PROFESSOR KOJIMA ON THE MACROECONOMICS OF FOREIGN DIRECT INVESTMENT

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Professor Kojima has an enviable capacity for applying theory to topical policy issues in an imaginative and challenging way.

In his recent article on "A Macroeconomic Approach to Foreign Direct Investment" he picks up a suggestion by Professor Harry Johnson that in tackling the major question posed to theory by direct foreign investment—the reasons why the transmission of a package of capital and knowledge is more profitable than the export of each separately—it is necessary to combine two approaches, the microeconomic approach of the theory of industrial organisation and the macroeconomic approach of traditional trade theory. The article does not actually address itself to Professor Johnson's major question. Instead, Professor Kojima reinterprets Johnson's methodological distinction between a microeconomic and a macroeconomic approach in terms of a Pigovian divergence between the private interests of foreign investors and the public interest, whether of the world as a whole or of the host (and sometimes also the home) countries. The chief welfare criterion is "international trade growth". Most of the article, therefore, consists of a classification of various types of direct foreign investment as "trade-oriented" or "anti-trade-oriented", an analysis which leads him to identify the former as being a characteristic feature of Japanese foreign investment, the latter of U.S. foreign investment. In the concluding section he proposes "a new role for and form of foreign direct investment" in which "agreed international specialization in the innovation activities" is the most novel proposal.

The purpose of this comment is to raise some questions about Professor Kojima's welfare criterion, his classification of types of foreign investment as trade or anti-trade oriented, his identification of these two categories with Japanese and U.S. foreign investment, and his proposal for agreed international specialisation in innovation.

I

There is no need to labour the first point. Professor Kojima would undoubtedly agree that "international trade growth," while certainly desirable, ceteris paribus, because it promotes a more efficient use of the world's economic resources, is not by itself a sufficient welfare criterion for the evaluation of various kinds of foreign direct investment. From the viewpoint of any one country, the distribution of the direct gains from both investment and trade is relevant. And there are the favourable and unfavourable externalities of foreign

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direct investment, such as the "wider spillover effects for genuine national-economic development" (p. 17) in less developed host countries to which Professor Kojima himself refers in the last part of his article. Obviously, some kinds of foreign investment which win high marks as being "trade oriented" may rank lower by the other criteria, and vice versa. The point is worth making only because through most of the article Professor Kojima concentrates so exclusively on the trade orientation criterion that some readers may come away with a false impression.

II

Professor Kojima distinguishes four main types of foreign direct investment: natural resource oriented, labour oriented, trade-barrier-induced market oriented, and oligopolistic market oriented. He regards the first two as clearly trade-oriented, the third as potentially trade-oriented (if import substitution grows successfully towards export orientation) but the fourth as anti-trade-oriented. One cannot help but feel that this is a very considerable oversimplification and particularly misleading if, with all the emphasis on the trade criterion, the other welfare criteria are given little attention.

We may agree with Professor Kojima that "natural resource-oriented investment is obviously trade-oriented" if it "results from the investing country's desire to increase imports of its comparatively disadvantageously produced or domestically unavailable commodities" (p. 2). But it may be no less trade-oriented if, like most 19th century investment in natural resource development, it aims at production for competitive world commodity markets, rather than exclusively to meet the needs of the investing country. As Professor Kojima points out, integrated marketing, like integrated production, may leave "smaller benefits to those countries endowed with natural resources" (p. 2). Most natural resource oriented foreign direct investment, moreover, tends to have minimal favourable spillover effects because of its enclave character.

As Professor Kojima himself mentions (p. 3), the distinction between "labour oriented" and "trade barrier induced market oriented" foreign direct investment has no very logical basis. Foreign direct investment in less developed countries designed to take advantage of cheap labour tends from the start to be export-oriented in small economies such as Hong Kong or Singapore but home market oriented (import-replacing) in large countries such as India or Indonesia. In the latter case, if the cost advantage of cheap labour is initially outweighed by cost disadvantages in conditions of underdevelopment, the new industries may need infant industry protection: in other words, foreign direct investment, although "labour oriented", will also be "trade barrier induced market oriented".

The case of such tariff-protected import-replacing cheap-labour industries points up the ambiguity of Professor Kojima's term "trade oriented". Insofar as the low cost of labour outweighs all other influences on comparative costs, as Heckscher-Ohlin reasoning would suggest, investment in such industries may be said to be in accord with "the structure of comparative advantage" (p. 7). But while it remains in the import-replacing phase, it will tend to reduce trade, even though declining trade in finished products may be partially offset by increasing trade in components, parts or equipment. (Clearly, foreign direct investment cannot be classified as "trade oriented" merely because, as Professor Kojima seems to imply at one point, it enables firms in the investing country to "increase exports,
How much benefit "labour oriented" foreign direct investment confers on the host country depends on its direct and indirect (spillover) developmental effects. The effects may be thought very favourable, even if such investment is for some time "anti-trade-oriented", provided it contributes substantially not only to employment but also to developing local entrepreneurship, managerial and technical skills and through backward and forward linkages generates other important external economies. Conversely, "labour oriented" foreign direct investment may be of very little benefit to the host country if, as in the case of the bond-processing "offshore" type, its developmental effects are virtually confined to employment (and perhaps training) of labour, much like those of the former Swiss policy of temporary importation of cheap labour from developing countries.

The fourth type, "oligopolistic market oriented" foreign direct investment, is defined by Professor Kojima in terms of Vernon's product-cycle theory. A new product is invented and manufactured on a large scale in a leading industrial country. "Exports of this product grow in so far as a 'technological gap' exists between the product-developing country and foreign countries. Foreign producers imitate the new technology and follow suit. Then exports slow down and through direct investment an attempt is made to secure foreign markets. When the technology is standardized and widely disseminated and the limit of scale economies is reached, trade based on wage costs, or factor proportions, starts and the [investing] country turns to import this product from abroad" (p. 6). So far, this description does not suggest that, in its effects on trade, the product-cycle type differs from any other foreign direct investment which is designed to defend export markets. During the import-substitution phase it tends to reduce trade, while in the subsequent export-oriented phase it tends to increase trade. Why then does Professor Kojima characterise this type as "anti-trade-oriented"?

His main answer is that it works "against the structure of comparative advantage. Those new industries should strengthen exports of their products if they were conscious of national economic interests, but actually they set up foreign subsidiaries, cutting off their own comparative advantage and inducing increased imports of those products from abroad where they invest" (p. 7). This is contrasted with "direct investment for creating manufacturing capacity in developing countries [which] plays a harmonious role for both sides" because the industries chosen, such as textiles and other labour-intensive consumer goods industries, are those in which the investing industrial country "is losing comparative advantage while developing countries are gaining it" (p. 4).

Thus, when Professor Kojima describes the product cycle type of foreign investment, in contrast to the cheap labour type, as being "against the structure of comparative advantage", he seems to have three points in mind: first, the product cycle type cuts off the investing country's own comparative advantage; secondly, instead of transferring whole industries from the investing to the host countries, it leaves a tail of high-cost industries in the investing country which then require protection from foreign competition; and thirdly, the new industries which it establishes in the host countries are unsuited to their factor proportions and therefore unlikely either to become internationally competitive or to have favourable spillover effects. None of these propositions seems to be of general validity.

(a) It is of course true that when motor vehicle, electronics or pharmaceutical manufacturers in leading industrial countries establish subsidiaries abroad they contribute
to the elimination of the technology gap on which their previous comparative advantage rested. But a comparative advantage based on a technology gap in a particular product or process is, in the nature of the case, temporary, inevitably undermined sooner or later by foreign imitators or rivals. Scope for trade continues provided technological advance reopens the gap in new industries as fast as it is closed through international transmission in old ones. As Professor Kojima himself says, "it is true that new products are successively created and new product cycles take place one after the other" (p. 13). His answer to this objection is not fully spelled out. He merely asserts that "the creation of new products becomes smaller whilst the spread of new technology is fast and is accelerated by the foreign direct investment. Thus, the [investing country's] economy will lose its comparative advantage in new products...sooner or later" (p. 13).

In any case, the process by which international transmission of technology, whether through foreign direct investment or through imitation by local investors in foreign countries, undermines the initial comparative advantage of the leading industrial country is not peculiar to the "oligopolistic" product-cycle case. It was the same process that led to the United Kingdom losing its earlier comparative advantage in cotton textile and other light consumer goods production first to Western European countries and the U.S.A. and later to India, Japan and other low-wage countries. The case which Professor Kojima has in mind, where the loss of comparative advantage is due primarily to rising productivity and real wages in the exporting country is so far unique to Japan, though Hong Kong, Singapore and other countries may before long enter the same stage of development.

(b) Professor Kojima argues that, in contrast to labour oriented foreign investment, the product-cycle type, by causing loss of export markets and later reverse imports, generates employment problems for the investing country, and consequent protectionist barriers to exports of manufactures by less developed countries: "Both the loss of foreign markets and reverse imports later on result in balance of payments difficulties and the 'export of job opportunities... Where are laborers to be employed? They should be employed in the new industry sector. However in actuality the new industry sector does not offer many job opportunities, rather the reverse, because of foreign direct investment. Therefore, the labor force has to be absorbed in traditional, comparatively disadvantaged industries and the service sector, requiring strong protection" (pp. 7, 13).

Even for the United States, which Professor Kojima obviously has here in mind, it is hard to swallow the notion that domestic unemployment is due to export of jobs through foreign investment of the product-cycle type and that such foreign investment therefore also bears the blame for policies of protection of high-cost textile and other older industries. The fact that these consequences have not resulted from product-cycle foreign investment by other leading industrial countries, such as Sweden or Switzerland, while protection of domestic labour-intensive industries from low-wage competition is practised by many countries, such as Australia, which hardly yet invest abroad, still further detracts from the plausibility of the general proposition.

Professor Kojima claims that Japanese foreign investment in Asian manufacturing industries will avoid the need to protect a tail of high-cost domestic producers from competition by low-wage industrialising countries because it brings about a "step-by-step transfer of manufacturing industries from advanced to developing countries... A textile industry which is losing comparative advantage in Japan moves away from Japan through
increased direct investment in developing countries” (p. 5). If Japan in fact succeeds in phasing out its domestic labour-intensive industries entirely, thus dispensing with any protectionist policies for them—and this remains to be seen—she will owe this success partly to a very high rate of domestic economic growth which facilitates structural adjustment (though such adjustment, it should be added, is also being actively promoted by sound government policies) and partly to the fact that the export markets which much of her foreign investment is designed to protect have been markets for the very labour-intensive consumer goods which the industrialising countries are beginning to produce. Neither of these conditions applies to the older and more advanced industrial countries.

(c) Thirdly, Professor Kojima regards the product cycle type of foreign investment as contrary to the structure of comparative advantage because the industries which it establishes in the host countries tend to be unsuitable to their factor proportions. Clearly, it is necessary here to distinguish between product and process. It may be unfortunate that there should be a demand in many poor less developed countries for the luxury consumer goods produced by modern technology—motor cars, transistor radios, Coca-Cola. But if there is such a demand, it is not much good proclaiming that “such industries should preferably be export-oriented, not merely serving the benefit of the economically privileged classes in recipient countries” (p. 4). One may deprecate the existing distribution of income in the host countries, the demonstration effect of affluence on their consumer tastes and the penchant of their governments for policies favouring local production or assembly. But given all these, it is hard to see how foreign investment in such industries can be said to be contrary to the structure of comparative advantage. It is true, of course, as has often been pointed out, that investment in such capital and technology intensive industries tends to have few favourable spillover effects on employment and development in less developed countries. This makes it desirable to encourage, wherever possible, the development and use of more labour-intensive processes to produce the same products and even perhaps to discourage demand for the products. But scope for either kind of intervention is usually limited.

The root of this problem is the width of the disparity in technology and factor prices between the most and the least developed countries. The problem is negligible in product cycle foreign investment among the most developed industrial countries or even in countries in an intermediate stage of industrial development, such as the USSR or Australia. No one has yet suggested that the Pepsi-Cola and Fiat projects are unsuited to the factor proportions of the USSR, nor that the establishment of General Motors Holden which has become a significant exporter was contrary to Australia's pattern of comparative advantage. But by the same token, the problem is likely to be less for investment in less developed countries by one in an intermediate stage of industrial development, such as

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2 Ironically, Professor Kojima almost goes out of his way to reject, or at least to suspend judgment on, what might well be thought to be the one strong argument for expecting the product-cycle type of foreign direct investment to be “anti-trade-oriented”. This is the inhibiting effect on exports by manufacturing subsidiaries of multinational corporations which may be exercised, through restrictions on export franchises and in other ways, in the interest of integrated marketing. Professor Kojima refers to the “internationalization of production and marketing through vertical and horizontal integration of big multinational enterprises” as “a fifth type of foreign direct investment” (p. 3). But, he adds somewhat mysteriously, “whether this is anti-trade-oriented or not depends upon whether the main activity comprises oligopolistic investment or not” (p. 3). In any event, Professor Kojima’s concern about “reverse imports” would suggest that he does not regard restrictions on exports by subsidiaries as a major problem.
Japan. We shall return to this point in the next section.

Professor Kojima has much to say about the "oligopolistic" nature of the product-cycle type of foreign direct investment and quotes extensively—and seemingly with full approval—Stephen Hymer's apocalyptic views on the manifold evils of such investment in the hands of multinational corporations (p. 15). But none of this seems to throw any further light on the effects of different types of foreign investment on trade, and as an evaluation of other welfare effects of such investment it is, to say the least, debatable.

III

Right at the outset of his article, Professor Kojima refers to "two different types of foreign direct investment: trade oriented (the Japanese type) and anti-trade-oriented (the American type)" (p. 1). He would, of course, not wish this sweeping dichotomy to be interpreted as implying that all Japanese investment is of the one kind, and all American investment of the other. But even in the weaker sense that Japanese investment tends to be "trade-oriented" and most American "anti-trade-oriented", this generalisation smells too much of the "Goodies" and "Baddies" of old-fashioned Westerns, especially when it is put forward as the main explanation for the fact that "there are many accusations against anti-trade-oriented or American type investment but few in principle against the trade-oriented or Japanese type investment" (p. 16). What is the evidence?

There is no reason to suppose, and Professor Kojima does not claim, that there is any great difference in the degree of "trade-orientation" between American and Japanese "natural resource oriented" foreign direct investment. This in itself constitutes a significant qualification of Professor Kojima's dichotomy. For such resource oriented investment accounts for about one-third of the total for both countries, and only slightly more for Japan (33 per cent) than for the United States (28 per cent). If there is a major qualitative difference between Japanese and American "resource-oriented" investment, it is probably that the former is even more single-mindedly directed at meeting the raw material needs of the investing country. This has the advantage to the host country of providing an assured market for the mineral or other products, but also exposes them to some risks as "captive supply bases", to use Professor Tsurumi's expressive phrase.

As regards foreign direct investment in manufacturing, there is general agreement that most of it is designed to defend export markets, and this applies equally to Japanese and American investment. A recent survey of Japanese investment in Southeast Asia found that the motive of "securing, maintaining and developing overseas markets has been the dominant motive, accounting for 56 per cent of the projects and 75 per cent of

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2 By a curious myopia, those who lay most stress on the distorting effects of oligopolistic behaviour on international trade seem invariably to neglect what is surely by far the most important example of such behaviour, the commercial and other external economic policies of nation states.

4 The former figure is that given by Professor Kojima in his Appendix Table for 1970 and refers to "agriculture-forestry, fisheries and mining"; the latter figure is taken from U.S. Department of Commerce estimates (quoted in T.W. Allen, Direct Investment of United States Enterprises in Southeast Asia, Study No. 02, Economic Cooperation Center for the Asian and Pacific Region, Bangkok, March 1973, p. 4) and refers to "mining and smelting, petroleum" only, excluding investment in agriculture, forestry and fisheries.

6 Yoshi Tsurumi, "Japanese Direct Investments in Indonesia: Baby Elephant or Mouse?" (mimeographed), May 1973, p. 7.

6 Tsurumi, op. cit., p. 9; Allen, op. cit.; Yoshino, op. cit., p. 11.
A similar survey of U.S. investment in Southeast Asia found the local-market motive accounting for 40 per cent of all (manufacturing and other) projects. In both surveys, the Heckscher-Ohlin "cheap labour" motive ranked second, accounting for 32 per cent of U.S. projects and 18 per cent of Japanese manufacturing projects.

The similarity of motive, of course, is deceptive. Since American manufacturing exports have been very different from Japanese, so have foreign direct investment projects designed to protect established or potential export markets. The difference, in fact, illustrates the importance of the width of the technology gap between home and host countries which we noted in the preceding section. American manufacturing exports have for long depended on comparative advantage in the most technology-intensive industries, while Japanese manufacturing exports have until recently consisted predominantly of products of relatively labour-intensive consumer goods industries. This gives Japanese foreign direct investment two important potential advantages over American in less developed countries: greater ease of transmission of technology and business know-how and greater likelihood that the new industries will be internationally competitive. As has often been pointed out, the technological gap between subsidiaries of U.S. manufacturing corporations, with their emphasis on advanced technology and accompanying large scale and capital intensity, on the one side, and domestic enterprise in less developed countries, on the other, is so wide as to constitute a major obstacle to transmission of technical and business know-how and to make such know-how as is transmitted often detrimental rather than conducive to economic development. This is not true to anything like the same extent for Japanese foreign investment in manufacturing in its present phase. As Professor Kojima points out, "the Japanese textile industry has a long experience of excellent management and technology which is more suitable to developing countries than that of America or Europe" (p. 5). Similarly, Japanese manufacturing subsidiaries or joint ventures in less developed countries tend, for the same reason, to be in relatively labour-intensive industries and/or to use rather more labour-intensive techniques and should therefore find it easier to develop export markets.

These two points constitute the substance of Professor Kojima's case. It is a valid case and worth making, but it needs to be qualified in several respects.

In the first place, since the advantages of Japanese direct investment derive from the fact that the Japanese economy is only just emerging from the stage of industrial development which the host countries are about to enter, it is unlikely that the same advantages would accrue—either to the investing or the host countries—if more highly developed industrial countries tried to compete with Japan in the same fields of direct investment. It is difficult to agree with Professor Kojima's judgment that "it would be better if even the USA invested abroad in traditional manufacturing industries, such as textiles . . ." (p. 14).

Secondly, Japan's potential advantage in that, on account of the narrower technology gap, foreign direct investment by her manufacturing industries can be more beneficial to

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1 Allen, op. cit. (Japan), p. 12.
3 Ibid.
4 Here again, the problem hardly presents itself for product-cycle investment among highly industrialised countries or even in a country like Australia; cf. D. Brash, American Investment in Australian Industry, A.N.U. Press, Canberra, 1966.
the host countries, both through greater export-orientation and through more favourable spillover effects, and should therefore be more welcome, is not always realised.

In small countries, such as Korea and Taiwan, where Japanese manufacturing investment is export-oriented, it is almost entirely dependent on the single Japanese export market and much of it consists of bond-processing offshore production which, in its nature, has few beneficial spillover effects. In larger countries like Indonesia, it is at present still geared almost entirely to the local market, and despite much earnest endeavour on the part of Japanese business and government is not as universally welcome as its economic advantages would lead one to expect. There is a good deal of evidence to suggest that Japan's advantage through a narrower technology gap is largely outweighed in the less developed countries of Southeast Asia by a wide cultural gap.

As one recent observer has put it, "although Japanese investment is small in relative terms, it has already come under severe attack in a number of countries, particularly in Southeast Asia". In the most general terms, he sees the problem for Japanese firms as one of adapting "their highly culturally bound management practices . . . The very fact that the Japanese system has been evolved in a highly insulated environment and derives its strength mainly from culturally induced values, poses a difficult challenge for Japanese management in the operation of a large multinational enterprise". More specifically, he lists "several noteworthy features of Japanese investment which create special sources of tension". Among them are the predominance of Japanese firms in some countries, such as Thailand, where they are said to preempt opportunities that would otherwise be open to local entrepreneurs; a Japanese tendency to keep local production to a minimum in order to maximise export from the parent company to the foreign subsidiary; doubts about transfer pricing practices; and finally, and most elusively, the enclave character of Japanese business communities in the major host country cities: "These enclaves are characteristically closed, exclusive, and almost impregnable . . . Japanese businessmen overseas are often accused of using the Japan Airlines, staying at Japanese hotels, eating at Japanese restaurants, and doing business exclusively with their fellow Japanese." Professor Kojima specifically concedes that "there are complaints about the performance and behaviour of Japanese firms abroad", but claims that, in contrast to the "many accusations against anti-trade-oriented or American type investment" there are "few in principle against the trade-oriented or Japanese type investment" (p. 16). This may be drawing a sharper line than the facts justify.

Thirdly, Japan's economy is growing and changing so rapidly that her own foreign investment is already in part of the product-cycle type and is likely to resemble the U.S. type increasingly in the years to come. As the same observer points out, "some of the leading Japanese corporations have begun to explore the feasibility of becoming multinational

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12 M.Y. Yoshino, "Japanese Foreign Direct Investment" (mimeographed), Harvard University, November 1972, p. 24.
13 Yoshino, pp. 25f.
enterprises, like their major international competitors. There is a growing recognition among the leading Japanese firms that development into multinational enterprises is likely to represent a major thrust for corporate growth in the coming decade.\footnote{Yoshino, \textit{op. cit.}, p. 22.} Stephen Hymer in one of the passages quoted by Professor Kojima speaks of the challenge of Japanese as well as European firms to American corporations, first in competition, then in “collusion as dominant firms of the center present a united front” to the third world (p. 15). One need not follow the flights of Hymer's imagination to realise that the special features of Japanese foreign direct investment which Professor Kojima stresses may themselves be a passing phase, as the home base of Japanese manufacturing shifts rapidly towards advanced technology-intensive industry.

IV

Professor Kojima has become so persuaded of the evils of “American type foreign direct investment” that he wants to do away with it altogether. “It might be desirable for advanced countries to arrange an agreement to specialize in the line of innovation in which each country concentrates its effort… If all advanced countries liberalize imports of new goods and exporting countries make serious efforts at exporting, mutual trade in these goods among advanced countries will certainly expand and there is no need to undertake foreign direct investment. If firms still dare to undertake direct investment, it is because monopolistic profits are anticipated and they should not be allowed. Such agreed international specialization in the innovative activities may be the only solution for avoiding the vicious circle resulting from American type foreign direct investment” (p. 19, italics supplied).

Perhaps what Professor Kojima has in mind is something like the agreed specialization in innovation that seems to have occurred in recent years between NASA in moon exploration by manned spacecraft and its Soviet counterpart in space exploration by unmanned craft. Whether or not specialization in this case was due to (at least tacit) agreement or merely to Soviet inability to compete at this stage in the NASA speciality, the example suggests some of the questions liable to be encountered by Professor Kojima's proposal.

Specialisation in innovation in space exploration has occurred not merely in relation to discovery of new knowledge but also in its development. Although each side has, as far as we know, kept its new knowledge secret from the other, the new technology might just as well have been made available as a public good to the rest of the world since no other enterprise besides the two has commanded the capital, managerial know-how and marketing outlets (to consumer governments) needed to make use of the new knowledge. In the areas of technology which are the subject of product-cycle foreign direct investment, such as new model motor cars or computers or pharmaceutical products, the situation is very different. If agreed specialization in innovation were confined to the production of new knowledge by research and this knowledge were made a public good, the flow of new knowledge might dry up since it is difficult to see how Professor Kojima's proviso that “there is enough incentive for innovation” (p. 17) could be met, but otherwise scope for
product-cycle foreign direct investment would continue virtually unchanged; for the same multinational corporations as at present would command the resources needed for development—capital, managerial know-how and marketing contacts. If, on the other hand, agreed specialisation were extended beyond discovery to development of new products or processes, the result would be complete monopolisation of each new product or process by one country. Even the present oligopolistic rivalry among multinational giants in particular industries which yields some at least of the benefits of competition would be eliminated. Agreement to share out the market for innovations even among a handful of the major countries would be no easy matter, and it would leave all others, developed or developing, out in the cold.