a list of critical military technologies that would not be available for foreign purchase, while the definition of national security be expanded to include elements of economic security.’¹⁹

However, with very few notable exceptions, CFIUS has adopted a passive role. Agency officials have “received over 700 notices since the inception of Exon-Florio in August 1988. Of that total, 13 transactions have been subject to a 45-day extended review. Nine of those reached the President desk for decision. In eight of those nine transactions, he decided to take no action.”²⁰

¹⁵ House Wednesday Group, op. cit., footnote 6.

¹⁶ Statement by Stephen J. Canner, Treasury official Director for International Investment, before the Defense Policy Panel and Investigations Subcommittee of the Armed Services Committee, U.S. House of Representative..., May 14, 1992.

¹⁷ See statement by Olin Wethington, Assistant Secretary for International Affairs, U.S. Department of the Treasury, at Hearing before the Subcommittee on International Finance and Monetary Policy on June 4, *Foreign Acquisition of U.S. Owned Companies* (Washington DC: U.S. Government Printing Office, 1992), pp. 5-6.

¹⁸ For example see Statement of Peter Mills, Former Chief Administrative officer of Sematech, at Hearing before the Subcommittee on International Finance and Monetary Policy on June 4, ibid., pp. 15-18. Some analysts argue that without change the Exon-Florio legislation would support much more restrictive policies towards FDIUS. See Edward M. Graham and Michael E. Ebert, “Foreign Direct Investment and U.S. National Security,” *The World Economy*, vol. 14, No. 3, September 1991, pp. 245-268.

¹⁹ Statement by Laura D’Andrea Tyson, at Hearing before the Subcommittee on International Finance and Monetary Policy on June 4, op. cit., footnote 17, pp. 18-19.

²⁰ Statement by Stephen J. Canner, op cit., footnote 6.

In the **case** of the attempted purchase of General Ceramics Ltd. by the Tokuyama Soda Co., CFIUS recommended **that the** acquisition be blocked because the U.S. firm was a supplier of nuclear defense technology. The sale went through after the nuclear weapons component was sold to another firm. The only recorded case of a sale being blocked after CFIUS review was the proposed purchase of Mamco Manufacturing of Seattle by the China National Aero-Technology Import and Export Corp. According to the director of CFIUS, the agency “is achieving its goal of protecting the national security without discouraging foreign direct investment.”²¹

The limited use to date of the legislative provisions under which CFIUS operates does not appear to represent a significant barrier to foreign direct investors. Moreover, many observers note that informal limitations on foreign investors are minimal or nonexistent in the United States.²² However, some contend that the very existence of CFIUS has had a chilling effect on FDIUS.

The loss of both market insularity and U.S. technological superiority has heightened competition from many European and Japanese firms and their affiliates operating in the United States. Formerly, the issue of mutual openness for trade and investment was treated by U.S. policymakers **as** relatively unimportant. In the context of U.S. economic dominance, policymakers often considered America’s primary economic role to be that

of a locomotive for global prosperity. But the successful regeneration of the economies of Europe and the emergence of Japan as an economic superpower, coupled with a relative decline in U.S. economic strength and technological advantage, has put new competitive pressures on U.S.-based MNEs.²³

During the 1980s, the United States was the largest single recipient of FDI, accounting for over 30 percent of global FDI that totalled about **\$1 trillion, with** Britain in second position at 15 percent.²⁴ This was a dramatic change for the United States, whose MNEs have been the largest overseas investors for most of the **post-WWII** period.

In the early 1970s, U.S. scholars worried that large overseas investment by America’s largest and most powerful MNEs might contribute substantially to a decline in U.S. competitiveness, and to the growth in the budget deficit, particularly if the profits were not repatriated. At the same time, Europeans feared that Europe would be dominated by the subsidiaries of U.S.-based MNEs, and that European companies might not develop sufficient scale and scope to compete on a European or global basis.²⁵

In the late 1980s, the focus of debate changed dramatically, as the huge surplus of U.S. direct investment abroad (USDIA) over FDIUS reversed course. Based on book value calculations, FDIUS exceeded U.S. foreign investments for the

²¹ **Ibid.** For details of the review process itself undertaken by CFIUS, see statement of Frederick Volcansck, Acting Assistant Secretary for Trade Development, U.S. Department of Commerce, in Hearing before the Subcommittee on International Finance and Monetary Policy on June 4, op. cit., footnote 17, pp. 10-11.

²² For an alternative view, see services of the Commission of the European Communities, op. cit., footnote 5, pp. 82-90.

²³ This issue was a central one addressed in *Competing Economies*, op. cit., footnote 1.

²⁴ In contrast, the Federal Republic of Germany attracted investments totaling \$19 billion in this period. See ‘Study: U.S. Leads, Germany Trails, in Attractiveness to Direct Investors,’ *This Week in Germany*, Oct. 23, 1992, p. 5.

²⁵ For a discussion of these issues see C. Fred Bergsten, Thomas Horst, and Theodore H. Moran, *American Multinationals and American Interests* (Washington, DC: Brookings Institution, 1978); Robert Gilpin, *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (New York, NY: Basic Books, 1975); Fred Block, *The Origins of International Economic Disorder: A Study of the United States International Monetary Policy from World War II to the Present* (Berkeley, CA: University of California Press, 1977); and Jean-Jacque Servan Schreiber, *The American Challenge* (New York, NY: Atheneum, 1978).

first time in 1989; foreign MNEs invested more in the United States than did U.S. MNEs abroad.²⁶

Although global FDI rose from \$208 billion in 1973 to \$1,403 billion in 1989, FDIUS increased much faster, from \$21 billion (10 percent of the total) to \$401 billion (29 percent of the total) in the same period. The flow of direct investment into Japan, however, remained low,²⁷ Table 3-2 compares the shares of total global inward FDI of several host countries and regions.

The United States thus became the world's largest importer of capital in the 1980s. The gross total of FDIUS grew from \$83 billion to \$185 billion between 1981 and 1985, increasing at an annual rate of 17 percent. The rate of FDIUS growth accelerated between 1985 and 1989, averaging 21 percent. In 1990 and 1991, however, the rate of FDIUS slowed dramatically and may even have become negative in 1992, although OECD and U.S. Department of Commerce data do not agree on this last point (see figure 1-2 in chapter 1 and figure 3-1 in this chapter).

Some economists argue that a decline in new FDI in 1990 and 1991 may have signaled a break in new FDIUS; they postulate that the flow of net lending from parents to affiliates declined and the stock of retained earnings of U.S. affiliates fell because affiliates paid dividends to their parents despite negative earnings.²⁸ Figure 3-1 graphically illustrates the cumulative position and growth rate of FDIUS. While there has been a dramatic decline in the growth rate in the early

1990s, the total of FDIUS has grown, despite a recession and slow recovery.

I Measuring Foreign Presence

Measuring the importance of foreign firms in the domestic economy is complex.²⁹ On the face of it, foreign-controlled production does not loom large in the landscape of the U.S. economy. Despite the sometimes contentious public debate surrounding FDIUS, foreign firm accounted in 1988 for a relatively small share of the U.S. economy—no more than 4.1 percent of total employment and 4.1 percent of total domestic product.³⁰ As one Commerce Department analyst observed, “the role of foreign-owned firms in the U.S. economy—in terms of proportion of domestic sales, assets or employment—remains the lowest, except for Japan, among industrial countries.”³¹ In 1988, U.S. affiliates of foreign firms did, however, account for a larger share of the domestic manufacturing economy, with 14.7 percent of the assets, 12.2 percent of the sales, and 10.5 percent of the gross product. (See box 3-A.)³²

These figures, however, underestimate the importance of foreign multinationals in the U.S. economy. To appreciate the full impact of foreign-based firms, all foreign-owned production—both FDI and imports—should be considered together. In specific industries—many of them related to critical technologies—the foreign position is much larger than the averages suggest. For example, in the automotive industry, foreign

²⁶ U.S. Department of Commerce, Office of the Chief Economist, *Foreign Direct Investment in the United States: Review and Analysis of Current Developments* (Washington DC: U.S. Government Printing Office, August 1991), p. 4. It should be noted that the U.S. book value of the net foreign direct investment position has been positive since 1990 (see figure 3-A-3 in box 3-A). U.S. Department of Commerce, “Net International Investment Position, 1992,” op. cit., footnote 4.

²⁷ U.S. Department of Commerce, *Foreign Direct Investment in the United States*, ibid., p. 21.

²⁸ Graham, op. cit., footnote 2, p. 1740.

²⁹ For discussions on the issue of alternative measures of FDI see Julius, op. cit., footnote 9, pp. 14-24; Robert Eisner and Paul J. Pieper, “The World’s Greatest Debtor Nation?,” *North American Review of Economics and Finance*, 1 (1), pp. 9-32; U.S. Department of Commerce and Bureau of Economic Analysis, *Survey of Current Business*, May 1991, especially p. 41.

³⁰ Gerald R. Moody, “Role of Foreign-Owned U.S. Affiliates in the U.S. Economy, 1977-88,” U.S. Department of Commerce, *Foreign Direct Investment in the United States*, op. cit., footnote 26, p. 30.

³¹ Sumiye Okubo McGuire, “Summary and Conclusions,” U.S. Department of Commerce, ibid., p. 84.

³² Moody, op. cit., footnote 30, p. 30.

Table 3-2—Host Country Share of Global Foreign Direct Investment, Selected Years (percent of world total)

	1967	1973	1980	1989
U.S.	9.4	9.9	16.5	28.6
EC	23.5	32.7	37.0	34.5
Japan	0.8	0.8	0.7	0.7
LDCs	30.6	26.1	22.0	19.2
Other	29.4	24.8	18.7	13.0

NOTES: All figures are EC-12, regardless of year. LDCs denote lesser developed countries, as defined in the source.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Review and Analysis of Current Developments* (Washington, DC: U.S. Government printing Office, August 1991), table 4-2,

producers control about 31 percent of the U.S. market. In the merchant semiconductor market, the figure was about 30 percent in 1991,³³ and in the chemical industry, the foreign share was about 26 percent.³⁴

Significant foreign production is conducted in the United States. Foreign firms provide an estimated 72,200 automotive industry jobs in the United States,³⁵ 280,800 jobs in the chemical industry, and 51,500 jobs in the steel industry.³⁷ This accounts for a significant share of total domestic employment in major industries, as shown in figure 3-2.

The pattern of FDIUS that developed during the 1980s was characterized by an increase in Canadian, Japanese, and European investment.³⁸ In the aggregate, Europe remained the leading foreign investor,³⁹ accounting for approximately 65 percent of all FDIUS in the 1980s, but the Japanese position rapidly expanded. Figure 3-3 charts these investment positions. Japan's rise from the fourth to the largest single investor is particularly striking.

Japan's investments have received intense scrutiny for a number of reasons. These include

the accelerated rate of growth of Japanese direct investment (in the context of the competitive challenge of the Japanese economy), the asymmetry in trade and investment access by U.S. firms to Japan, and the burgeoning U.S. trade deficit. In addition, there is a widespread perception—right or wrong—that Japanese investors are better able to maximize market share and absorb technology than other foreign investors. Furthermore, Japan is the most diversified of the major foreign direct investors in the United States, and often all their major producers in a sector—such as automobiles or steel—invest in the United States, giving critics a sense that Japanese investment is enveloping the U.S. economy.

The breadth of Japanese investment is reflected in employment figures for manufacturing industries by sector. Table 3-3 profiles foreign affiliate employment in the manufacturing and wholesale trade sectors, covering the seven largest investors in the United States during the early 1990s. While Britain and Canada remain the largest two manufacturing employers, the table shows significant employment levels for Japanese affiliates. The table also illustrates the comparatively broad

³³ Semiconductor Industry Association, *Annual Data Book*, 1991, p. 12.

³⁴ U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various issues 1992; U.S. Industrial Outlook (Washington DC: U.S. Government Printing Office, January 1992 and January 1993).

³⁵ AS of 1988; Economic Strategy Institute, "The Case for Saving the Big Three," interim report (Washington, DC: Economic Strategy Institute, 1992), p. 56.

³⁶ AS of 1988; U.S. Department of Commerce, *Foreign Direct Investment in the United States*, op. cit., footnote 26, p. 68,

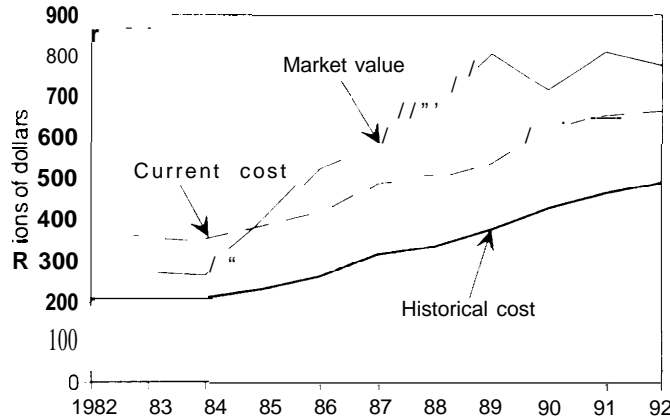
³⁷ Ibid., p. 62.

³⁸ Ibid., p. 23.

³⁹ KPMG Peat Marwick, "European Investment in the United States," report for The European Institute, 1991, p. 1.

Box 3-A-Three Ways To Calculate Foreign Direct Investment in the United States (FDIUS)

Figure 3-A-I—Alternative Valuations of U.S. Direct Investment Position Abroad, 1982-1992



SOURCE: J. Steven Landefeld and Ann M. Lawson, "Valuation of the Net U.S. International Investment Position," *Survey of Current Business*, May 1991, p. 40, table 1; Russell B. Scholl, Raymond L. Mataloni, and Steve D. Bezirgianian, "The International Investment Position of the United States in 1991," *Survey of Current Business*, June 1992, p. 53, table 4; U.S. Department of Commerce, Bureau of Economic Analysis, "Net International Investment Position, 1992," press release, June 30, 1993.

Measuring global foreign direct investment (FDI) is a contentious issue. Depending on how FDI is calculated, very different outcomes can be reached in identifying the ratio of U.S. direct investment abroad (USDIA) to FDIUS, and second, the relative significance of foreign investment in the United States. The most widely used method is the "book value" or "historical cost" approach. This approach calculates the value of FDI from the initial cost of the investment ignoring subsequent changes in the value of the investments. There are **two major problems** with the book value approach: it usually understates **substantially the** current value of investments; and it can be distorted by currency fluctuations.

One alternative to calculating by book value is to calculate by stock or

current cost. This approach calculates the current value of an investment, not its original value. This method also has problems, principally because it is very laborious to update repeatedly the values of numerous investments.

A third method is the "replacement cost adjustment" or "market value" method. This is similar to the **stock value method, but focuses on investment goods prices rather than on share prices.** This approach has two major deficiencies. First, the current value of many investments has little to do with the replacement cost of the original capital goods, much of which maybe outdated; second, the value of an investment may have less to do with the market value of physical capital assets than with the value of intangible assets such as skills, knowledge, or goodwill.¹

There are two practical implications of the distinctions among the book (historical cost), stock (current cost), and replacement (market value) methods. The first concerns the **ratio between the out flow of FDI from the United States (USDIA) and the inflow of capital (FDIUS).** According to Department of Commerce estimates, based on **book value**, FDIUS exceeded USDIA for the first time in 1989.² This method prompted some economists to contend that the United States had become the "world's greatest debtor nation," based on its net international investment position. Others, relying on stock estimates that recalculate old investment at present values, have reached a different conclusion, especially when other resources such as gold are added to equity ownership.³

¹For a general discussion of the merits of all three approaches see Robert Eisner and Paul J. Pieper, "The World's Greatest Debtor Nation?," *North American Review of Economics and Finance*, vol. 1, No. 1, pp. 9-32. The market value figures are available in BEA, "Valuation of the U.S. Net International Investment Position of the United States," *Survey of Current Business*, June 1992, p. 53, table 4.

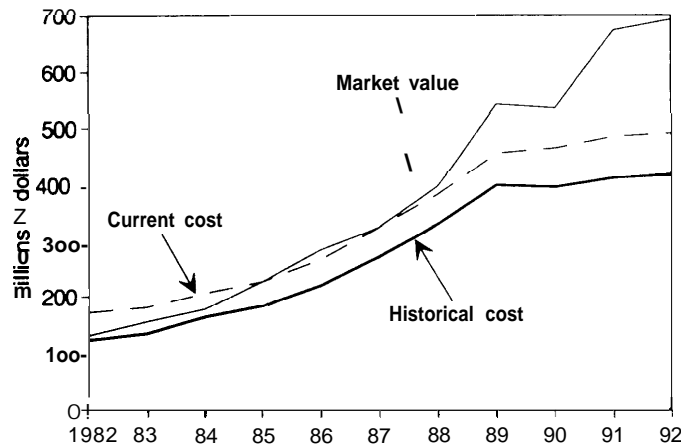
²U.S. Department of Commerce, Office of the Chief Economist, *Foreign Direct Investment in the United States: Review and Analysis of Current Developments* (Washington, DC: U.S. Government Printing Office, August 1991), p. 4.

³Eisner and Pieper, op. cit., footnote 1, p. 11.

(continued on next page)

Box 3-A-Continued

Figure A-2—Alternative Valuations of the Foreign Direct Investment Position in the U.S., 1982-1992



SOURCE: Landefeld and Lawson, p. 40, table 1; Scholl, Mataloni, and Bezirganian, p. 53, table 4; U.S. Department of Commerce, Bureau of Economic Analysis, "Net International Investment Position, 1992," press release, June 30, 1993.

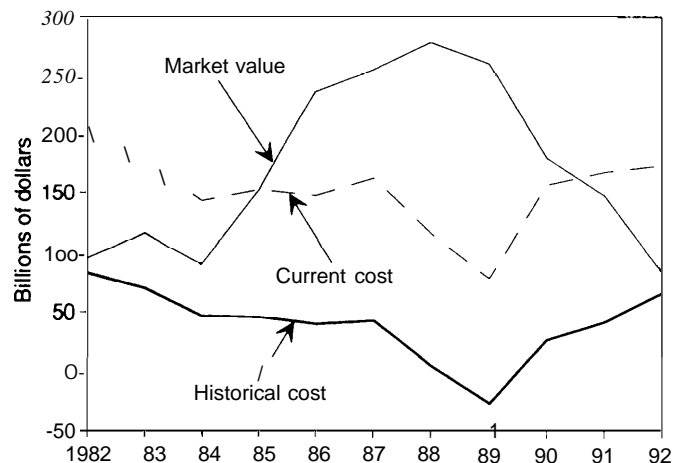
Using Bureau of Economic Analysis (BEA) data and all three methods of calculating USDIA, FDIUS, and the net position, Department of commerce economists in 1991 concluded that only the book method showed the United States as a net debtor in 1989. Both the stock and the replacement methods yielded a net direct investment surplus. (Figures 3-A-1, 3-A-2, and 3-A-3 show the results of the different measurements of USDIA, FDIUS, and the net direct investment positions.)

Using assigned stock or replacement value as an indicator suggests that USDIA is still greater than FDIUS by a large margin. Even the book method shows the net investment position of the United States in surplus after

1989. However, the replacement value figures are affected by the high value of the U.S. dollar in the 1950s and 1960s relative to its value between 1985 and 1990. In addition, the figures are potentially distorted by stock market fluctuations.

The second practical implication concerns the investment positions of different countries in the United States. Critics suggest that book value understates the position of historical European, particularly British, investment and overstates the extent of the Japanese position because it is more recent. This view holds that Japanese FDI is overstated on a global scale as well as in the United States.⁴ On the other hand, some analysts argue that too much emphasis is placed on the timing of FDIUS. The distortion of the position of the major bilateral investors is much smaller than critics suggest because the vast majority of both European and Japanese FDI occurred in the 1980s.⁵

Figure 3-A-3-Alternative Valuations of the Net U.S. International Direct Investment Position, 1982-1992

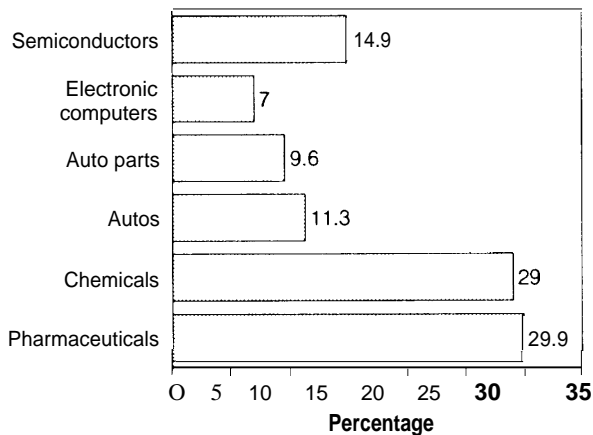


SOURCE: Landefeld and Lawson, p. 40, table 1; Scholl, Mataloni, and Bezirganian, p. 53, table 4; U.S. Department of Commerce, Bureau of Economic Analysis, "Net International Investment Position, 1992," press release, June 30, 1993.

⁴ DeAnne Julius, *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (London: Royal Institute of International Affairs, 1990), p. 38.

⁵ See Elener and Pleper, op. cit., footnote 1, p. 17, table 5B.

Figure 3-2—Percent of U.S. Workforce Employed by Foreign-Owned Affiliates in Selected Manufacturing Sectors, 1990

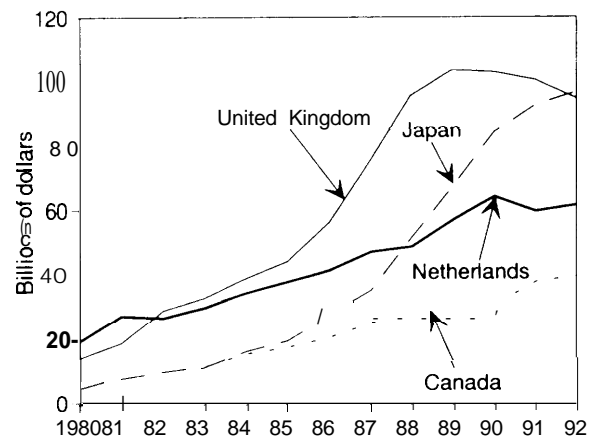


SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, "Employment and Wages in Foreign Owned Businesses in the United States, Fourth Quarter 1990," press release, October 20, 1992, table 2.

distribution of Japanese affiliates, as well as the relatively high levels of Japanese affiliate employment in wholesale trade. In comparison, Canadian affiliates, which have approximately the same number of workers in aggregate, employ only 13.5 percent as many workers in the wholesale trades. British investors employ nearly a quarter-million more people, yet they employ some 90,000 fewer in wholesaling. Given that wholesale trade is directly related to the import of goods, rather than their domestic manufacture, this statistic suggests that Japanese investors employ a large percentage of workers among affiliates that are primarily devoted to importing. This issue is returned to later in this chapter.

Japanese manufacturing investment in the United States also differs from traditional investment patterns because of its strategic nature. Japanese firms have invested heavily, for example, in steel, rubber, and autos as one complex, or triangle, of investment (consumer electronics, semiconductors, and computers are another). These horizontally and vertically integrated

Figure 3-3-Foreign Direct Investment Position in the U.S. by Selected Country, 1980-1992



NOTE: All data are calculated on a historical cost basis and are not adjusted for inflation.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Review and Current Developments*, August 1991, table 2-4; U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: An Update* (Washington, DC: U.S. Government Printing Office, June 1993); U.S. Department of Commerce, Bureau of Economic Analysis, "Net Investment Position, 1992," press release, June 30, 1993, table 3.

groups appear to be more coherent, comprehensive, and strategic than European patterns of FDIUS, such as heavy British investments in chemicals, medical instruments, and publishing, and have thus tended to generate more concern among critics. Figure 3-4 shows Japanese affiliates' assets in several manufacturing sectors.

Overall, Japan's FDIUS rose from \$4.7 billion in 1980 to \$69.7 billion in 1989, increasing at an average annual rate of 32.5 percent between 1980 and 1985, and accelerating to 37.8 percent between 1985 and 1989. The rate of Japanese FDIUS declined between 1990 and 1992,⁴⁰ because of a recession in Japan and an increase in the cost of capital in Japan.

Putting these figures in perspective, the EC countries' expansion of FDIUS, although notable, was much slower than Japan's. European FDIUS rose from \$47.3 billion in 1980 to \$234.8 billion

40. "Japan Keeps Cash at Home," *op. cit.*, footnote 4, p. 4.

Table 3-3-Employment of Affiliates by Industry of Affiliate and by Country of Ultimate Beneficial Owner, 1990 (In thousands of employees)

Industries	Canada	France	Germany	Netherlands	Switzerland	Britain	Japan
<i>Total manufacturing</i>	305.5	181.1	249.7	127.7	178.6	538.7	291.7
Food and kindred products	NA	12.5	2.9	17.4	NA	105.0	15.1
Beverages	NA	5.5	0.5	0.0	*	2.4	4.3
Other	21.0	7.0	2.4	17.4	NA	102.8	10.7
Chemicals and allied products	NA	22.8	94.4	41.5	60.4	129.2	23.7
Industrial chemicals	NA	NA	70.1	NA	1.1	80.3	11.2
Dregs	*	NA	4.2	*	53.6	32.0	7.2
Soap, cleaners, and toiletries,	1.5	0.5	18.0	NA	NA	NA	2.7
Other	0.4	0.9	2.2	NA	NA	NA	2.6
Primary and fabricated metals	32.2	35.3	21.8	10.5	8.2	39.5	61.8
Primary metal Industries	24.2	NA	6.0	0.0	5.7	10.4	54.0
Ferrous	9.3	3.1	2.0	0.0	0.3	0.5	50.0
Nonferrous	14.9	NA	4.1	0.0	5.4	9.9	4.0
Fabricated metal products	8.0	NA	15.8	10.5	2.5	29.1	7.8
Machinery	41.3	34.5	59.9	NA	49.3	92.1	89.6
Machinery, except electrical	6.1	15.1	20.9	1.6	NA	44.7	54.7
Computer and office equipment	0.7	NA	2.7	0.7	NA	10.3	25.2
Other	5.4	NA	18.2	1.0	18.3	34.4	29.5
Electric and electronic equipment	35.2	19.4	39.0	NA	NA	47.4	34.9
Audio, video, and commercial	NA	NA	NA	NA	NA	7.5	3.4
Electronic components	2.1	NA	12.6	2.7	0.4	11.1	24.1
Other	NA	5.5	NA	0.5	NA	28.8	7.4
Other manufacturing	90.2	76.0	70.8	NA	NA	172.7	101.6
Textile products and apparel	10.7	1.9	7.7	0.4	1.5	20.0	8.6
Lumber and furniture	2.4	0.7	5.5	0.0	0.4	6.2	1.0
Paper and allied products	5.9	0.5	1.6	NA	NA	5.9	4.2
Printing and publishing	51.1	NA	NA	NA	NA	33.7	NA
Rubber products	NA	NA	NA	NA	*	NA	NA
Misc. plastics products	3.5	4.8	3.4	NA	0.5	10.8	3.5
Stone, clay, and glass products	NA	29.9	10.1	NA	5.3	30.7	11.2
Transportation equipment	NA	10.9	6.1	0.7	0.5	22.4	26.2
Motor vehicles and equipment	7.6	NA	4.5	0.0	0.5	4.0	26.2
Other	NA	NA	1.6	0.7	0.0	18.4	0.0
Instruments and related products	1.1	6.6	9.4	0.3	7.1	30.9	5.6
Other	1.3	3.0	0.7	*	2.4	NA	3.8
<i>Total wholesale trade</i>	20.7	43.4	65.6	16.2	14.9	59.9	152.9
Motor vehicles	1.4	NA	18.4	0.1	0.0	5.0	38.1
Professional/commercial equipment	0.2	0.4	4.0	2.2	5.7	6.1	18.7
Metals and minerals	NA	2.4	6.8	0.7	0.1	3.6	7.1
Electrical goods	0.9	0.8	NA	0.1	0.4	2.1	68.3
Machinery and equipment	3.1	0.7	4.6	2.8	3.0	4.3	9.2
Other durable goods	0.7	2.4	1.5	2.5	1.2	19.5	5.7
(Groceries and related products	NA	NA	NA	1.4	0.2	7.6	1.2
Farm product raw materials	0.1	11.9	0.1	0.6	NA	0.3	1.5
Other nondurable goods	7.4	11.4	4.2	5.8	NA	11.5	3.1

NOTES: Ultimate Beneficial Owner is that firm, moving up a U. S. affiliate's ownership chain, and beginning with and including the foreign parent, that is not owned more than 50 percent by another firm. An asterisk indicates fewer than 50 employees, NA indicates data is not available.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, Operations of U.S. Affiliates of Foreign Companies, Preliminary 1990 Estimates* (Washington, DC: U.S. Government Printing Office, August 1992), table F-3.

in 1989,⁴¹ at an average annual increase of 17.8 percent between 1980 and 1985, and 21.6 percent between 1985 and 1989. In other words, the growth rate of Japanese FDIUS was much higher than the European growth rate of FDIUS, although cumulative EC FDIUS is still much higher than that of Japan. Japanese FDIUS is also much higher than U.S. investment in Japan. (See figure 1-10 in chapter 1, which compares Japanese investment in the United States to U.S. direct investment in Japan through the 1980s. See also figure 1-9, which compares U.S. investment in the European Community to EC investment in the United States.⁴²)

I Reasons for Reversal

What explains the shift in flows toward FDIUS? Traditional economic theory postulates that foreign investors make decisions based on two sets of considerations. Classical macroeconomic investment theory points to the significance that investors attach to the marginal returns on capital relative to its cost, motivated by the desire to maximize returns while hedging against interest and exchange rate fluctuations.⁴³ The alternative, macroeconomic or industrial organization approach, focuses on the strategic behavior of the multinational enterprise. It claims that MNEs set up foreign subsidiaries because of their desire to sustain profits in the face of stiffer competition; to gain access to a market or expand share; to sustain or create a comparative advantage enjoyed by the firm; to service the particular needs of a customer or its market; or for political reasons.⁴⁴

Dating from the late 1970s, foreign firms—most particularly Japanese firms—began to follow the pattern traditionally associated with U.S. firms as they became MNEs. Besides the large and persistent U.S. balance of trade deficits, which itself is caused in part by barriers to trade and investment in certain key markets, analysts have identified at least six possible reasons for the growth of FDIUS in the United States. These reasons are not mutually exclusive and varied in importance for MNEs from different countries.

The first reason was *changes in the cost of capital*. U.S. debt and equity markets had traditionally been a source of relatively cheap capital, and American firms benefited from this system. However, during the late 1970s and 1980s, the pattern changed. The traditional U.S. advantage of access to liquid capital markets of unrivaled scope disappeared. Exacerbated by the rising budget deficit, high inflation levels raised domestic interest rates. These factors, when combined with the globalization of some financial markets, meant that foreign producers could benefit from comparable and often lower interest rates than their U.S. counterparts.⁴⁵ **This development is** reflected in figures 3-5 and 3-6, which show the nominal corporate and prime interest rates in the United States and Japan between 1970 and 1991.

As the figures indicate, the beginning of the boom in Japanese FDIUS in the early 1980s coincided with the period of greatest disparity between U.S. and Japanese interest rates, whether corporate or prime. How are these interest rate differentials and the growth of Japanese FDIUS

⁴¹ Ibid.

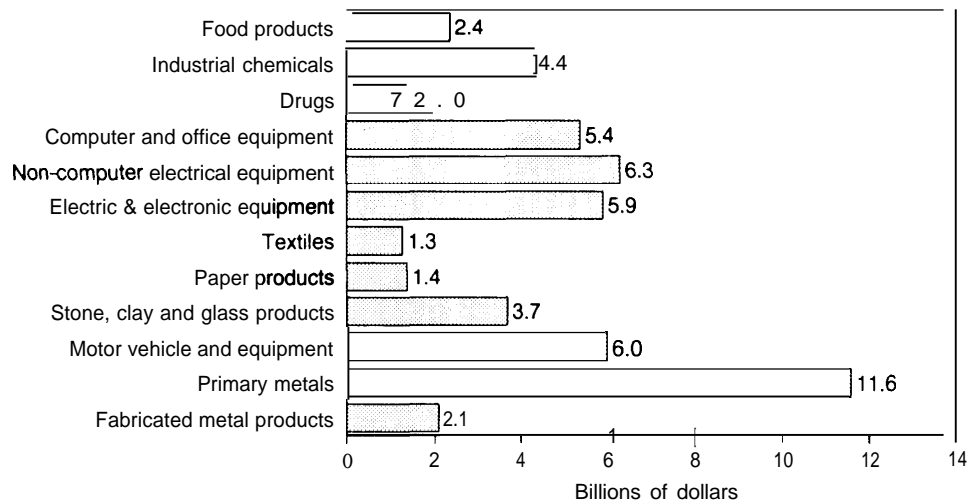
⁴² **When these investment levels** are considered in real terms, despite slight discrepancies the same patterns emerge in both cases.

⁴³ See, for example, Gary Hufbauer, “The Multinational Corporation and Direct Investment,” in Peter B. Kenen, ed., *International Trade and Finance: Frontiers for Research* (Cambridge: Cambridge University Press, 1975).

⁴⁴ **The most noted proponent of this view** is Stephen H. Hymer. See his two books: *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge, MA: MIT Press, 1976) and *The Multinational Corporation: A Radical Approach* (Cambridge, MA: MIT Press, 1979). More recent versions of this argument have evolved into the theory of internationalization. For example, see John Cantwell, “A Survey of Theories of International Production,” in Christos N. Pitelis and Roger Sugden, *The Nature of the Transnational Firm* (New York, NY: Routledge, 1991), pp. 16-63 and especially pp. 23-26. Dunning makes similar arguments in his eclectic paradigm. For a recent version see John H. Dunning, *Multinational Enterprises and the Global Economy* (New York, NY: Addison Wesley Publishing Co., 1993).

⁴⁵ For a discussion of this point see, for example, “Capital Punishment,” *The Economist*, May 23, 1992, p. 1.

Figure 3-4-Assets of Japanese Manufacturing Affiliates in the U.S. by Selected Industry, 1990



NOTE: Data are calculated in 1990 dollars.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States, Operations of U.S. Affiliates of Foreign Companies, Preliminary 1990 Estimates*, August 1992, table B5.

related? As the cost of money falls (adjusted for inflation and currency fluctuations), the incentive to invest grows. Thus, as long as inflation remains low and currency exchange rates remain favorable, interest rate disparities encourage Japanese investors to pursue opportunities abroad. This is what they did.

Correspondingly, as the difference between interest rates in the United States and Japan shrank and all but disappeared in the early 1990s, so too did the propensity towards Japanese FDIUS.⁴⁶ Indeed, it has been suggested that Japan has suffered from a capital cost disadvantage since 1992.⁴⁷ These figures support the proposi-

tion that the cost of capital affected the propensity toward foreign investment; as it becomes cheaper in the investing country, the prospect of FDI becomes more attractive.⁴⁸

The expansion of Japan's equity market during the 1980s caused new sources of cheap capital to develop, as Japanese firms benefited from leveraged loans. However, the subsequent decline of the Japanese stock market in the early 1990s did much to offset this advantage.⁴⁹ In the early 1990s, therefore, while the growth rate in foreign investment in the United States has declined, Japanese as well as European investment has levelled off after the fast growth of the previous

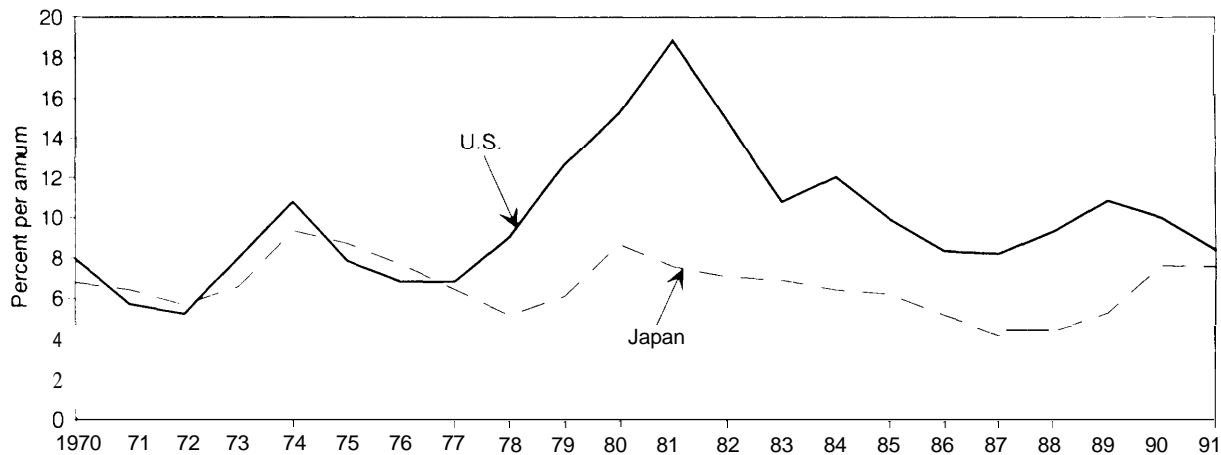
⁴⁶ For details in the decline in major investments in the United States, see "Fewer Deals, Less Investment," *Forbes*, July 20, 1992.

⁴⁷ Richard P. Mattione, "Capital Cost Disadvantage for Japan?" (Tokyo: Morgan Guaranty Trust Co., Apr. 6, 1992).

⁴⁸ This slow-down in the rate of increase of Japanese FDIUS was part of a general deceleration or possible decline of FDIUS among OECD countries (see footnote 50), which suggests one of three possibilities: first, that the cost capital differential shrank among the United States and all major investors in the United States at about the same time; second, that the cost of capital issue only appertained as an incentive to Japanese investors because the differential was so great; or third, that the cost of capital differential is only a partial explanation of the changes in rates of Japanese FDIUS. Finally, there is also an argument, and appropriate supporting evidence, contradicting the claim that there is a relationship between the cost of capital and patterns of FDI. For a summary discussion of this debate, see ch. 6.

⁴⁹ James Sterngold, "Japan's Cash Fountain Has All But Dried Up," *New York Times*, Dec. 6, 1991, p. D1.

Figure 3-5—Nominal Prime Interest Rates in the U.S. and Japan, 1970-1991



SOURCE: Adapted from Richard P. Mattheone, "A Capital Cost Disadvantage for Japan?" Morgan Guaranty Trust, Tokyo, April 1992, p. 3.

decade.⁵⁰ The decline can be attributed largely to the U.S. recession of the late 1980s, but problems in the Japanese economy during the early 1990s also contributed. As the Japanese stock market bubble deflated, industrial firms that engaged in heavy financial engineering suffered heavy losses, as did many Japanese banks that might have provided loans to replace equity financing.⁵¹

The 1970s and 1980s also saw the impact of three distinct systems of capital among leading OECD countries. While the American and British economic systems continued to rely on equity markets, some countries (like Germany) developed a credit-based system run by national banks, and others (like France) had a state-run system.⁵²

Both the national bank-led and state-run systems were characterized by greater patience and a willingness to make long-term capital available at lower interest and on a more liquid basis to domestic firms than to foreign-owned firms.⁵³

In Germany, for example, national banks usually serve on the boards of the companies to which they provided loans, ensuring a measure of fiscal prudence as well as coordinating company behavior through interlocking directorates. In Japan, a similar function is performed by banks associated with specific keiretsu or groups of companies.⁵⁴ In France, state-owned banks facilitated investment by providing capital at lower interest rates. France reversed its net FDI position

⁵⁰ James Sterngold, "Japan's 'Recycling' of Its Trade Surplus Declines," *New York Times*, Feb. 22, 1993, p. A1. Due to the preliminary nature of the 1992 data, Department of Commerce, OECD, and Bank for International Settlements estimates of FDI inflows show either a slight increase or decrease in FDIUS. This small discrepancy, when compared to aggregate FDIUS and the lower direct investment outflows from Japan and Europe, still supports the general evidence of a slowdown in FDIUS in the early 1990's. See "Japan Keeps Cash at Home," op. cit., footnote 4; U.S. Department of Commerce, "Net International Investment Position, 1992," op. cit., footnote 4; and OECD, *Financial Market Trends*, June 1993, table 1, p. 44.

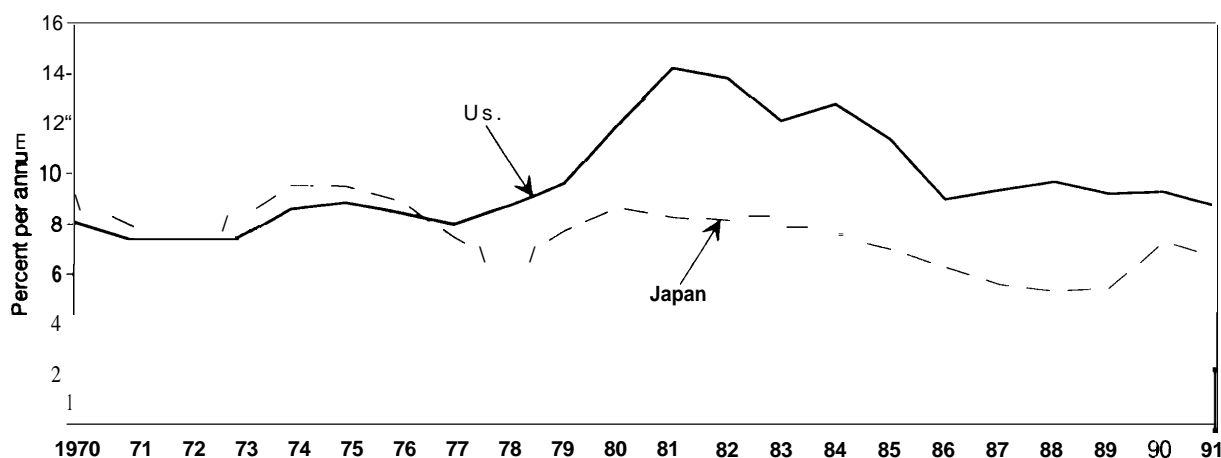
⁵¹ Anthony Rowley, "Ebbing Streams; Japanese Firms Curtail Their Overseas Forays," *Far Eastern Economic Review*, June 18, 1992; also see Sheridan Tatsuno, "Japanese Redirect Electronics Investments to Asia," *New Technology Week*, Nov. 16, 1992, p. 6.

⁵² For a full discussion of this issue see John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca, NY: Cornell, 1983).

⁵³ For an analysis of this issue see Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry* (Washington, DC: Council on Competitiveness, 1992).

⁵⁴ For a discussion see Robert J. Ballon and Iwao Tomita, *The Financial Behavior of Japanese Corporations* (Tokyo: Kodansha International, 1988), especially pp. 58-63.

Figure 3-6-Nominal Corporate Bond Rates in the U.S. and Japan, 1970-1991



SOURCE: Adapted from Richard P. Matteone, "A Capital Cost Disadvantage for Japan?" Morgan Guaranty Trust, Tokyo, April 1992, p. 3.

and became a net FDI exporter for 8 of the 9 years between 1983 and 1992.⁵⁵

These institutional arrangements encouraged foreigners to invest in the United States. The influence of capital shortages, one of the traditional impediments to investment on the scale required to compete in the United States, had been alleviated, creating incentives for a variety of foreign firms to expand their manufacturing or resource base to the United States.

The second reason for the shift in FDI flows is the *liberalization of rules governing the outward flow of capital in some OECD countries in the 1970s and 1980s*. The most prominent examples included countries that had previously restricted outbound FDI, such as France, Italy, and Japan. Of these, Japan was initially perhaps the slowest to respond.⁵⁶ Yet when capital liberalization in 1972 finally replaced the Foreign Exchange Control Law of 1949, Japanese overseas investment grew quickly. Reflecting its importance,

Japanese officials often refer to liberalization as the "gannen" of overseas FDI, a term usually reserved for the first year of the reign of a Japanese emperor.⁵⁷ Overseas investment by Japanese firms almost doubled in the early 1970s, to a total of \$345 million,⁵⁸ and continued to increase dramatically. By the end of the 1980s, Japanese global external direct investment totaled \$201 billion, with \$69.7 billion invested during 1989 in the United States alone.

The third major reason was *the shift in exchange rates between the dollar and the yen*. The **dramatic** fall in the value of the dollar against the yen between 1985 and 1988, under the terms of the Plaza Agreement in 1985, encouraged the influx of FDIUS. During this period the yen rose against the dollar by about 90 percent. This rapid strengthening of the yen brought about a sharp, widespread decline in the cost of production in host countries relative to the cost in Japan, including the initial costs of investment. Thus the

⁵⁵ Julius, *op. cit.*, footnote 9, p. 24.

⁵⁶ Japan's rules regarding both inbound and outbound FDI are chronicled in Dennis Encarnation, *Rivals Beyond Trade: America Versus Japan in Global Competition* (Ithaca, NY: Cornell University Press, 1992), pp. 36-146.

⁵⁷ Ryutaro Komiya, *The Japanese Economy: Trade, Industry and Government* (Tokyo: University of Tokyo Press, 1990), p. 118.

⁵⁸ *Ibid.*, p. 112.

strong yen is an important factor behind the sharp increase in FDIUS. Further, the yen's appreciation gave Japanese firms a strong incentive to develop labor-intensive manufacturing facilities offshore.⁵⁹

The fourth major reason for the shift was the *institution of a series of formal and informal protectionist barriers*. During the 1980s, the United States extended its protectionist measures to limit direct competition in manufacturing sectors for the first time since 1945, a pattern characteristic of the EC as a whole and many of its member states. Increased U.S. protectionism was accomplished through a variety of formally negotiated agreements or informally negotiated, self-imposed restraints, such as voluntary export restraints and orderly marketing agreements in such areas as the automobile, machine tool, textiles, and steel industries.⁶⁰ As a result, many firms transferred some part of their manufacturing or sales to the United States. They did so either to ensure continued access to what was, in many sectors, the world's largest market, or to maintain price competitiveness in the face of possible tariffs.

A fifth factor affecting the growth in FDIUS was *pressure from the Japanese Government* designed to encourage some of their largest domestic corporations to invest in the United States. Often these firms were initially reluctant to do so, being concerned about the political, cultural, and economic implications of trans-

planted investments. Officials of Japan's Ministry of International Trade and Industry (MITI) were often vocal proponents of FDIUS and believed that it would mitigate the fiction between the United States and Japan generated by the burgeoning trade deficit. This was most evident in the case of the automobile industry, where Toyota and Nissan initially resisted MITI's prompting and were subsequently disciplined by having their market share of exports to the United States reduced under the terms of the Voluntary Export Restraint Agreement of 1981.⁶¹ (See chapter 4.)

A final factor was *the tendency to follow the leader for fear of the opportunity cost of not doing so*. Companies, as risk-averse actors, fear that their competitors will gain a significant advantage. This is particularly true among Japanese firms, who compete so aggressively with each other in their domestic market. Thus, once one major foreign competitor is persuaded to invest in production or other facilities abroad, MNEs from the same country tend to follow to prevent the competitor from developing a comparative advantage.⁶² That tendency was evident in many cases involving Japanese FDIUS in the 1980s, as every major Japanese auto producer, for example, followed Honda's lead, albeit with some initial reluctance and at MITI's prompting.

The influx of FDIUS was due to many factors, some exogenous and others the result of U.S. Government policy.⁶³ The collective result was

⁵⁹ For a discussion, for example, of how this change in exchange rates affected Japanese FDI in the auto industry see "Asian Carmakers: The Sun Also Sets," *The Economist*, May 24, 1986, pp. 66-67.

⁶⁰ For details of these measures see Tyson, op. cit., footnote 8; and Ellis S. Krauss and Simon Reich, "Ideology, Interests, and the American Executive: Toward a Theory of Foreign Competition and Manufacturing Trade Policy," *International Organization*, 46, 4, autumn, 1992.

⁶¹ For a detailed discussion of MITI's relationship with the auto firms and illustration of this point regarding the distribution of market shares, see Paul A. Summerville, "The Politics of Self-Restraint: The Japanese State, and the Voluntary Export Restraint of Japanese Passenger Car Exports to the United States in 1981" (Ph.D. Doctoral Thesis, University of Tokyo, 1988).

⁶² Frederick T. Knickerbocker, *Oligopolistic Reaction and Multinational Enterprise* (Boston, MA: Harvard University, Graduate School of Business Administration, 1973); and Theodore Moran, "Foreign Expansion as an 'Institutional Necessity' for U.S. Corporate Capitalism: The Search for a Radical Model," *World Politics*, 25, No. 2 (April 1973). For a discussion of this point in application to Japanese investment in the United States, see Tom Roehl, "Firm, Industry and Country Level Influences on Japanese Foreign Investment in the United States," in Vladimir Pucik, ed., *The Internationalization of Japanese Firms* (forthcoming).

⁶³ For a discussion of a variety of these influences on Japanese investors see Roehl, *ibid.*

that there were three major changes in the nature of Japanese investment. The first was in the *aggregate amount* of Japanese FDIUS, which grew rapidly, as outlined above. The second was in the *thrust* of this investment, as it shifted from mining, natural resources, and manufacturing to include tertiary industries like finance, insurance, and real estate. The third change was in *the distribution and location of Japanese FDI*, as the North American fraction of all Japanese FDI increased from about a quarter (an average of 26.8 percent between 1951 and 1980) to nearly a half by the middle of the 1980s (46.8 percent in 1986). The increase in Japan's manufacturing investment was more dramatic, rising from an average 19.3 percent of Japanese investment in the United States between 1951 and 1980 to 57.8 percent by the middle of the 1980s.⁶⁴

Changes in the cost of capital and exchange rates in the early 1990s have slowed the growth of FDIUS, particularly from Japan.⁶⁵ But it is also possible that increased protectionism may either sustain FDIUS or generate new forms of strategic agreements or alliances among firms, which could affect the structure and competitiveness of the U.S. economy.

| Benefits and Disadvantages of Increased FDIUS

Many analysts believe that the increase in foreign investment during the 1980s was influenced both by U.S. presidential policy and congressional politics. The Reagan administration vigorously pursued policies to increase the influx of FDIUS, in order to offset the decline in U.S. competitiveness and the loss of domestic jobs. These efforts by the Reagan and Bush administrations were buttressed by arguments suggesting that the impact of investment by foreign-based MNEs did not differ from that of their domestic counterparts.⁶⁶ Congressional proponents of action on behalf of beleaguered domestic industries may also have played a part in promoting the growth of FDIUS, through their advocacy of domestic content legislation.⁶⁷ Although the administration disagreed with the domestic content ideas, the congressional efforts often provided the President with a credible basis to suggest that either foreign governments negotiate an informal agreement or face a less sympathetic Congress likely to introduce policy through formal legislation.

The success of this policy, however, has generated policy issues of its own. There have been two responses to the significant expansion of

⁶⁴ Komiya, *op. cit.*, footnote 57, PP.122-123.

⁶⁵ For a discussion of new limits on and pattern of Japanese overseas direct investment in general see "Japanese Spoken Here," *The Economist*, Sept. 14, 1991, pp. 67-68. For evidence regarding its reduction in the United States, see "Fewer Deals, Less Investment" *Forbes*, July 20, 1992, p. 290; or the more comprehensive data in Steve D. Bezirgianian, "U.S. Affiliates of Foreign Companies: Operations in 1990," in *Survey of Current Business*, May 1992, pp. 45-68; and in Rutter, *op. cit.*, footnote 4.

⁶⁶ Notable proponents of the view that foreign and domestic investment is largely undifferentiated in effect include Graham and Krugman, *op. cit.*, footnote 12.

⁶⁷ For examples regarding the auto industry, see Hearing before the Subcommittee on Trade, Committee on Ways and Means, *Fair Practices in Automotive Products Act of 1983, HR 1234*, Section 2, later resubmitted as the *Fair Practices in Automotive Products Act of 1983, HR 5133* (Washington, DC: U.S. Government Printing Office, 1984); Subcommittee on Trade, Committee on Ways and Means, *Domestic Content Legislation and the U.S. Auto Industry: Analyses of HR 5133*, Committee Print, p. 10 and seep. 30; Hearing before the Senate Subcommittee on Economic Stabilization Committee on Banking, Housing, and Urban Affairs, *The Effect of Expanding Japanese Automobile Imports on the Domestic Economy* (Washington DC: U.S. Government Printing Office, April 1980). For a discussion of the dynamics of protection in the case of steel see Michael Borrus, "The Politics of Competitive Erosion in the U.S. Steel Industry," John Zysman and Laura Tyson (eds.), *American Industry in International Competition* (Ithaca, NY: Cornell University Press, 1983); Krauss et al., *op. cit.*, footnote 60; Robert S. Walters, "U.S. Negotiation of Voluntary Restraint Agreements in Steel, 1984: Domestic Sources of International Economic Diplomacy" (Pittsburgh, PA: Pew Charitable Trusts/University of Pittsburgh, Graduate School of Public and International Affairs, Pew Case Studies in International Negotiation no. 107, 1988); Robert W. Crandall, *The U.S. Steel Industry in Recurrent Crisis* (Washington DC: Brookings Institute, 1981).

FDI in the U.S. economy, one stressing the advantages and the other the disadvantages. These responses are summarized below.

| Benefits of FDIUS

Advocates of direct investment by foreign MNEs emphasize four advantages created by FDIUS.⁶⁸ The first is the subsidy to levels of investment in the presence of low U.S. savings. This argument cites the stimulating macroeconomic effects of financial infusions to the U.S. economy, regardless of the source, and emphasizes that Americans save less than people in other advanced industrial states. Indeed, U.S. savings and investment growth rates began to diverge in 1983, when the United States began a 5-year period of economic expansion, with the gap between gross saving and investment peaking at \$155 billion in 1987.⁶⁹

A second commonly cited advantage is managerial and organizational innovation, especially to manufacturing.⁷⁰ Examples are the just-in-time inventory system, the more general system of lean production, and the decentralization of decision-making now being tried by some of America's multinational firms.⁷¹ Consistent with these changes is a shift toward less hierarchical bureaucratic structures, team personnel organization, and a

renewed attention to quality that has accompanied foreign manufacturing investment. These, collectively, enhance manufacturing productivity in the United States.⁷²

Third, proponents of FDIUS who distinguish between domestic and foreign firm argue that foreign producers in the United States sharpen the competitiveness of U.S. business. They assume that increased competition will encourage domestic firms to enhance their productivity, particularly where they operate under monopolistic or oligopolistic conditions.⁷³ In this view, FDI is a symptom of a lack of competitiveness, not its cause.⁷⁴ Benefits accrue to consumers in the form of lower prices and a wider selection of products.

The fourth benefit of FDIUS is job creation. There are, for example, 10 transplant automakers with plants in the United States, with BMW a proposed eleventh and Daimler-Benz a twelfth. These collectively account for 50,000 jobs in assembly and parts making operations and 16 percent of the 14.8 million vehicle capacity.⁷⁵ On a broader scale, as of 1990, British-owned affiliates accounted for over 1 million jobs in the United States, Japan for 617,000, Germany for 513,000, and the Netherlands for 290,000.⁷⁶ (See table 3-4.)

⁶⁸ For examples of work that tend to emphasize the benefits of FDIUS, see Earl H. Fry, *The Politics of International Investment* (New York, NY: McGraw-Hill, 1983) and more recently his "Foreign Direct Investment in the United States: Public Policy Options," a paper prepared for the International Studies Association Conference, April 1990; see also Robert Kudrle, "Good for the Gander," *International Organization*, vol. 45, No. 3, summer 1991, pp. 397-424.

⁶⁹ See U.S. Department of Commerce, *op. cit.*, footnote 10, p. 13.

⁷⁰ See, for example, Martin Kenney and Richard Florida, "How Japanese Industry is Rebuilding the Rust Belt," *Technology Review*, vol. 94, No. 2, February-March 1991, pp. 25-33.

⁷¹ See, for example, Michael Cusumano, "Manufacturing Innovation: Lessons from the Japanese Auto Industry," *Sloan Management Review* 30 (fall 1988) pp. 29-39.

⁷² For a discussion of this point see Robert R. Rehder, "What American and Japanese Managers Are Learning from Each Other," *Business Horizons*, 24 (March/April) 1981, pp. 63-70; Kazuhiko Nagato, "TIM Japan-United States Savings Rate Gap," Daniel Okimoto and Thomas Rohlen, eds., *Inside the Japanese System* (Stanford, CA: Stanford University Press, 1988), pp. 64-70.

⁷³ For an example of such a claim, see Graham and Krugman, *op. cit.*, footnote 12, pp. 57-59.

⁷⁴ Graham, *Op. cit.*, footnote 2, p. 1742.

⁷⁵ "Transplant' Auto Factories Have Redefined the Industry," *New York Times*, July 23, 1992, p. C5.

⁷⁶ U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1990 Estimates*, August, 1992, table A-2.

Table 3-4-Selected Financial Data for U.S. Affiliates of Foreign Companies, 1990

	Japan	United Kingdom	Netherlands	Germany
Number of affiliates	2,142	1,161	346	1,144
Total assets (in \$ bil)	370	262	91	101
Sales (in \$ bil)	313,138	188,852	72,819	107,521
Net income (in \$ bil)	-2,191	2,406	32	219
Number of employees (in thousands)	616.7	1,039.2	290.2	513.3
Average compensation (in \$, per employee) . . .	37,203	32,036	34,290	34,307
Exports by affiliates (in \$ bil)	39,155	7,926	2,829	7,041
Imports to affiliates (in \$ bil)	87,712	13,225	6,588	17,858
Ratio of imports to sales	0.28	0.07	0.09	0.17
Ratio of exports to imports	0.45	0.60	0.43	0.39

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1990 Estimates*, August 1992, table A-2; U.S. Department of Commerce, Bureau of Economic Analysis, *Foreign Direct Investment in the United States: An Update*, June 1993.

Proponents of FDIUS who emphasize job creation often blur the distinction between foreign and domestic firms and, at the extreme, reject the notion of national firms. Some have argued that a foreign-based MNE with manufacturing facilities in the United States contributes more to the U.S. economy than a U.S.-based MNE that transfers the bulk of its manufacturing to offshore facilities.⁷⁷ In this view, U.S. prosperity lies in the skills of the labor force, not necessarily in the success of U.S.-owned firms. The implication is clearly that incentives or regulations should be used to encourage forms of FDIUS that use, and help develop, a skilled labor force for high value-added jobs. Such a theoretical dichotomy between a foreign firm that invests in the United States and a U.S. firm that invests abroad excludes discussion of what many argue is the preferred option—a U.S.-owned firm that invests in plant and labor in America.

| Disadvantages of FDIUS

Critics of the national treatment approach to FDIUS emphasize four major complications:

harm to competitiveness, unfair employment and hiring practices, financial subsidies, and economic and military security issues relating to technology transfer. All four link multinational corporate responsibility to aspects of U.S. economic and social development.

First, critics stress competitiveness—namely, the potentially adverse economic consequences of unregulated FDI for U.S. manufacturing firms and for the U.S. technology base.⁷⁸ In contrast to the argument that direct competition will improve the productivity of U.S. firms, these analysts stress that foreign competitors can destroy domestically based firms because they can compete in an unrestricted U.S. economy from the basis of highly restricted international competition in their own market. As a result, unrestricted competition may benefit consumers in the short term, but both consumers and the national economy will eventually lose.

Along these lines, recent work contrasts the “trade-creating” nature of Japanese direct investment abroad (DIA) with the “trade-destroying”

⁷⁷ See, for example, Robert B. Reich, “Who is Us?,” *Harvard Business Review*, January-February 1990, pp. 53-64.

⁷⁸ See, for example, Martin Tolchin and Susan Tolchin, *Buying into America: How Foreign Money Is Changing the Face of Our Nation* (New York, NY: Times Books, 1988); Pat Choate, “Political Advantage: Japan’s Campaign for America,” *Harvard Business Review*, 1990: 87-103; Norman Glickman and Douglas Woodward, *The New Competitors: How Foreign Investors Are Changing the U.S. Economy* (New York, NY: Basic Books, 1989); Daniel Burstein, *Yen!: Japan’s New Financial Empire and Its Threat to America* (New York, NY: Simon and Schuster, 1988); Thomas Omestad, “Selling Off America,” *Foreign Policy*, No. 76 (fall 1989), 119-140.

DIA of the United States.⁷⁹ For example, the formation of affiliates of Japanese auto assemblers has been accompanied by the formation of affiliates of some of their supplier keiretsu members. As advocates of the trade-creating view would expect, the U.S. trade deficit with Japan in autoparts has grown as the Japanese assemblers have increased production in the United States.⁸⁰

Table 3-4 examines the import, export, and sales patterns of U.S. affiliates of the four major foreign direct investors. These data seem to support the proposition that Japanese investment is more trade-creating than trade-destroying, with a ratio of imports to sales of .28 (over three times that of Dutch investment, and four times that of British investment). This table also indicates that Japanese-based MNEs tend to use their U.S. affiliates as a conduit for the sale of products made in Japan, rather than as facilities to replace Japanese-made goods with U. S.-made goods. A higher proportion of goods sold by Japanese firms seem to be assembled in the United States from components built in Japan, relative to U.S. affiliates of other foreign firm.

What accounts for this pattern, and will it be sustained over time? Proponents of FDI claim that a life cycle pattern exists for FDI, whereby foreign investors initially rely more on imports from their parent organization but increasingly shift to a higher domestic content as they mature. Because Japanese firms have invested in the United States so recently, they would naturally

have higher import propensities, but this will change with time.⁸¹

Critics of this suggestion present two arguments. First, although importing is common among new investors, Japanese-based MNEs tend to transplant suppliers along with production facilities more often than other foreign-based firms. While domestic content might indeed rise, it will not do so because of a heavier reliance on domestic producers. Second, critics stress that vis-a-vis domestic content and use of nontraditional suppliers, the behavior of Japanese firms in the EC differs significantly from that of the same firms in the United States, even when the investment dates from the same period.

What might explain a greater Japanese commitment to domestic content in the EC? One possible answer is the differing rules and regulations that Japanese investors face in Europe and the United States.⁸² If this is correct, then responsibility for the decision of Japanese firms to import more or to use their traditional suppliers more in the United States lies partly with the U.S. Government, which has articulated few rules to encourage alternative forms of MNE behavior. Many analysts believe that the U.S. Government cannot fault Japanese firms for playing by the rules as they exist.

The second concern of critics of FDIUS relates to the economic and social effect of FDIUS on domestic employment. This concern has two components. One is about the types and number

⁷⁹ Robert Gilpin reflects this sentiment in citing the work of Kiyoshi Kojima, a distinguished Japanese economist. Gilpin states that "[c]ontrasting Japan's foreign direct investment with that of the United States, Kojima argues that Japanese foreign direct investment attempts to be 'trade-creating', whereas American foreign direct investment has been 'trade-destroying'. Japanese foreign direct investment has sought to increase, or at least maintain, Japanese exports; U.S. foreign direct investment, on the other hand, has tended to replace U.S. exports by establishing production facilities abroad to serve the U.S. or world markets. Although Kojima was referring specifically to direct investment by Japanese corporations, his characterization is applicable to almost all Japanese foreign investment." The argument offers an explanation why the U.S. trade deficit with Japan ballooned while Japanese FDIUS grew. In Robert Gilpin, "Where Does Japan Fit In?" *Millennium: Journal of International Studies*, vol. 18, No. 3, 1989, p. 337.

⁸⁰ See, for example, Richard G. Newman, "The Second Wave Arrives: Japanese Strategy in the Auto Parts Market," *Business Horizons*, vol. 23, No. 4, July/August 1990, pp. 24-30; and Andrew Pollack, "Trade in Auto Parts Favors Japan Despite Gains by U.S.," *The New York Times*, July 1, 1993, pp. D1 and D18.

⁸¹ Graham, op. cit., footnote 2, p. 1743.

⁸² See Robin Gaster, "Protectionism With Purpose: Guiding Foreign Investment," *Foreign Policy*, fall 1992, No. 8*, pp. 96-100; "The Enemy Within," *The Economist*, June 12, 1993, pp. 67-68; Office of Technology Assessment, op. cit., footnote 1, p. 207.

of jobs created by FDIUS, particularly in manufacturing. Critics assert that some transplanted manufacturing facilities are little more than screw-driver plants that assemble high value-added components produced abroad.⁸³ This practice results in relatively few, and possibly inferior, jobs.

The quality-of-jobs issue is far from clear-cut. Leading analysts assert, for example, that "for manufacturing as a whole, and for individual industries within manufacturing, there is no systematic difference between the foreign and the domestic firms in compensation and value added per employee," and provide aggregate data to support that contention.⁸⁴ Yet data drawn from individual industries, such as the auto industry, suggest that this claim is more complex than these analysts assert.⁸⁵

The employment issue is further complicated by assertions that some foreign investors discourage unionization and may employ discriminatory employment Practices.⁸⁶ This view, critics claim, is buttressed by lawsuits filed against several

major Japanese firms. The suits have claimed discrimination against women and against non-Japanese employees in promotion decisions; several companies, including Sumitomo and Honda of America, have settled.⁸⁷ Nevertheless, while one position is that the "increased rate of foreign-based multinational investment in the United States raises the specter that discriminatory motives will become substantially more prevalent in plant relocation, site selection, and subcontracting decisions," the same is potentially true of U.S. firms that develop greenfield sites.⁸⁸

The third form of criticism of FDIUS focuses on tax subsidies, infrastructure development, and other incentives that foreign direct investors often receive from State and municipal authorities. The States have repeatedly competed with each other to secure investment by foreign-based MNEs, particularly in the manufacturing sector. Individual States have, in effect, pursued their own industrial policies, offering lucrative tax, infrastructural, and loan incentives to foreign MNEs to

⁸³ Robert B. Reich and Eric D. Mankin, "Joint Ventures With Japan Give Away Our Future," *Harvard Business Review*, vol. 64, No. 2, March-April 1986.

⁸⁴ Graham and Krugman, op. cit., footnote 12, p. 70.

⁸⁵ For a discussion of how pension plans in transplant facilities are systematically inferior to those at domestic plants, see Candace Howes, "The Benefits of Youth: The Role of Japanese Fringe Benefits Policies in the Restructuring of the U.S. Motor Vehicle Industry," *International Contribution to Labour Studies*, 1, 1991, pp. 113-132; Teresa Ghilarducci, "Pension Costs and Changing Pension Norms: The Case of Japanese Auto Transplants and the U.S. Auto Firms," unpublished paper, University of Notre Dame.

⁸⁶ For a variety of arguments that support this point see Timothy J. Bartik, "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes and Other Characteristics of States," *Journal of Business and Economic Statistics*, Jan. 3, 1985, pp. 14-22; John S. McClenahan, "Who Owns U.S. Industry?," *Business Week*, Jan. 7, 1985; and Steven R. Reed, "Japanese in the American South," in Kozo Yamamura, ed., *Japanese Investment in the United States: Should We Be Concerned?* (Seattle, WA: Society for Japanese Studies, 1989), p. 219; Robert E. Cole and Donald Deskins, Jr., "Racial Factors in Site Location and Employment Patterns of Japanese Auto Firms in America," *California Management Review*, fall 1988, pp. 15-18; and Douglas Woodward, "Locational Determinants of Japanese Plants," *Southern Journal of Economics*, vol. 58, January 1992, pp. 690-708.

⁸⁷ See Rehder, op. cit., footnote 72, p. 92. Also see Employment and Housing Subcommittee, House Committee on Government Operations, "Employment Discrimination by Japanese-Owned Companies in the United States: Hearings" (Washington DC: U.S. Government Printing Office, 1992). According to Japanese sources, the following firms have been sued on discrimination charges: Toyota, Nissan, Honda, Mitsubishi Motors, Suzuki, Sony, Matsushita Electric Industrial Co., Hitachi, NEC, Fujitsu, Ricoh, Canon, Toshiba, Kyocera, Dai-Ichi Kangyo Bank, Sanwa Bank, Mitsubishi Bank, C. Itoh & Co., Shiseido, Japan Air Lines, Sanyo Securities, Dentsu Inc., Hakuhodo Inc., and Recruit Corp. See "Companies in U.S. Accused of Discrimination," *Chuo Koron* magazine (Nagami Kishi, September 1992, in FBIS, Sept. 11, 1992), p. 1. However, consistent with the principles of U.S. law, none of these firms should be considered to have transgressed any law until they have been found guilty. For a general discussion of the behavior of Japanese firms see Douglas Woodward, "Locational Determinants of Japanese Plants," *Southern Journal of Economics*, vol. 58, January 1992, pp. 690-708.

⁸⁸ For this quotation and a discussion of the issue of discrimination in hiring practices see Marley S. Weiss, "Risky Business: Age and Race Discrimination in Capital Redeployment Decisions," *Maryland Law Review*, vol. 48, pp. 901-1017, especially pp. 917-921.

induce them to locate in their States.⁸⁹ Indeed, some critics note that more States maintain economic development offices in Tokyo than in Washington.

The financial incentives offered by competing States have grown dramatically since the mid-1970s. In practice, the incentive package that won the last Japanese factory becomes the opening bid for the next plant. The State of Ohio, for example, paid \$16 million in direct incentives to Honda to secure the Marysville plant in 1982; by 1988, Kentucky spent \$125 million in incentives convincing Toyota to locate its plant there.⁹⁰ Critics question whether State competition for FDIUS is in the nation's interest and whether this competition has reached a stage where the costs of incentives outweigh the benefits even at the local level. Figure 3-7, listing the cost of subsidy per job created, shows how State rivalries have escalated the costs of attracting jobs. Officials of one company that had benefited from such an incentive package told OTA that they would not push as hard for an incentive package if they were to open further facilities in the United States, suggesting that some of these packages may have been too generous, or possibly even unnecessary.

Critics also argue that domestic firms rarely benefit from state incentive packages, even though these packages in principle are equally available to domestic and foreign firms. According to these critics, domestic firms lack the

flexibility to shift plant locations because of the costs of moving production and the potential political conflict in replacing urban, unionized plants with nonunionized, rural manufacturing facilities—often in other regions of the country.⁹¹ Officials of domestic firms repeatedly told OTA that they would like to move production to greenfield sites, but were unable to do so for a variety of reasons. Nondiscriminatory state policies have therefore discriminated against domestically owned firms, assisting foreign MNEs more than indigenous ones.

Finally, recent developments have raised the concern that foreign investments in the United States, particularly those made by Japanese multinational firms, may not be permanent. This fear has already been realized. During 1993, the Japanese economy stumbled, and numerous Japanese firms announced plant closings, cutbacks in investment plans, and layoffs in the United States. These firms include Fujitsu, Seiko, Hitachi, Fanuc, Komatsu, Nissan, Daihatsu, Isuzu, and many others in both manufacturing and nonmanufacturing sectors.⁹² For example, Fujitsu recently announced plans to close a semiconductor manufacturing facility in California and transfer the production to a plant in Southeast Asia because of currency fluctuations.⁹³ Consistent with this concern, aggregate data indicates that foreign direct investors in general organized the net transfer of dividends from affiliates to parents in 1990 and

⁸⁹ Despite the failure of the Volkswagen venture and the cost to Pennsylvania's taxpayers, State officials subsequently offered an equally lucrative deal to Sony to use Volkswagen's plant for the production of televisions.

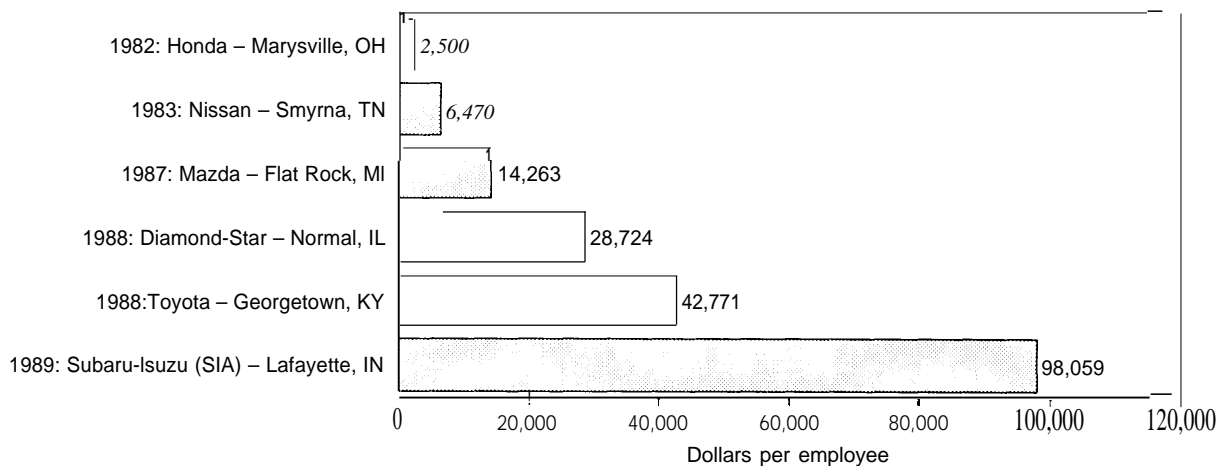
⁹⁰ T. David Mason and Frank M. Howell, "Japan Investment in the United States: A Study of Trends and Site Selection Behavior," a paper presented at the Annual Meeting of the International Studies Association Mar. 30-Apr. 4, 1992, Atlanta, GA, pp. 4-5.

⁹¹ Japanese auto producers often, although not always, locate plants in rural settings. Marysville, OH, home of Honda, had a population of 7,500 prior to the plant's arrival, while Nissan, Diamond Star (jointly owned by Mitsubishi and Chrysler), and Subaru-Isuzu all located in towns of less than 50,000 people. When looking at domestic firms, the most appropriate comparison to draw is between the transplant greenfield sites and that of General Motors' Saturn Plant in Spring Hill, TN, which is unionized. After experimenting with new contractual relations comparable to those found in transplant facilities, Saturn employees chose to return to a more traditionally structured contract. See "Reality Comes to G.M.'s Saturn Plant," *New York Times*, Nov. 14, 1991, p. C5.

⁹² "From the Expansion Route to an Emphasis on Profitability" ('*Kakuchō rosen kara saisansei jushi e*'), *Japan Economic Journal (Nihon Keizai Shimbun)*, Aug. 26, 1992, p. 3. This raises the question of whether foreign investors have scaled back their operations disproportionately to domestic firms. A critical response would be that the closure of capacity in the United States by MNEs, whether domestic or foreign-owned, is undesirable.

⁹³ Larry Holyoke, "Who's Afraid of the Big, Bad Yen? Not Japanese Exporters," *Business Week*, Oct. 12, 1992, p. 49.

Figure 3-7—Escalating American State Subsidization to Auto Manufacturers



SOURCE: Adapted from Martin Kenney and Richard Florida, "How Japanese Industry Is Rebuilding the Rust Belt," *Technology Review*, Feb.-March 1991, p. 30.

1991, even though many of those companies generated negative earnings.⁹⁴

ASYMMETRIES IN NATIONAL POLICY REGIMES

To understand the current state of FDI, it is necessary to review its history. There have been three distinct periods. The first, from the 1890s to the 1930s, was marked by protectionist trade policies in Europe, Japan, and the United States, complemented by open investment policies. Americans heavily substituted direct investment for portfolio investment in Europe and Japan, particularly in manufacturing production facilities. This preference was reflected in the outward expansion of firms like Singer and Ford.⁹⁵

Japan and France, although later resistant to foreign investment, were at this time receptive to U.S.-based MNE investment.⁹⁶ In discussing cultural and structural impediments that confront

U.S. firms in Japan, many analysts overlook the rich history of U.S. trade and investment in Japan in the early twentieth century, and their early successes producing and selling in Japan. This raises the question of why U.S.-based MNEs that were successful at providing and selling in Japan in the past should be less able to do so today.

In the second period, from the 1930s to the 1970s, the FDI policies of advanced industrial states diverged systematically. The United States and United Kingdom sustained largely unregulated, enthusiastic national treatment investment policies. Britain became a major recipient of U.S. MNE investment, largely involving the construction of fully integrated manufacturing facilities.

In contrast, in the 1930s, 1940s, and in some cases through the 1970s, Germany, Italy, Japan, and France either completely blocked foreign investment and sometimes threw U.S. firms out or took steps to ensure that foreign firms did

⁹⁴ Graham, *op. cit.*, footnote 2, p. 1740. This tendency was sustained in 1992 according to "Japan Keeps Cash at Home," *op. cit.*, footnote 4, p. 4, with Japanese investors sustaining net losses of \$2 billion.

⁹⁵ See, for example, Wilkins *et al.*, *op. cit.*, footnote 5; and Mason, *op. cit.*, footnote 5.

⁹⁶ For a discussion of Japan in this period, see Michael Cusuman O., *The Japanese Automobile Industry* (Cambridge, MA: Council on East Asian Studies, Harvard University Press, 1985); for France see Patrick Fridenson, "French Automobile Marketing, 1890-1970," Akio Okochi and Koichi Shimokawa (eds.), *The Development of Mass Marketing* (Tokyo: University of Tokyo Press, 1981).

not thrive. Of these countries, Japan provides the most consistent example of discriminatory behavior by both the public and private sectors in this period. While the public sector was responsible for Japanese restriction of FDI until the 1970s, analysts have suggested that the private sector introduced effective informal impediments to investment during the 1970s and into the 1980s.⁹⁷

During this period, France and Italy discouraged U.S. FDI altogether. The West German policy was more open and more complex, encouraging FDI while often using subtle impediments to protect domestic firms—thus benefiting from capital inflows and the jobs FDI created, helping to secure an economic base from which to compete effectively in the post-WWII period.⁹⁸

In addition to limiting FDI, these four governments organized the emergence of a series of firms that subsequently became the post-WWII national champions, and ultimately MNEs. Auto industry examples include Nissan and Toyota in Japan, Renault in France, Volkswagen and Daimler-Benz in Germany, and Fiat in Italy. While U.S.-based MNEs penetrated parts of Europe, their success varied greatly by country and sector. In the United Kingdom, they proved to be highly successful, while elsewhere they were less so.

Throughout the third period—the 1970s and 1980s—the United States sustained its policy of national treatment which, as intended, increased the flow of FDI. However, this policy, despite attempts by the Organization for Economic Cooperation and Development (OECD) to advance the

principal of national treatment, rarely led to reciprocal treatment for U.S.-based MNEs seeking to invest abroad. (See box 3-B.)

The EC's long debate on regulating inward FDI is largely unresolved. Evidence of a convergence in European FDI rules is limited. Agreements on domestic content laws regarding foreign MNEs often appear to be settled in principle, only to be disputed in practice. As one report noted about the provisions of the EC-Japan agreement on Japanese auto imports:

The agreement may fall apart because it leaves a number of matters open to interpretation—such as whether Japanese cars made in the U.S. will be counted [as imports from Japan]. Even the meaning of the 1999 ceiling on the total Japanese market share of 16.09 percent is not clear. The French and Italians argue that if this ceiling is attained, imports from Japan will have to be cut. Otherwise, they say, what is the point of setting the overall market share to the exactitude of a second decimal point? Not so, says Britain, home to a Nissan factory and soon to a Toyota and Honda one as well. Britain reckons transplant production will not be limited in any way—and that exports should not have to be cut back either . . . Given such different interpretations, the chances of the agreement reaching 1999 intact are remote. . . there is [also] a distinct possibility that the keenest Japan-bashers among EC car makers, like Jacques Calvet of Peugeot (or his successor), will ask for another transition period, delaying real liberalization even longer.⁹⁹

⁹⁷ See Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford, CA: Stanford University Press, 1982); Marie Anchordoguy, "Mastering the Market: Japanese Government Targeting of the Computer Industry," *International Organization*, 42 (summer 1988); T.J. Pempel, "Japanese Foreign Economic Policy: The Domestic Bases for Economic Behavior," in Peter J. Katzenstein, ed., *Between Power and Plenty* (Madison, WI: University of Wisconsin Press, 1978); Hideichiro Nakamura, "Japan, Incorporated and Postwar Economic Growth," *Japanese Economic Studies* 10:3 (spring 1982) pp. 68-109; Isamu Miyazaki, "The Real Reasons for Japan's Success in Economic Growth," *Japanese Economic Studies* 10:3 (spring 1982). For a focus on the shift in investment impediments to the private sector in that decade see Dennis J. Encarnation and Mark Mason, "Neither MITI nor America: The Political Economy of Capital Liberalization in Japan," *International Organization*, winter 1990, pp. 25-54; and Encarnation, op. cit., footnote 56.

⁹⁸ Reich, op. cit., footnote 5, pp. 303-328.

⁹⁹ "Stalling Japan's Car Makers," *The Economist*, Aug. 3, 1991, pp. 232.

Box 3-B—The OECD Declaration and Decisions on International Investment and Multinational Enterprises

National governments have found it difficult to regulate MNEs. Multilateral regulation maybe even more challenging, as demonstrated by the Organization for Economic Cooperation and Development (OECD) efforts to establish rules for MNEs and international investment

In its 1976 Declaration and Decisions on International Investment and Multinational Enterprises, the OECD established two sets of rules, one governing the practices of MNEs and the other governing FDI.¹ To govern MNEs, the OECD established a voluntary code of corporate conduct that encourages MNEs to give their subsidiaries the autonomy to abide by national laws and to cooperate with local business and labor. The code of conduct advises MNEs to permit labor representation, contribute to technology transfer, and not obstruct competition or harm the environment. To govern FDI, the OECD recommended that all member countries extend national treatment to foreign MNEs. The influence of both sets of rules has been limited primarily because they rely on the good faith of MNEs and member nations.

For example, the code of conduct for MNEs has no quantitative means of measuring effectiveness and commitment. Instead, it promotes good corporate citizenship among MNEs, measured primarily by membership in national business federations that affiliate and consult with the OECD through the Business and Industry Advisory Committee (BIAC).² Individual firms have been reluctant to endorse the OECD's rules because of the political and legal implications of explicit commitment, especially in labor and environmental disputes. Moreover, many MNEs reportedly feel that stronger, obligatory rules would be too intrusive.³ The business community sees asymmetries in policies as the major impediments to foreign investment, and the BIAC has been pressing the OECD to enhance the International Investment and National Treatment portion of the Declaration.⁴

¹ Organization for Economic Co-operation and Development, *Declaration on International Investment and Multinational Enterprises*, (Paris: OECD, 1976),

² The Business and Industry Advisory Committee to the OECD is based in Paris.

³ Confidential business federation interviews.

⁴ Business and Industry Advisory Committee. *BIAC Statement on a Potential OECD Broader Investment Instrument*, Paris, Dec. 3, 1992.

Examples of successful U.S. investments in Japan are still the exception.¹⁰⁰ OTA interviews with managers of U.S.-based MNEs suggest that the Structural Impediments Initiative has had only limited success in making the Japanese domestic market more receptive to foreign products. Structural, cultural, and governmental limi-

tations on investment practices by U.S. firms still exist.¹⁰¹ The success of a few U.S. firms in Japan does not indicate widespread application of free trade and open investment practices.¹⁰² U. S.-based MNEs like IBM, Texas Instruments, and Motorola have made commercial inroads often only after exhaustive efforts, and some have been

¹⁰⁰ For details concerning the efforts of individual companies in Japan, see Mason, op. cit., footnote 5, pp. 32-34. For a summary of the present situation see Office of the United States Trade Representative, *Second Annual Report of the U.S.-Japan Working Group on the Structural Impediments Initiative*, July 30, 1992, hereafter referred to as 2nd SKI report.

¹⁰¹ Analysis in support of this view comes from a number of sources. See Keidanren report, op. cit., footnote 6; The House Wednesday Group, op. cit., footnote 6; Office of the United States Trade Representative, op. cit., footnote 6, pp. 79-94.

¹⁰² For a list of the limits to free trade and open investment practices in Japan, see Keidanren report, Op. Cit., footnote 6.

The OECD rules promoting national treatment allow exceptions based on concerns for national security and public order, particularly in regard to the natural resource, energy, and service sectors.⁵ Given these exceptions, nations can impose tax obligations and investment controls on foreign controlled enterprises, restrict access to local bank credit and capital markets, and discriminate in government procurement contracts.⁶ Concerned with an apparent trend towards excessive restrictions, the OECD recommended a standstill on further exceptions in 1988. In 1991, the OECD encouraged nations to make restrictive measures more transparent and to commit to eliminating them in the future.⁷ At the same time, the OECD and the Committee on International Investment and Multinational Enterprises (CIME), which monitors use of the decisions by national governments and MNEs, expressed concern over a number of trends and activities in both private and government policies and practices, including sharp swings in investment flows, trade frictions, conflicting national requirements on MNCs, the marginal contributions of screwdriver assembly plants, preferential treatment in the private sector, the increase in bilateral investment agreements, and the use of reciprocity as a bargaining tool.⁸ The OECD fears these conditions undermine the Declaration and Decisions and may impede future multilateral attempts to liberalize foreign investment rules.

In sum, the nonbinding nature of the OECD Declaration and Decisions and their institutionalized deference to national laws and prerogatives leave them inherently weak. Member countries often have different reactions to the effects of asymmetrical investment incentives, and while some wish to strengthen the national treatment decisions, others prefer to include more rights of exception.⁹ These different views indicate that real progress towards further liberalization or enforcement of the Declaration and Decisions is unlikely.

⁵ OECD, *The OECD Declaration and Decisions on International Investment and Multinational Enterprises: 1991 Review*, (Paris: OECD, 1992), pp. 26-32.

⁶ OECD, *National Treatment for Foreign-Controlled Enterprises*, (Paris: OECD, 1985), pp. 20-22.

⁷ OECD, *The OECD Declaration and Decisions on International Investment and Multinational Enterprises: 1991 Review*, pp. 30-5; "National Treatment: Third Revised Decision of the Council," December 1991, revision of the Declaration by Governments of the OECD Member countries on International Investment and Multinational Enterprises.

⁸ OECD, *The OECD Declaration and Decisions on International Investment and Multinational Enterprises: 1991 Review*, pp. 18-20.

⁹ Confidential interviews.

forced to trade proprietary technology for market access.¹⁰³ Many U.S. firms have turned to their government for help in an effort to gain trade or investment access to Japan's market¹⁰⁴ or have simply given up, frustrated by the high costs of market entry.

Japan as a Special Case

In some cases, U.S. firms may not have made a realistic effort to gain market access in Japan; accordingly, their claims that the Japanese system is unfair maybe inappropriate. On the other hand, charges of Japanese limitations on trade and investment should not be dismissed merely as

¹⁰³ For a discussion of the experiences of these firms in Japan see Encarnation et al., op. cit., footnote 97, pp. 25-54; Mason, Op. cit., footnote 5; and Tyson, op. cit., footnote 8, pp. 53-75.

¹⁰⁴ Peter J. Katzenstein and Yutaka Tsujinaka, "Bullying vs. Buying: U.S.-Japanese Transnational Relations and Domestic Structures," paper delivered at the 1992 Annual Meeting of the American Political Science Association, Chicago, Sept. 3-6, 1992. The U.S. Government has initiated several export-promotion measures such as the 'Japan Corporate Program.' For details, see the American Chamber of Commerce, *The United States-Japan White Paper 1993* (Tokyo: American Chamber of Commerce in Japan, 1993), p. 2.

complaints by U.S. firms that could not learn **to** compete effectively.¹⁰⁵ Firms such as Dow Chemical, Motorola, Ford, and Coca Cola have either failed **to** penetrate the Japanese market or have succeeded only **after exhaustive** efforts; they have **not** had comparable difficulties penetrating other foreign markets. Difficulties gaining access to Japan by world-class competitive firms suggest that impediments in Japan are real.¹⁰⁶

The Trade Expansion Committee of the American Chamber of Commerce in Japan (ACCJ) has identified 34 areas of particular concern for market and investment access, including product and service sector limitations, as well as broader problems relating to distribution, government procurement, investment, and taxation.¹⁰⁷ In a 1993 article, the chairman of the Sony Corp. confirmed the continued discrimination **against** foreign products in Japan: "It is clear," he **wrote**, "**that many foreign products still** have trouble with entry into and distribution in the Japanese market."¹⁰⁸ And even if the cause of failure in many **or most cases is** lack of effort by individual foreign firms, reports of discrimination from groups such as the ACCJ and prominent Japanese business leaders cannot be dismissed.

There is currently a debate in both the United States and Japan over whether the Japanese Government **or** Japan's private **sector is the** primary source for deterrents **to** U.S. FDI. One view says **that the** government provides the major roadblocks, while another says that the major constraints on foreign investment have shifted

during the last decade from the public to the private sector. The latter view contends that Japan's major firms originally acted as aggressive intermediaries between the Japanese Government and U.S. firms, but have **now** taken charge of Japan's "strategic investment policy."¹⁰⁹

During the first three decades of the post-WWII period, the major limitations to U.S. FDI in Japan came from laws initiated and administered by **a** government intent on protecting its domestic market and encouraging inward technology transfer. The period up **to** 1950 has been described by one leading analyst as the "closed door" period, and **that** between 1950 and 1970 as the "screen door" period, when the government carefully faltered foreign investment to maximize technology transfer.¹¹⁰ A classic example of this pattern was the case of IBM. The Ministry of International Trade and Industry (MITI) made the firm's access to Japan conditional on the licensing of IBM patents to Japanese firms and charging them no more than a 5-percent royalty.¹¹¹

Japanese Government officials gave assurances of liberalization as early as 1969. Nevertheless, the Japanese market is still highly resistant to FDI. Many analysts and managers of U. S.-based MNEs argue that official government restrictions have been supplanted by "private sector impediments" emanating from an "interior layer of business practices."¹¹² One report recently suggested that access is still limited by ingrained structural factors that "stem from particular features of the Japanese economic

¹⁰⁵ For such a critical view of American management, see James Abegglen and George Stalk, Jr., *Kaisha, The Japanese Corporation* (New York, NY: Basic Books, 1985).

¹⁰⁶ It ~~should be~~ noted that some critics contend that the Japanese Government attempts to coopt a few leading U.S. firms for strategic political reasons; for example, see "Chipmakers Call For Easing Burden on Japan," *Wall Street Journal*, June 7, 1993, p. A3.

¹⁰⁷ Three are discussed systematically in ACCJ, op. cit., footnote 104, but see, for summary, pp. 2-6.

¹⁰⁸ Akio Morita, "Toward a New World Economic Order," *The Atlantic Monthly*, June 1993, pp. 90 and 96.

¹⁰⁹ Encarnation, op. cit., footnote 56, p. 41.

¹¹⁰ Mason, op. cit., footnote 5, pp. 209-218.

¹¹¹ See Cement by Sahashi Sigeru, former deputy director of MITI's Heavy Industries Bureau, quoted in Johnson, Op. cit., footnote 97, p. 245.

¹¹² Ibid., p. 200.

structure, business organizations, and relations between the Japanese private sector and the government.¹¹³

What factors produce these constraints, and are they amenable to reform? The claim that some are the product of immutable cultural factors and that others stem from an arcane and complex distribution system may have some foundation.¹¹⁴ Yet some analysts suggest that the constraints created by institutional factors and private and public sector policies are indeed amenable to reform.

In contrast to most countries, new FDI in Japan occurs primarily through greenfield establishments and/or joint ventures.¹¹⁵ This unusual pattern may be explained by Japanese attitudes toward mergers and acquisitions. Many companies in Japan are hostile to unsolicited takeovers, and the term takeover bid is often used to describe foreign attempts to acquire Japanese companies. Some analysts argue that the private sector in Japan instituted a system of stable shareholders as part of the liberalization of investment rules by the Japanese Government. According to this view, MITI encouraged companies to exchange shares and thus make acquisition by foreign investors more difficult, a practice that began with GM's attempt to purchase shares of Isuzu in 1969:

MITI finally announced that it would accept up to 35 percent foreign capital participation, on the condition that a substantial portion of the shares be held by stable shareholders. The term was used

to indicate shareholders of Japanese nationality who could be counted on to retain their shares, even if the stock declined in market value and favorable prices were offered by foreign interests ... A feasible means of finding stable shareholders would be for companies in a group or industry to hold each other's shares.¹¹⁶

Since then, companies have sought stable shareholders who are not interested in participating in the management of the company and who must obtain approval from the issuing company before selling their stock. The maximum share holding for financial institutions was reduced to 5 percent in 1987, apparently encouraging the wider distribution of company shares. But, in practice, members of the same keiretsu commonly exchange shares, binding their business relationships together more tightly and correspondingly making foreign acquisition of their respective companies more difficult.

It has been suggested that firms such as Toyota, as well as broader business groups such as Mitsubishi, Mitsui, and Sumitomo, consciously pursued stable shareholding acquisitions designed to achieve the "keiretsu-ization" (keiretsuka) of their firms.¹¹⁷ Keiretsu members and their related companies account for approximately 34 percent of all corporate assets in Japan.¹¹⁸ In practice, hostile takeovers are rare, and foreign takeovers usually occur only after all domestic possibilities have been exhausted.¹¹⁹ This view appears consistent with the details concerning a series of

¹¹³ Office of the United States Trade Representative, op. cit., footnote 6, p. 143. These constraints are systematically outlined in detail in the 2nd SII report, op. cit., footnote 100.

¹¹⁴ These are discussed in *ibid.*, p. 144; Internal Memorandum, Department of the Treasury, *Survey of G-7 Laws and Regulations on Foreign Direct Investment* (Washington DC: Department of the Treasury, Dec. 7, 1988), p. 2; The House Wednesday Group, op. cit., footnote 6, p. 6. See also United Nations Conference on Trade and Development (UNCTAD), Programme on Transnational Corporations, *World Investment Report 1993: Transnational Corporations and Integrated international Production* (New York, NY: United Nations, 1993), pp. 42-43.

¹¹⁵ Robert Z. Lawrence, "Japan's Low Levels of Inward Investment: The Role of Inhibitions on Acquisitions," *Transnational Corporations*, vol. 1, No. 3, December 1992, p. 47.

¹¹⁶ Ballon et al., op. cit., footnote 54, pp. 50-51.

¹¹⁷ Mason, op. cit., footnote 5, pp. 205-206; see also Nakashima Shuzo, *Kabushiki no mochiai to kigyo ho*, p. 46, as cited in Mason, p. 207 no. 16.

¹¹⁸ Ballon et al., op. cit., footnote 54, p. 42.

¹¹⁹ Internal memorandum, Department of the Treasury, Op. cit., footnote 114, p. 2.

acquisitions of Japanese firms by foreign companies in the early 1990s. Many Japanese companies recently acquired by foreign MNEs were generally described as distressed or unprofitable.¹²⁰ The rise in the value of the yen against the dollar in 1993 suggests **that even this limited trend towards foreign purchases may be difficult to sustain.**

Determined foreign investors may turn to greenfield site construction or licensing. But the high cost of land renders the greenfield option available to only a few companies. This may encourage U.S. firms to settle for licensing **agreements**, which save them the costs of manufacturing and market entry.¹²¹ Indeed, despite the liberalization of formal Japanese rules regarding inward FDI, in 1990 the \$1.2 billion earned by U.S. companies from royalties and licensing fees from Japan accounted for 35 percent of worldwide U.S. receipts from unaffiliated foreigners.¹²² This figure of \$1.2 billion was 61 percent of the figure for U.S. FDI in Japan in the same year. This proportion of fees to U.S. FDI has grown over the prior 10 years when liberalization of the rules for FDI in Japan suggests that it should have decreased. With liberalization, U.S. firms would expect to invest more and license less. Moreover, this percentage is out of line with the ratio between U.S. licenses and FDI in other countries, and with the ratio between Japanese licenses and FDI in the United States.¹²³

These figures suggest that the constraints on mergers and acquisitions, which many believe are

caused by keiretsu behavior, push U.S. firms into business arrangements **that effectively limit their market access.** But more importantly, it limits their capacity to compete in Japan. In joint ventures, U.S. firms often take a minority share. As compared to Europe, U.S. shareholders in Japan are more likely to be the minority partner.¹²⁴ At the same time, licensing ensures that Japanese firms gain access to U.S. technology, leading to wide-scale, nonreciprocated technology transfer from the United States to Japan.

As one advocate of this position states,

... the continued dependence on licensing, the heavy reliance on minority-interest ventures and the relatively large investments in majority-owned wholesale trade ventures support the argument that the marketing and distribution of foreign products in Japan is unusually difficult, or that current inflows have been too small to offset the impact of earlier policies.¹²⁵

In contrast to the limited amount of merger and acquisition activity by foreign investors in Japan, such activity among domestic Japanese firms is vibrant and unhindered. Figures provided by Japan's Fair Trade Commission (FTC) for 1990 note that 1,532 mergers and 969 acquisitions occurred.¹²⁶ Another source indicates that of 584 mergers and acquisitions involving Japanese firms in 1992, 387 involved Japanese firms acquiring other Japanese firms, and 165 were

¹²⁰ Jonathan Friedland, "The Urge to Merge," *Far Eastern Economic Review*, Jan. 28, 1993.

¹²¹ Lawrence, op. cit., footnote 115, pp. 47, 51-52, 63.

¹²² Ibid. Lawrence notes that Japanese firms earned only \$185 million in royalties and license fees from United States firms, p. 50.

¹²³ Ibid., pp. 52-53.

¹²⁴ "In 1990, majority-owned companies accounted for about 78 per cent of the FDI assets of United States firms. By contrast, only 34 per cent of the FDI assets in Japan and only 26 per cent of the assets in manufacturing were in majority-owned companies. Indeed, there is a relationship between countries that have generally discriminated against FDI and the share of majority-owned firms in FDI assets. While in developed countries that ratio averaged 76 per cent, the conspicuous outliers are the Republic of Korea (18 per cent), India (14 per cent) and Japan (34 per cent)." *ibid.*, p. 53.

¹²⁵ Lawrence, op. cit., footnote 115, p. 55.

¹²⁶ Japan Fair Trade Commission, *Annual Report to the Committee on Competition Law and Policy, OECD, on Developments in Japan* (Tokyo: January-December 1990), p. 32.

Japanese firms acquiring foreign firms. In only 32 cases did foreign firms acquire Japanese firms.¹²⁷

Evidence suggests that the keiretsu system impedes FDI in Japan as well as the capacity of Japanese affiliates of U.S. firms to trade in Japan.¹²⁸ The Structural Impediments Initiative stressed the inhibiting role of the keiretsu on market access for U.S. investors in Japan. Consistent with this claim, a recent ACCJ report emphasized the exclusionary business relationships that continually hinder the capacity of its members to trade in Japan. The report noted that the keiretsu arrangements "have affected the ability of certain American industries, such as the automotive, flat glass, insurance, and semiconductor industries, to take full advantage of market opportunities in Japan, even when the product is highly competitive."¹²⁹

According to some analysts, a final impediment to FDI instituted by the private sector in Japan is the adoption of articles in company charters that preclude any form of foreign participation in the running of the companies, such as excluding non-Japanese citizens from their boards. Toyota wrote this provision into its charter in the 1960s.¹³⁰

Limitations on new U.S. FDI in Japan are such that during the 1980s the sum of inward FDI in Japan grew primarily through the reinvested earnings of existing firms.¹³¹ The conclusion of

many analyses is that the major impediment to investment is the structure of Japan's private sector. The private sector may also create similar obstacles to trade.

Foreign firms able to establish a presence in Japan often face supply and distribution problems when a few firms control the supply of essential products in Japan. For example, efforts by Toys "R" Us to establish itself in Japan as a low-cost toy retailer have been undermined by a few supplier firms trying to ensure that other retailers are not damaged by the entry of a new competitor.¹³²

The automobile industry provides another example of how the keiretsu system can restrict market access. European auto firms complain about the collusion and exclusivity of the distribution system in Japan.¹³³

Automobile companies in Japan have much greater control of their dealership network than do their counterparts in the United States, through both direct ownership and individually negotiated contracts between the independent dealerships and the automobile manufacturers. In the absence of the active encouragement of the auto company that controls the dealership, penetration of the market through dual dealerships is exceptionally difficult. This makes the creation of an effective dealership network in Japan extremely time-consuming and expensive compared to establishing a network in the United States. For example,

¹²⁷ C. Fred Bergsten and Marcus Noland, *Reconcilable Differences? United States-Japan Economic Conflict* (Washington, DC: Institute for International Economics, 1993), p. 81. The large discrepancy in the total number of mergers and acquisitions between this source and the Japan FTC (cited above) may result from different counting rules. Bergsten and Nolan give the following statistics for 1990: total mergers and acquisitions, 801; Japanese firms acquiring Japanese firms, 341; Japanese firms acquiring foreign firms, 450; foreign firms acquiring Japanese firms, 10.

¹²⁸ See Michael L. Gerlach, *Alliance Capitalism: The Social Organization of Japanese Business* (Berkeley, CA: University of California Press, 1992), pp. 36-37 and 262-268.

¹²⁹ The details of these limits are offered in ACCJ, op. cit., footnote 104, pp. 30-34, 49-50, 64-68, 90-92.

¹³⁰ Mason, op. cit., footnote 5, p. 207.

¹³¹ Lawrence, op. cit., footnote 115, p. 70.

¹³² For details see Mark Mason, "United States Direct Investment in Japan: Trends and Prospects," *California Management Review*, vol. 35, No. 1, fall 1992, p. 108.

¹³³ See "European Auto Industry Proposes 'Joint Sectoral Initiative' With Japan," *International Trade Reporter*, May 19, 1993, pp. 830831. The European Auto Industry also noted the discriminatory effects of unfair taxation, administrative guidance, inadequate protection of intellectual property rights, and the cost of land.

establishing a distribution network in Japan from scratch, with sales outlets equal in number to Mazda or Honda (about 2,500) could be expected to cost more than \$1 billion, assuming acceptable locations were available.¹³⁴ Training the staff of such a large number of outlets would be time-consuming and expensive, further increasing the costs of creating a competitive dealer network.

Some analysts argue that the Japanese Government has liberalized FDI in order to defuse tension with the United States over its trade surplus.¹³⁵ Others contend that, despite the emphasis on capital liberalization, the government pursues policies that effectively constrain FDI. As a 1992 Keidanren report stated:

Japan has considerably more regulations on business than most other countries, and this undoubtedly obstructs the entry of new firms, both domestic and foreign, into the market. Many foreign firms, which are able to enter other markets, face greater difficulties in entering the Japanese market due to such regulations and administrative guidance.¹³⁶

The solution, according to this report, is a shift towards transparency in government administration. U.S. companies in Japan have made similar claims, suggesting that transparency in the decisionmaking process remains inadequate in Japanese agencies that have denied U.S. firms access to information concerning rules and regulations.¹³⁷

This criticism appears consistent with U.S. claims that Japan's Anti-Monopoly Law is administered "with inadequate penalties, less than vigorous enforcement, and numerous exceptions."¹³⁸ Furthermore, the law allows for "exemption cartels" that meet specified legal conditions. These exemption cartels numbered 256 at the end of 1990, and were defined as either "depression cartels" or "rationalization cartels" under The Anti-Monopoly Act.¹³⁹ One ACCJ report contends that monopolistic practices still exist in Japan as a result of selective application of the anticompetitive laws by the Japan FTC.¹⁴⁰ Due to these measures, U.S.-based MNEs investing in Japan are often unable to compete directly with their Japanese counterparts in areas where the Japanese firms are least competitive.

Furthermore, Japanese Government proscriptions of investments that threaten national security or public order, affect existing producers, or disrupt the national economy are vague enough to justify government intervention under many different circumstances.¹⁴¹ The Japanese Government's concern about the effects of disruptive practices may result in a variety of problems for foreign products and firms:

Foreign air transport companies face difficult and time-consuming obstacles to acquiring airport landing rights and brokerage licenses. Medical equipment companies have experienced both slowing of approvals of new medical technology in which the U.S. has a leadership position, and

¹³⁴ This estimate is based on a 10-percent share of Autorama, which cost Ford \$10 million in 1992. Autorama had 328 sales outlets. Honda and Mazda each had approximately 2,500 sales outlets in 1990. Indirect investments by Mazda (currently 25 percent owned by Ford) to support Autorama, in which it currently has a 41 percent stake, probably exceed \$100 million. Source: Ford Motor Co. and Japan Automobile Manufacturers Association, Inc., *Automotive Distribution in Japan* (JAMA: Washington, DC: June 1990) p. 3.

¹³⁵ See, for example, Julius, *op. cit.*, footnote 9, p. 33.

¹³⁶ Keidanren report, *op. cit.*, footnote 6, p. 5.

¹³⁷ Examples of the adverse effects of such problems are evident in the case of construction projects, the setting of regulations for solid wood products use, and the procedures for date labeling of certain food products. ACCJ, *op. cit.*, footnote 104, p. 5.

¹³⁸ Office of United States Trade Representative, *op. cit.*, footnote 6, p. 144.

¹³⁹ For details see Japan Fair Trade Commission, *op. cit.*, footnote 126, pp. 30-31.

¹⁴⁰ ACCJ, *op. cit.*, footnote 104, p. 3.

¹⁴¹ Internal memorandum, Department of the Treasury, *op. cit.*, footnote 114, table, p. 5. For a list see 2nd SII report, *op. cit.*, footnote 100, pp. 1-63.

funding of Japanese products directly competing with U.S. products. Imported food products face rigid barriers such as unrealistic short delivery deadlines and onerous date-labeling requirements, in addition to being required to meet food safety standards different from those used in other countries. Restrictions on premium pricing and sales promotions handicap foreign and new-to-market companies, such as travel and tourism agencies and processed food importers.¹⁴²

The definition of a legitimate basis for government intervention to deny foreign investment is therefore far broader in Japan than in the United States.

According to a recent report of the United States Trade Representative (USTR), government measures that are transparent often remain discriminatory. The USTR reported that the Japanese Government retains the authority to restrict investment in specified sectors, including aircraft, space development, agriculture, fishing and forestry, oil and gas, mining, leather and leather product manufacturing, nuclear power, weapons and ordnance manufacturing, and tobacco.¹⁴³

U.S. firms often raise five additional issues. These are:

1. **intellectual** property and patent rights;
2. Japanese Government and private sector procurement practices;
3. inadequate funding of programs intended to encourage FDI in Japan;
4. the high withholding rate on dividends repatriated to overseas parents;
5. continuing regulation intended to support prices in the property and financial sectors.

The issue of intellectual property rights in Japan is complex, extending both to advanced high-technology sectors such as biotechnology and to more established sectors such as automobiles and textiles. U.S.-based MNEs are concerned that Japanese patent protection rules and the longer duration of patent registration (compared to other nations) has a deleterious effect on the competitiveness of foreign firms.¹⁴⁴ This claim is not new, dating to initial U.S. efforts to re-enter the Japanese market. It has become more acute, however, because of the heightened competitiveness of Japanese firms, the access of Japanese firms to America's best technology, and the importance attached to patent issues at the continuing Uruguay Round of the General Agreement on Tariffs and Trade (GATT). Attempts to address U.S. concerns have not been effective.¹⁴⁵

The procurement issue focuses on the claim that pervasive " 'Buy Japanese' attitudes and practices persist in such sectors as construction and engineering, radio communications (wireless telecommunications equipment), and semiconductors, for which major 'market-opening' or purchasing agreements exist."¹⁴⁶ The same claim has been advanced about U.S. supercomputers. Despite the clear superiority of U.S.-made supercomputers, the Japanese *Government* procured only five machines from U.S. companies in the 1980s, preferring to source an additional 46 machines from Japanese firms. This led to agreements between the United States and Japan over supercomputer procurement in 1987 and 1990.¹⁴⁷

In some cases, specifications for Japanese Government procurement are not made public. But even when they are, critics suggest, they often effectively deny foreign vendors the right to

¹⁴² ACCJ, op. cit., footnote 104.

¹⁴³ Office of The United States Trade Representative, op. cit. footnote 6, p. 161.

¹⁴⁴ Ibid., pp. 18-20. Recent reforms cut the patent examination period from 37 months in 1988 to 30 months in 1991. 2nd SII report, op. cit., footnote 100, p. 50.

¹⁴⁵ This point is made in *ibid.*, especially pp. 49-50.

¹⁴⁶ Ibid., p. 4, For a listing of procurement limitations in Japan, see pp. 13-17.

¹⁴⁷ For a detailed discussion of this issue, see Office of Technology Assessment, op. cit., footnote 1, pp. 273-78.

participate. The U.S. firms remain unable to penetrate the Japanese market despite transparent, nondiscriminatory procurement standards adopted under a 1990 agreement revised in 1992.¹⁴⁸ MITI officials agree that only limited progress has been made and that “there is a need to do more to improve transparency and avoid discrimination in procurement practices.”¹⁴⁹ Progress in reaching an agreement has been made in a number of areas, including software and a variety of chemical treatments.¹⁵⁰

In addition to restrictions authorized under the Foreign Exchange Control Law, Japan sources cite specific restrictive industry laws in sectors such as air and marine transport, communications, and broadcasting. A 1992 Keidanren report indicated that these individual industry regulations “are actually more responsible for restricting foreign investment than the Foreign Exchange Control Law.” Thus “opaque restriction of entry by policies and administrative guidance based on specific industry laws virtually discriminate [against] foreign capital and limit the competition.”¹⁵¹ These laws often complement the industry-, group- or firm-specific private impediments that originated in the 1970s.

U.S. sources support these generalizations with specific examples. An ACCJ report concluded that:

While deregulation has proceeded to some extent in recent years, many archaic and arbitrary regulations and guidelines remain in effect, serving as impediments to trade. Many building codes preclude the use of certain wood products, Radio communications and telecommunication services and equipment continue to be highly regulated

sectors. These regulations keep prices high and delay access for competitive and high-quality American goods and services. . . . Air transport services suffer from regulations which control the prices they charge and the services they offer. In some cases all that is required is simplification and clarification of regulations (cosmetics), or modification of guidelines for existing “liberalizing laws (telecommunications services carriers),¹⁵²

Institutions with programs designed to encourage FDI in Japan, such as the Export-Import Bank of Japan’s Product Import Promotion Financing Program, lack adequate funding and are consequently limited in effectiveness.

The Japanese Government has also established artificially low ceilings for the financing of projects by foreign corporations through the Japan Development Bank.¹⁵³

Tax policies also discourage FDI. The government has sustained an artificially high withholding tax rate of 10 percent on dividends paid from subsidiaries in Japan, in contravention of the 5 percent OECD model convention. Some analysts suggest that this constitutes discrimination; a Keidanren report separately advocates that the Japanese Government lower its rate to 5 percent, consistent with the multilateral tax convention.¹⁵⁴

A recent congressional report argues that pervasive government measures continue to regulate land and financial markets, in effect sustaining extremely high prices despite the bursting of the speculative bubble in Japan.¹⁵⁵ Artificially high land prices discourage the establishment of new facilities and the expansion of existing

¹⁴⁸ For details see 2nd SII report, op. cit., footnote 100.

¹⁴⁹ Ibid., p. 28.

¹⁵⁰ ACCJ, op. cit., footnote 104, pp. 13-17, 71.

¹⁵¹ Keidanren report, op. cit., footnote 6, p. 8.

¹⁵² ACCJ, op. cit., footnote 104, p. 4.

¹⁵³ Ibid., pp. 8-9.

¹⁵⁴ Ibid., p. 10.

¹⁵⁵ House Wednesday Group, op. cit., footnote 6, p. iii.

operations. Inflated financial markets hinder entry and expansion through acquisitions,

The sources cited above appear to disagree on whether impediments to investors originate in the private or public sector. The Japanese Government claims it is trying to impose liberalization on a recalcitrant private sector, while representatives of the private sector suggest the converse is true. Regardless, both seem to impede FDI in Japan. This conclusion stems from the evidence that Japanese public and private sector officials have often resorted to minor concessions to accommodate foreign pressures for change, while avoiding major changes. Amaya Naohiro, a high-level MITI official, suggested as early as 1969 that this was the thrust of MITI policy,¹⁵⁶

In interviews conducted by OTA, both U.S. Government officials and business executives echoed these observations. In view of the history of concerted Japanese barriers to inward FDI, several said that those who believe that Japan is liberalizing its FDI policy should provide evidence in the form of concrete results, for many data indicate that this is not the case. In 1990, Japan's level of inward FDI per capita was much lower than other OECD countries such as Germany and the United Kingdom. The U.S. level in 1990 was more than 20 times that of Japan (see figure 1-8 in chapter 1.) Figure 1-4 shows only moderate growth in the overall FDI position in Japan for 1991 and 1992, especially when compared to the growth in Japan's FDI position abroad for the same years.

Japanese figures demonstrate an asymmetry in the comparable position of foreign firms in the United States and foreign firms in Japan. According to MITI, foreign-owned firms employed 0.5 percent of the work force in Japan in 1991, compared to 3.8 percent in the United States. Products of foreign companies came to 1.2 percent of total sales in Japan, compared to 16.5 percent in the United States. Moreover, foreign affiliates controlled only 0.9 percent of total assets in Japan, compared to 20.4 percent in the United States (see figure 1-1 in chapter 1).¹⁵⁷ By the end of the 1980s, U.S. FDI in Japan totaled nearly \$20 billion, doubling between 1985 and 1989, and accounting for 9 percent of all U.S. Direct Investment Abroad (USDIA), although that figure remained well behind the leading recipients, Canada (18 percent) and the Britain (16 percent).¹⁵⁸ In 1992, Japanese direct investment abroad reached approximately \$250 billion, more than 10 times the amount of FDI in Japan (see figure 1-4 in chapter 1).

The United States and Japan share what many have described as the most important bilateral relationship in the world, a relationship that is critical to the growth of global free trade. At the same time, Japan's export surpluses are a leading cause of the U.S. trade deficit. These two factors help to explain why so many analysts and policymakers focus on policy asymmetries between the United States and Japan and on the structural conditions that shape Japan's private sector.¹⁵⁹

¹⁵⁶ As cited in Mason, op. cit., footnote 5, p. 201.

¹⁵⁷ From *Gaishi-Kei Kigyō Kōdō Chōsa, Hōjin Kigyō Tōkei, MITI 1991*, as cited in House Wednesday Group, Op. Cit., footnote 6, p. 4; Lawrence, op. cit., footnote 115, p. 48, suggests that all FDI in Japan totals 1 percent.

¹⁵⁸ Encarnation, op. cit., footnote 56, pp. 95-96.

¹⁵⁹ House Wednesday Group, op. cit., footnote 6, p. 26.