



Is the U.S. Ready for FDI from China? Lessons from Japan's Experience in the 1980s

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Investing in the United States
A Reference Series for Chinese Investors
Volume 1

Audit • Tax • Consulting • Financial Advisory.



Investing in the U.S.: A Reference Series for Chinese Investors

Foreword

One of the world's most important bilateral relationships is that between China and the United States. An increasingly visible component of that relationship concerns foreign direct investment (FDI).

United States firms have invested in China for years — almost US\$60 billion since China opened to the world in 1978. They have been welcomed and play an important role in many sectors of that country's economy.

All indications are that a growing number of Chinese firms are interested in investing in the United States, and are prepared to allocate considerable resources for that purpose. Naturally, like all firms, they need to observe the regulatory framework of the United States, both when establishing themselves in that country and operating in it. They also need to become accepted insiders that contribute to their host country's economy and society. This raises an important question, however, namely: "Is the United States ready to receive foreign direct investment from China, including in the form of cross-border M&A?"

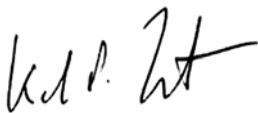
This booklet is part of a series entitled "Investing in the United States: A Reference for Chinese Investors." It is the result of a joint research project undertaken by the U.S. Chinese Services Group of Deloitte LLP and the Vale Columbia Center on Sustainable International Investment (VCCI) of Columbia University. This series explores key topics associated with the receptivity of the United States business environment to future Chinese direct investment.

Booklets currently planned for this series include:

- *Is the U.S. Ready for FDI from China? Lessons from Japan's Experience in the 1980s*
by Curtis J. Milhaupt
- *The U.S. Regulatory and Institutional Framework for FDI*
by David N. Fagan
- *International Investment Law Protections*
by Mark Kantor
- *The Politics of Chinese Investment in the U.S.*
by Timothy Frye and Pablo M. Pinto

Anyone interested in Chinese direct investment in the United States — and, for that matter, investment by firms from other emerging market economies — will hopefully find these booklets useful, be it from a business, policy or academic perspective.

New York, November 2008



Karl P. Sauvant

Executive Director
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Is the U.S. Ready for FDI from China?: Lessons from the Japanese Experience in the 1980s

Preface

As China's leading companies continue to venture abroad, more are coming to recognize that a successful global company must compete effectively in the U.S. The U.S. has some of the world's largest and most sophisticated markets, served by well-established brands distributed through complex, ever-evolving channels. This is a market that will only grant acceptance to those who are fully prepared to take on the challenges.

This booklet, the first in a reference series for Chinese executives with global aspirations, traces the path of Japanese investment in the U.S. since the 1980s. The relevance of this story to this new generation of Asian investors is two-fold. First, understanding the Japanese experience helps Chinese executives shorten the learning curve, especially in terms of managing stakeholder relationships and becoming a good corporate citizen in the U.S. Second, Chinese executives can gain insight into how their investment decisions are likely to be perceived in the U.S. — by officials, media and the public-at-large. Many Americans will benchmark Chinese investors against their extensive experience with the Japanese investors. If anything, this booklet points out that Chinese executives will need to work harder to achieve acceptance in the U.S., given Japan's stronger institutional ties to the U.S. during the 1980s and 1990s as a fellow democracy and Cold War ally.

Our key message to Chinese executives is therefore this — get started now, whether by developing human capital, mobilizing financing or building relationships with U.S. officials and executives, even if the timing of U.S. market entry is still uncertain.

As Chinese investors ascend their investment learning curve in the U.S., U.S. executives might also take this opportunity to reflect on the lessons they have learned from competing with Japanese companies and begin preparing themselves for the next wave of inbound investment from Asia.

New York, November 2008



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Is the U.S. Ready for FDI from China?

Lessons from Japan's Experience in the 1980s

by Curtis J. Milhaupt

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Executive summary

The U.S. environment for inbound FDI from China today exhibits striking parallels with the environment for Japanese FDI in the 1980s. The motivations for Chinese FDI — building on extensive export activity by reaping advantages from location and ownership in the U.S., as well as by internalizing processes that are currently external to Chinese firms targeting U.S. markets — are also likely to parallel those of Japanese firms during the boom in FDI from Japan in the 1980s. While the Japanese experience in the U.S. was initially rocky, many Japanese firms learned to adapt and thrive, particularly at the local level. Much can be learned from these parallels, particularly the sources of friction that Chinese firms are likely to encounter in Washington, and the means of dealing with these frictions both nationally and locally.

Foremost among these lessons is the need to distinguish between the FDI environment at the federal and state level. While the federal political and regulatory climate may be problematic for Chinese firms, state and local governments and communities are likely to be much more receptive to Chinese investment, particularly of the greenfield variety. Chinese firms will need to integrate fully into the community by forming dense networks of interaction with local suppliers, businesspeople and politicians, and by being “good citizens” in the realms of employment practices, philanthropy and community involvement. At the national level, Chinese firms probably can anticipate substantial wariness toward Chinese FDI by Congress and federal agencies. There is no magic formula for escaping political skepticism and even hostility at the national level. The Japanese case suggests that avoiding high profile acquisitions and overt lobbying efforts by individual Chinese firms (as opposed to working with organizations representing foreign investors generally) is a sound strategy for mitigating friction. On the bright side, the Japanese experience confirms that attention spans in Washington and in the media are relatively short. Eventually, concern about the new foreign investor entering the FDI market dims, scrutiny passes to the next hot topic, and foreign affiliates are left to go about their business as good corporate citizens in the United States. In the late 2000s, Japan remains a major source of U.S. FDI, Japanese affiliates employ 600,000 American workers, and the bilateral investment climate is continuously examined by a thick network of governmental and private-sector actors. Thus, Japan's long-term experience of investing in the U.S. provides a positive example for Chinese investors.

Introduction

Twenty years before China became a rising star in the global economy and a major potential source of outward foreign direct investment (FDI), another East Asian country — Japan — occupied this role. Japan's FDI flow into the United States skyrocketed from less than \$1 billion annually in the early 1980s to a peak of over \$18 billion in 1990 alone. As a percentage of total stock, Japanese FDI in the U.S. went from 6.2% in 1980 to 20.7% in 1990 (Kang 1997, p. 319, tbl 5).



This boom in Japanese FDI took place in an unsettled environment. Reactions in the United States were colored by trade friction,



exchange rate controversy, cultural misperceptions, politically charged debates about the unique (and for many U.S. observers, “unfair”) underpinnings of Japanese capitalism, and the “threat” posed to U.S. interests by Japan's economic ascendance.

At least as of 2008, any influx of Chinese FDI into the United States will take place against a backdrop that bears a striking resemblance to the situation two decades ago.

This booklet examines the Japanese experience of U.S.-directed FDI, principally in the 1980s, seeking to draw lessons for China. As detailed below, the booklet focuses principally on the 1980s because this decade marked the high water point of Japanese FDI in the U.S. and concomitant political and media debate about Japanese investment. Controversy over Japanese FDI died down significantly beginning in the early 1990s, as Japan's own economic problems caused a contraction in the overseas operations of Japanese firms.¹ Thus, some of the most salient lessons for Chinese executives are to be found in the hothouse environment of the 1980s. The booklet asks whether the parallels are sufficiently close that the Japanese experience can serve as a roadmap for understanding the patterns and likely pitfalls in Chinese FDI in the future. If yes, we then consider what lessons Chinese actors at the firm and governmental levels might learn from Japan's experience.

To state the conclusions very briefly at the outset, despite some important differences principally stemming from China's political orientation and geo-strategic position vis-à-vis the United States, the background parallels between the two cases are striking. Moreover, an examination of Japan's experience in light of FDI

¹ The quelling of controversy may also be attributed in part to learning effects by Japanese firms operating in the United States and “conditioning” of the U.S. public to foreign investment from Japan — we will examine these possibilities below.

theory indicates that the experience was not unique, despite major differences in U.S.-Japanese organizational structures, regulatory policies and culture. Japanese firms did not re-write the rules of FDI; to the contrary, they closely followed the trajectory and patterns suggested by standard FDI theories. This suggests a high degree of “fit” in the Japan analogy. If this is accurate, Chinese FDI is likely to be motivated by factors similar to, and produce a range of frictions closely resembling, those experienced by Japanese firms two decades ago. Today, Japan remains a major source of U.S.-directed FDI, and Japanese affiliates are a significant source of employment for U.S. workers. As detailed at the end of the booklet, the Japanese example provides some guidance on how Chinese firms might navigate the frictions they will inevitably face, and ultimately integrate into the local business communities in the United States.

The booklet is structured as follows: Part A briefly surveys several leading theories on the motivations for FDI, and shows that Japan's experience closely tracked the predictions of those theories. Part B provides a sketch of key phases in Japanese FDI into the United States, followed by an analysis of the underlying causes of controversy these investments engendered. Part C examines the response of Japanese firms and governmental actors to the frictions arising from U.S.-directed FDI. Part D describes the current status of Japanese FDI into the United States. Part E draws lessons for China.

A. Literature review and orientation of the analysis

In the early stages of Japanese FDI, some commentators speculated that it would follow a unique pattern due to Japan's cultural distance from the U.S., as well as the perceived uniqueness of business structures and governmental linkages of Japanese firms. In particular, commentators pointed to the fact that Japanese firms tended to use affiliated trading companies (*sogo shosha*) as their agents in foreign markets, which was thought to lend a distinctive character to Japanese FDI (Vernon 1993, p. 70; Kojima 1978, pp. 85–87; Yoshida 1983, pp. 15–18). Moreover, some predicted that the mode of entry into the host country (greenfield investment versus acquisition) would be influenced by the lack of acquisition activity in Japan's home market.

By the early 1990s, however, it was evident that Japan's experience in the U.S. was readily explainable by existing FDI theories (though its experience played a role in extending existing theories). As Vernon (1993, p. 70) noted, by this time “the patterns of foreign direct investment by Japanese firms were converging toward the norms recorded by their U.S. and European rivals.” Moreover, although Japanese firms may have displayed some early aversion to acquisitions as the mode of entry, any such aversion fell away rapidly in the mid-1980s.

While space constraints do not permit even a brief recitation of all potentially relevant theoretical literature, what ties these perspectives together is a view of FDI as a means by which multinational enterprises (MNEs) defend market shares they gained through exporting by exploiting potential advantages



in ownership, location, or internalization.² FDI can be seen as the facilitating link in the natural transition from exporting, to assembling, to producing in the foreign market (see CRS 1989b). Viewed in this light, FDI has multiple motivations — some firm specific, such as a desire to produce closer to the foreign market, achieve economies of scale, or reduce transaction costs. Other motivations are political, such as shifting production to avoid export restraints, or to fend off threatened protectionism in a foreign market. Still other motivations are based on the macro-economic environment, such as movements in exchange rates, which can affect trade performance and competitiveness. The following paragraphs outline several leading theories on FDI behavior, and provide references to literature confirming Japan's conformance with the main predictions of these theories.

Micro-analysis of FDI

Internalization theory: the MNE internalizes what would otherwise be an arm's-length market transaction in the host country. Inherent disadvantages of the firm operating in an alien commercial and legal setting are overcome by the opportunity to develop technological assets and extend organizational structures in the host country, building on strengths in the home country market.

From this perspective, exports and FDI are complementary. Exports reveal demand sufficient to warrant the higher fixed cost of FDI, which (partially) internalizes the production and/or distribution process in the export market.

Exploitation of internalization advantages is a component of the prevailing “eclectic theory” of FDI (see Dunning 1997), along with exploitation of ownership advantages (such as brands or economies of scale) and location advantages of managing the activity within a MNE's boundaries rather than through exports.

² The “eclectic theory of FDI” associated with John H. Dunning represents a mix of three different theories in asserting that FDI is motivated by ownership advantages, location advantages and internalization advantages.

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As will be shown in Part B of this booklet, internalization, along with other elements of the eclectic theory, provide a solid explanation for the significant qualitative and quantitative changes in Japanese FDI that took place beginning in the late 1970s and early 1980s. As Caves (1993, p. 279) noted: “[T]he microeconomic behavior underlying Japanese foreign investment does not differ qualitatively from what other countries’ foreign investors have exhibited.” He continued (p. 284): “Many company-level studies of the foreign investment process have observed a sequence in which a company first establishes itself as an exporter to a foreign market, then undertakes foreign investment to support and expand its position there. This sequence was strongly evident for Japanese foreign investment.”

FDI behavior is motivated not only by responses to organizational and transaction cost factors operating at the firm or industry level, it is also heavily influenced by political economy variables. The most important of these are actual or threatened protectionist activity in host countries.

Macro-analysis of FDI

Tariff jumping FDI: firms engage in FDI to avoid existing tariffs and other trade protectionist measures in the host country.

As shown in the next part of the booklet, Japan’s experience is a clear illustration of this phenomenon. Voluntary export restraints are cited as factors motivating Japanese investment in the U.S. steel industry (CRS 1990, p. 11) and television-manufacturing activity (CRS 1982, p. 9). In response to voluntary export restraints on automobiles, “Japanese automakers fundamentally altered their U.S. investment strategies,” creating production facilities in the U.S. and forming alliances with state and local governments, which were eager to influence plant location decisions with a variety of incentives (Encarnation 1992, pp. 131–33).

Quid pro quo FDI: Investment occurs as an attempt to reduce the probability that threatened but as yet unimplemented protectionist measures will be imposed — “it is tariff-defusing” FDI (Bhagwati, Dinopoulos and Wong 1992).

Japan’s experience in the 1980s is quite literally a text book example of defensive FDI designed to defuse protectionist impulses in the host country. A survey of Japanese firms undertaking FDI between 1980–1986 by Japan’s Ministry of International Trade and Industry (MITI) found that the overwhelming majority of firms cited “avoiding trade friction” as their main motivation (Bhagwati 1990; Bhagwati, Dinopoulos and Wong 1992, p. 189). One commentator suggested that *quid pro quo* FDI was particularly salient to Japanese firms in the 1980s, because by that time their stake in major foreign markets such as the United States had become so huge and critical to their success: “[T]he defensive motivations that commonly lie behind the creation and spread of multinational enterprises are likely to act even more powerfully on the Japanese than on their U.S.-based and Europe-based competitors” (Vernon 1993, p. 69).

In addition to these political economy considerations, macro-economic factors are of course also relevant to FDI behavior. Currency exchange rates, asset values in the home and host countries, and the balance of international trade can all influence the level and form of FDI.

Location decisions

A second strand of FDI literature relevant to this booklet concerns industry location decisions: what factors influence foreign industry transplants to locate where they do? A threshold question relates to the countries in which MNEs choose to invest. For Japanese MNEs in the 1980s, as for Chinese MNEs today, the United States is a crucial and attractive overseas market due to its size, the quality of its physical infrastructure, the highly skilled nature of its labor force, and a host of related factors.

Some literature has also focused on industry location decisions within the United States. The Japanese location experience may be of limited direct relevance to Chinese firms, but as will be shown later in the booklet, the state-level dynamics of location decisions may be informative for prospective Chinese investors. Kong (1992) provided the most extensive discussion of these theories in relation to Japanese FDI. He proposed an organization/resource dependence model that predicts that transplanted industries will locate near required resources and services. Since similar industries have similar needs, a good location for one factory will be a good location for another with similar requirements. A “state model” predicts that location decisions are strongly affected by state government policies, with the state acting as an entrepreneur to lure transplants with a variety of tax and other incentives. Finally, a “class model” argues that strong unions are a negative factor in influencing industrial plant location decisions. Examining the Japanese automobile industry, Kong (1992) found that resource dependency provides the strongest explanation for location decisions. State government incentives were also very influential. Labor force unionization, however, did not appear to be a significant factor.

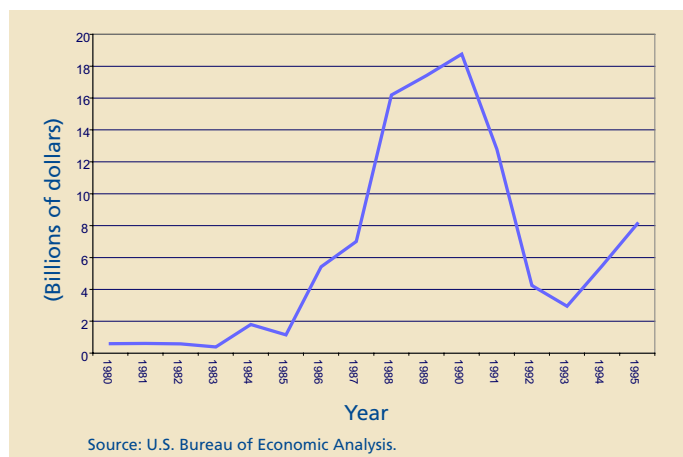
The bottom line from the theoretical literature as applied to Japan's experience is consistent and clear: organizational/ transaction cost factors and political considerations figured prominently in the FDI decisions of Japanese firms in the 1980s. With a few exceptions discussed below, distinctive qualities of Japanese firms, government policies and culture — to the extent they existed — did not lend a distinctive pattern or form to Japanese FDI. On the other hand, perceptions in the United States about these distinctive qualities were extremely important in coloring the U.S. reaction to Japanese FDI as it developed in response to economic and political contexts.

This conclusion orients the analysis and increases the relevance of the Japan analogy for China. It suggests three analytical default positions that will animate the remainder of the booklet³: First, that the basic motivations for and trajectory of Chinese FDI into the United States will resemble those of their Japanese counterparts, despite the distinctive setting from which such investments will emanate. Second, that many of the frictions likely to be generated by Chinese FDI into the United States will have direct parallels with those generated by Japanese FDI in the 1980s. Third, as a result, the strategies and adaptations of Japanese firms operating in the U.S. may offer useful lessons for China.

B. Japanese FDI in the 1980s: characteristics and frictions

During the 1980s, Japan's total stock of assets held abroad increased twenty-five-fold, and its share of total FDI flows into the United States rose from 19% in 1980 to 31% in 1987. Figure 1 traces the huge expansion in Japan FDI flows into the United States over the course of the 1980s.

Figure 1. Japanese FDI flows in the United States, 1980–1995



This major expansion in Japanese investment over the decade generated a host of frictions. This part of the booklet examines the factors leading to the rapid increase in Japanese FDI, outlines the main characteristics of that investment and analyzes the key strands of criticism that Japanese FDI into the United States evoked.

1. Investment trajectory and characteristics

As noted above, in the first stages of development of Japan's multinational networks it was thought that Japanese MNEs would exhibit quite a different pattern of FDI than their U.S. and European counterparts. Until the 1970s, Japanese investment in the U.S. was an adjunct to international trade. Many Japanese producers were not large enough or enjoyed too few competitive advantages to engage in FDI; others relied on affiliated trading companies as their agents in foreign markets. Thus, the bulk of Japanese FDI at the time was undertaken by the trading companies and the banks that financed the trade. A handful of Japanese manufacturers made investments in the 1960s and early 1970s, but FDI related to trade activities predominated: in 1980, Japan's share of foreign investment in U.S. wholesale trade was 37%, but in manufacturing it was less than 5% (Caves 1993, p. 281).

During the 1980s, the character of Japanese FDI in the United States changed significantly. Japanese investment in U.S. manufacturing accelerated, and Japanese firms sought to replicate their operating systems in the United States. Heavy investments were made in the U.S. distribution sector to support the marketing of autos and other goods that require extensive coordination of manufacturing and distribution. Many factors contributed to the shift, including increased Japanese R&D, the accumulation of intangible assets that support foreign investments, better learning about the transfer of intangible assets and skills to foreign markets, and increased sales promotion. Also important was the development of organizational skills and business practices of Japanese firms. The character of these organizational developments explains Japan's international comparative advantage in automobiles and other high-value-added durable goods, where systematic innovations in product quality are rapidly incorporated into the production process (Caves 1993, pp. 287–88).

This shift in Japanese FDI activity is in accord with the standard theory of investment based on transaction costs and exploitation of ownership and location advantages, in which distribution and other operational activities are brought in-house when they provide lower costs and greater benefits than arms-length relationships. But some distinctive characteristics of Japanese investment in the United States did emerge. One was the high propensity of Japanese MNEs to control their production affiliates tightly from Japan, relying almost exclusively on Japanese input sources and Japanese nationals as top managers (Vernon 1993, pp. 71–72). The tendency of foreign affiliates to rely so heavily on sources in Japan was attributed to consensual decision-making processes, just-in-time production processes and other distinctive organizational features of Japanese firms (Vernon 1993, p. 72; Yoshida 1983, pp. 16–17).

By the mid-1980s, Japan-based firms were expanding their multinational networks at a rapid pace (figure 1). Vernon (1993, p. 72) noted that some of the factors that had slowed the growth of these networks in the past now served to accelerate their proliferation. The desire, just noted, of Japanese firms to rely on Japanese input sources is one prominent example. This resulted in foreign affiliates of Japanese firms pulling large numbers of Japanese satellite suppliers with them into the foreign market. Again, this type of activity is highly consistent with internalization

³ Subject, of course, to adjustment for the major differences in geopolitical relations vis-à-vis the United States and domestic political differences between China in the 2000s and Japan in the 1980s.

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theory, which emphasizes the transaction cost minimizing effects of expansion into foreign markets as a prime motive for FDI.

Turning to macro-economic factors, the Plaza Accord in 1985 resulted in a major adjustment in the yen/dollar exchange rate. The depreciation of the dollar led to increased FDI from Japan, particularly in the form of acquisitions. Blonigen (1995), examining the period 1974–1992, showed that a weaker dollar relative to the yen was strongly correlated with greater acquisition FDI by Japanese firms. As theory predicts, he found that the effect was strongest in industries in which the presence of intangible assets is more likely, such as manufacturing, particularly of high-tech products.⁴

A second macroeconomic factor boosting Japanese FDI in the latter half of the 1980s was Japan's speculative bubble economy. This was a period of massive asset inflation — particularly real estate and equities. Research by Blonigen (1995) showed that increases in the Japanese stock market index in the 1980s were highly correlated with increased Japanese acquisition activity. It is quite possible that the poor performance of some Japanese acquisitions in the United States at this time (e.g. Sony's purchase of Columbia Pictures, overpaying for trophy assets such as Rockefeller Center and Pebble Beach Golf Course) was a spillover effect of speculative bubble activity in Japan.

A third macro-economic factor leading to increased Japanese FDI was the bilateral trade imbalance. As noted above, FDI can be viewed as a complement to international trade — as Japanese exports grew, FDI continued to expand. At the same time, the continuing trade imbalance between the United States and Japan created a *political* environment highly conducive to FDI, as explained next.

Growing protectionist sentiment in the United States served as an important catalyst for Japanese FDI in the United States (CRS 1989, pp. 89–447E, 7). Firms faced with protectionism established operations in the United States to protect their market share (Palugod 1990). It is well established in the literature that quantitative restrictions on Japanese exports were correlated with higher Japanese foreign investments (e.g. Drake and Caves 1992). The starkest example of the correlation is the automobile industry.

In 1981, Japanese firms began voluntarily restraining exports of autos to the United States to give the U.S. auto industry a period of time to make the necessary adjustments to become more competitive with imports. The Japanese renewed their restraints in each subsequent year through 1984. The automobile voluntary restraint agreement (VRA) induced Japanese auto makers to locate operations in the United States. Three major Japanese auto producers, which accounted for almost 75% of U.S. imports from Japan, began investing heavily in auto assembly facilities in the United States after imposition of the VRA (USITC 1985). A similar correlation between the imposition of export restraints and higher Japanese investment in the United States was exhibited in the color television industry and the semiconductor industry (Palugod 1990, pp. 101–102). Blonigen (1995) empirically confirmed that the threat of protectionism had a significant impact on Japanese FDI in the United States. Thus, it is plain that Japanese managers (and possibly government officials, if one credits MITI with a significant planning and coordination role in the economy at this time) took political factors into account in deciding whether to invest in the United States.

Mode of entry

As was true of other major investors in the 1980s, the cumulative expenditures of Japanese investors over the decade was heavily directed toward acquisitions. Table 1 shows annual investment by mode of entry.

Table 1. Japanese FDI in the United States, by investment type, 1980–1989 (Millions of dollars)

Year	Acquisitions	Greenfields
1980	521	75
1981	469	147
1982	137	450
1983	199	193
1984	1,352	454
1985	463	689
1986	1,250	4,166
1987	3,340	3,666
1988	12,232	3,956
1989	11,204	6,206

Source: U.S. Bureau of Economic Analysis

As the table indicates, greenfield investments and acquisitions were roughly equivalent in the first half of the decade. The distinctive feature of Japanese acquisition activity is its huge increase in the latter half of the decade. As just discussed, it is quite likely that the spike in acquisition activity in this period was motivated by the twin macro-economic factors of dollar depreciation and dramatic asset inflation in Japan.

⁴ Because intangible assets acquired abroad can generate returns in the home country without a foreign currency transaction, currency depreciation in the country where the assets are acquired increases the return on those assets to the home country firm.

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It is helpful, however, to place Japanese acquisition activity in context. Although Japan was one of the top eight foreign acquirers in the late 1970s through mid-1980s, it ranked well below the U.K., Canada, the Federal Republic of Germany and France in terms of numbers of acquisitions. For the period 1976–1986, Japan accounted for only 4.5% of foreign purchases of U.S. companies (CRS 1987, pp. 5–6). A significant portion of the Japanese acquisition activity, particularly in the latter part of the decade, consisted of real estate purchases. It is unlikely that Japanese acquisition activity became controversial at the end of the decade due solely to sheer numbers or volume of transactions but, rather, as a result of some high profile acquisitions capping a decade of trade imbalances (see the discussion below). One possible exception was Japanese acquisitions in the U.S. banking industry. As of 1989, 33 Japanese banks controlled about half of the total foreign banking assets in the United States — \$329 billion. Their overall U.S. banking asset market share as of that date was 10%, triple the market share of a decade earlier. Their market share in California was particularly high, with Japanese controlling the five largest banks in the state (CRS 1989, pp. 89–407E, 3).

Location decisions

The location decisions of Japanese manufacturers in the 1980s followed predictable patterns, with one exception. A study of startup manufacturing plants in high tech industries conducted in the early 1980s showed that, for the majority of companies, the quality of the labor force, proximity to markets and lack of labor unionization were the three most important factors in the location decision (cited in Yoshida 1987, pp. 65–67). California was the overwhelming choice for the firms surveyed (*ibid.*). Focusing on Japanese automobile transplants, Kong (1992) found that plant location decisions were driven by a combination of straightforward production factors (access to materials, skilled labor, distribution channels) and state-level government incentives. Japanese automobile factories were clustered in the lower Midwest (Ohio, Indiana, Illinois, Kentucky, Tennessee). Surprisingly, this study found that, although Japanese automotive executives routinely expressed concerns about working with organized labor in the United States, labor unionization did not appear to be a highly salient factor in automobile plant location decisions. This finding, however, is in tension with the commonly accepted view that Japanese manufacturers sought to avoid locations with heavy populations of unionized labor.

2. Frictions and controversies

Consonant with the (ultimately inaccurate) view that Japanese firms would exhibit unique foreign investment behavior, some predicted that Japanese FDI would be less controversial than FDI from some other nations. As Vernon (1993, p. 70) noted, “from this early pattern [of Japanese FDI based on trade relations and led by the general trading companies], it appeared that the Japan-based multinational enterprise might root itself much more deeply in its foreign markets than did the U.S.-based and Europe-based companies, with results that might prove more benign from the viewpoint of the host country.” Unfortunately for Japan,



this prediction also turned out to be inaccurate. This part of the booklet outlines the principal sources of friction in the United States associated with Japanese FDI in the 1980s. The discussion is pursued in some detail because the parallels with contemporary China are striking, and thus this phase of Japanese FDI may be of particular interest to Chinese executives.

Reciprocity issues

The largest underlying cause of friction over Japanese FDI in the 1980s was the perception that, while the U.S. was wide open to Japanese investment and imports, U.S. firms faced substantial barriers to investment and trade in Japan. Reciprocity-based criticisms of Japanese FDI appeared frequently in Congressional hearings and public commentary throughout the decade.⁵ Consider two reactions to high-profile Japanese acquisitions in 1989:

The purchases of Columbia Pictures and Rockefeller Center occupied the headlines throughout the fall, and raised the question of whether the public reaction to these acquisitions was racist, since British and Dutch acquisition — though not as dramatic — did not evoke the same reactions. While some of the reactions displayed an ugly racist tone, for the most part the reactions were based more on the perception that the Japanese were not playing fair with their trading practices; that in their failure to open their markets and remove their investment barriers, they were not in the same category as our major trading partners, who...are habituated to more open trade.⁶

An editorial in *Newsweek* made a similar point:

Those who are uncomfortable with the Oct. 30 agreement to sell 51% of the company that owns Rockefeller Center...to Mitsubishi Estate Co. must realize that there is a connection: As long as Americans can't pay for Japanese products by exporting goods and services of their own, they will have to pay with real estate and other capital assets — even with a national treasure like Rockefeller Center...There will be no

⁵ As Saxonhouse (1986, p. 245) recounted: “In 1982, when Senator Russell Long was discussing the so-called ‘reciprocity legislation’ in the United States, he said: ‘No lesser mind than the Deity itself can keep up with all the subtleties and rules of Japanese import trade which are so effective in excluding American products’.”

⁶ Statement of Susan Tochin, Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Rep., 101st Cong., 1st Sess., Nov. 15, 1989, p. 116.

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improvement in American access to Japanese markets until Washington makes up its mind to confront Japan with some formula that requires real reciprocity in trade for all U.S. companies.⁷

Reciprocity was also central to the debate about Japanese investment in the U.S. banking sector, which, as noted above, was one of the key targets of Japanese FDI in the 1980s. While the sheer magnitude of the investment was a concern to some observers, the most frequent complaint was that U.S. banks were denied similar access to the Japanese financial sector (CRS 1989a, p. 7).

This precise line of criticism may not be available to critics of inbound Chinese FDI. The claim that China is “closed” to foreign investment and trade — a claim frequently made in relation to Japan in the 1980s — is fairly untenable.⁸ China has been the largest destination for FDI among developing nations and among the top five destinations overall for over a decade running.⁹ Moreover, for most of this decade, China has been the fastest growing U.S. export market, overtaking Japan as the U.S.’ third largest export destination in 2007.¹⁰ While the reciprocity argument may not be open to China critics, the reciprocity critique of Japanese FDI took place against a complex economic and political backdrop. The underlying strands of that backdrop have many direct parallels with the U.S.-China relationship today. Consider the following sources of friction in Japan-U.S. trade and investment in the 1980s.

Spillover from the trade imbalance

The setting for inbound FDI from Japan was an unprecedented U.S. trade imbalance with that country.¹¹ This imbalance colored

U.S. perceptions of Japan and served as the background against which the entire decade’s debate over Japanese FDI played out. It seems safe to predict that perceptions of Chinese FDI will also be heavily colored by the overall state of the U.S.-China trade relationship, in which, of course, the U.S. currently runs a massive deficit (\$262 billion in 2007, accounting for about 35% of the total U.S. trade deficit). Large bilateral trade deficits get the attention of politicians and raise protectionist sentiment in Washington. The past year has seen several signs of protectionism reminiscent of the climate in Washington in the 1980s.¹² The target has changed, but the Congressional rhetoric and action by the administration are similar to that of two decades ago. For example, in 2007, the Commerce Department imposed countervailing duties on Chinese coated paper, the first time it had taken such action against an imported product in 22 years, and the U.S. Trade Representative (USTR) initiated three cases against China in the WTO. As with criticism of the yen in the context of Japan’s trade imbalance with the United States in the early 1980s,¹³ many critics today claim that an undervalued yuan allows China to flood the U.S. with cheap imports.¹⁴ Protectionist and “anti-China” sentiment, concern over U.S. jobs and a more generalized fear of growing Chinese economic might — all fuelled in some way by the trade imbalance — can be expected to color U.S. views of Chinese FDI, just as they did two decades ago with respect to Japan (CRS 2007). As Senator Max Baucus commented: “China’s competitive challenge makes America nervous. From Wall Street to Main Street, Americans are nervous about China’s effect on the American economy, American jobs, on the American way of life.”¹⁵

Japan’s economic threat to the U.S.

Throughout the 1980s, some members of Congress and vocal critics in academia promoted the view that the Japanese posed a threat to U.S. economic wellbeing. The argument, tied in part to the reciprocity complaint, was that the Japanese were not engaging in fair trade competition. The precise dimensions of the perceived unfairness varied with the critic, but several common themes were repeated: First, U.S.-Japan trade and investment did not take place on a “level playing field” because Japanese firms received (generally undefined) “subsidies” from their government.¹⁶ Second, Japanese firms were said to engage in anticompetitive practices in their home country and were exporting these practices through their investment activities in the United States. This view was articulated before Congress in 1989 by Japan critic Pat Choate:

[W]e are seeing [that] foreign investment permits foreign corporations, particularly from Japan and, to a lesser degree, from Europe, to extend into the U.S. market the operation of

⁷ *Newsweek*, November 13, 1989, p. 186.

⁸ Although China critics in Congress argue that China’s WTO compliance is uneven, and former USTR Rob Portman argued that the U.S.-China trade relationship lacks equity. See CRS 2007, p. 34–35.

⁹ UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development* (New York and Geneva: United Nations, 2007), Annex table B.1., p. 251.

¹⁰ USTR, 2008 National Trade Estimate Report on Foreign Trade Barriers, p. 75. China, in turn, replaced the U.S. as Japan’s largest export destination in mid-2008.

¹¹ See Saxonhouse (1986) for a thorough discussion of the trade imbalance and its policy implications.

¹² See, e.g., Heather Stewart, *US-China Trade War Looms*, *The Observer*, March 26, 2007, <http://www.observer.guardian.co.uk/business/story/0,,1739428,00.html>.

¹³ See, e.g., Bergsten 1982.

¹⁴ One likely effect of a substantial adjustment in the yuan/dollar exchange rate is an increase in Chinese acquisitions of U.S. firms. Although that effect of a revaluation of the yuan has received almost no attention, it is what the Japanese response to the Plaza Accord suggests, as shown above.

¹⁵ Statement of Senator Max Baucus, Senate Committee on Finance Hearing on U.S.-China Relations, June 23, 2005, cited in CRS 2007, pp. 1–2.

¹⁶ See, e.g., Statement of Susan Tolchin, Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Rep., 101st Cong., 1st Sess., Nov. 15, 1989, p. 112.

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cartels that are prohibited under American law. These cartels are able to engage in anti-competitive practices. And what's more, under existing policies of the U.S. government, they operate with a sort of diplomatic immunity.¹⁷

A deeper conspiracy behind Japanese FDI was seen by adherents of the "Japan, Inc." school that emerged in the late 1970s, fuelled by Chalmers Johnson's enormously influential book, *MITI and the Japanese Miracle*. In this view, Japan's economic success was a product of industrial policy formulated and executed through close cooperation between the economic bureaucrats at the Ministry of International Trade and Industry and the business sector, with the support of LDP politicians. In the most extreme version of the Japan, Inc. story, Japan's industrial policy consisted of the government "picking winners and losers," forming cartels and tolerating oligopolistic behavior in key sectors, ensuring a supply of low-cost bank finance to favored industries, and sheltering nascent industries from outside competition until they could dominate world markets. For adherents of this worldview, the Japanese "had developed a powerful, rapidly growing, purposively managed, and relentlessly self-interested economic juggernaut which was posing a fundamental challenge to U.S. economic supremacy" (Yoshida 1987, p. 2, quoting Destler et al. 1976). The Japan, Inc. school found adherents within Congress and certain sectors of the U.S. administration, including the Commerce Department. The notion of Japan as a rising juggernaut that jeopardized U.S. interests was widely shared by the public. In 1988, polls showed that more Americans feared the Japanese economy than the Soviet threat.¹⁸

Today, although the particulars differ considerably, similar complaints are raised about "unfair" Chinese trade practices (such as dumping and poor intellectual property protections) and "subsidies" from the Chinese government.¹⁹ Today, as two decades ago, some of the complaints will be lodged by U.S. competitors most directly challenged by the entry of foreign players into the U.S. market.²⁰ And, of course, public discourse in the United States today is filled with references to the "threat" posed by China's economic rise. As a Congressional Research Service Report for Congress recently noted: "In many respects, the rise of China as a global economic power is subject to the same interpretation as the economic rise of Japan during the 1970s and 1980s and the impact that rise was thought to have on the U.S. economy" (CRS 2007, p. 2).

Concerns about national security and political influence

Even though Japan was (and remains) a close military ally of the United States, Japanese acquisition activity in the 1980s was not immune to objections based on national security concerns. The most controversial transaction from a national security perspective was Fujitsu's attempted acquisition in 1986 of Fairchild Semiconductor (which ironically was already controlled by Schlumberger, a French firm). Congressional objections to the bid specifically and surrounding controversy over Japanese acquisitions of U.S. high-tech companies more generally eventually caused Fujitsu to withdraw its bid.²¹ To give a flavor of the public debate at the time, William Safire, in opposing the bid in his newspaper column, noted that "Japanese businessmen were accused of stealing secrets from IBM and are suspected of technology diversions through Hong Kong."²² Controversy surrounding the Fujitsu-Fairchild transaction was a major impetus behind passage in 1988 of the Exon-Florio provision, which revised the CFIUS process for review of foreign acquisitions of U.S. firms.



It authorized the President or his designee to investigate foreign acquisitions to determine their effects on national security. Two decades later, another amendment to the CFIUS process was motivated by a controversial *Chinese* bid for a U.S. firm. In 2007, the Foreign Investment and National Security Act²³ codified and clarified the CFIUS process in direct response to CNOOC's politically charged and ultimately withdrawn bid for Unocal.

Post enactment of the Exon-Florio provision, other Japanese acquisitions proved controversial as well. For example, an agreement by Fanuc Ltd., a Japanese machine tool manufacturer, to acquire a minority equity stake in Moore Special Tool Company

¹⁷ Statement of Pat Choate, Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Rep, 101st Cong, 1st Sess., Nov. 15, 1989, p. 15.

¹⁸ Cited in Green 2006, p. 108.

¹⁹ One of the key criticisms of CNOOC's attempt to acquire Unocal in 2005 was that its bid was "subsidized" by low-cost Chinese government financing because CNOOC is a state-owned enterprise.

²⁰ In the 1980s, Congress frequently invited senior U.S. executives from major industries such as automobiles and semiconductors to provide views on Japanese FDI. Not surprisingly, their views were almost uniformly negative, and their testimony was often laced with hyperbole about the threat Japan posed to U.S. competitiveness and technological prowess.

²¹ From 1988–1992, Japan accounted for about two-thirds of all high-tech acquisitions in the U.S. Kang 1997, p. 320, tbl. 6. Alan Greenspan (prior to taking his position as Chairperson of the Fed) was critical of governmental interference in the Fujitsu-Fairchild acquisition. Greenspan commented "that the incident frightened foreign investors and precipitated the decline in the dollar and the rise in interest rates....The end result: billions of dollars in additional interest costs for the U.S. government and U.S. consumers and businesses" (quoted in CRS 1987, pp. 16–17).

²² Cited in Kang 1997, p. 321.

²³ Pub. L. No. 110–49, 121 Stat. 246.

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of Connecticut, a maker of precision machine tools, triggered a CFIUS investigation in October 1990, and was ultimately abandoned when a congressional challenge to the transaction became apparent. The purchase by Nippon Sanso of Semi Gas Systems, which produced gas systems for semiconductor production lines, was not blocked by CFIUS, but it did generate a Senate subcommittee hearing in 1990 chaired by Al Gore over its implications for U.S. technological competitiveness.²⁴

Because Japan was an important military ally, national security concerns over Japanese acquisitions were often framed in terms of the potential for industrial espionage and blended into *angst* about the sustainability of U.S. economic and technological supremacy in the face of Japan's perceived industrial policy.²⁵ Consider the statement of Senator Frank Murkowski in regard to the Semi Gas acquisition, contrasting what he viewed as the inability of CFIUS to gather detailed company-level information in reviewing the deal with the workings of the Japanese government:

Well, let me tell you what the French do and the Japanese do. They exchange this information ... in order to achieve an objective and that objective is the advancement of technology in a competitive world....[In Japan,] every business, every industry there has a goal and a strategy to achieve the goal. Recognizing that resources are usually scarce, a successful Japanese strategic industry plan is adopted by MITI. It is coordinated, formulated...By targeting strategic markets, an infrastructure is built up which insures a solid basis for economic expansion...Thus in Japan, every technology becomes a stepping stone. Every product becomes the basis for another, and the resulting efficiencies of scale are enormous, as we have seen.²⁶

²⁴ "The fact is that large parts of the U.S. semiconductor equipment sector and the overall electronics industry are now being systematically acquired by foreign interests with potentially devastating effects for both U.S. security and economic competitiveness, and the current administration shows little, if any, inclination to question these purchases at all." Statement of Senator Al Gore, Hearing before the Subcommittee on Science, Technology, and Space of the Committee on Commerce, Science and Transportation, U.S. Senate, 101st Cong., 2d sess, Oct. 10, 1990, pp. 1–2.

²⁵ Typical of works taking a critical view of Japan as a potential adversary and competitor is Prestowitz 1988.

²⁶ Statement of Senator Frank H. Murkowski, Hearing before the Subcommittee on Foreign Commerce and Tourism of the Committee on Commerce, Science, and Transportation, U.S. Senate, 101st Cong., 2d Sess., July 19, 1990, pp. 13–15.

A related concern was that heavy Japanese FDI could affect the U.S. political process. In Congressional testimony, Susan Tolchin, a frequent critic of Japanese FDI at the time, asserted that over 100 political action committees run by foreign affiliates sought to "influence our public officials."²⁷ Congressman John Bryant asserted that "the sheer magnitude of these [Japanese and other foreign] investments has increased foreign influence and leverage over U.S. economic policymaking and political decisionmaking, and every Member of Congress has already felt it."²⁸ He went on to complain that "the amount spent in 1988 by Japanese interests to influence U.S. policy is more than the combined budgets of the five most influential American business organizations in Washington..."²⁹

In great contrast to Japan's status as a military ally of the United States (an "unsinkable aircraft carrier," as one striking metaphor put it), China poses significant military and geo-strategic challenges to the United States.³⁰ The Pentagon routinely expresses concern over China's rapid military buildup and the non-transparency of its military budget and goals.³¹ The Taiwan issue constitutes a potential flashpoint for armed conflict in the region involving the United States and China. China already appears to be leveraging its economic rise into a more muscular foreign policy, particularly in the Asian region. It seems safe to predict that the long-range interests of the United States and China may diverge over a host of issues ranging from the economic to the military and political. Given this backdrop, and in view of the controversial nature of *Japanese* FDI in the 1980s, Chinese acquisitions involving technology, finance or natural resources are likely to evoke high levels of concern and scrutiny in Washington as well as widespread public controversy.

National security concerns are also likely to amplify controversy over China's "unfair" trade practices. For example, CRS (2007, p. 38) reported that some analysts believe national security needs require the U.S. to maintain an independent supply of steel. U.S. steel producers have complained that overcapacity and overinvestment may cause China to dump cheap steel on world markets, jeopardizing U.S. industry. This example is reminiscent of the argument, lodged by U.S. manufacturers in several industries in the 1980s, that Japanese acquirers were deliberately targeting vulnerable U.S. firms (Kang 1997, p. 318). But the fact that China is now the subject of criticism is likely to raise the stakes and heighten the linkage between "unfair" or "adversarial" economic competition and "national security threat."

²⁷ Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, House of Rep, 101st Cong, 1st sess. Nov. 15, 1989, p. 110.

²⁸ Statement of Hon. John Bryant, Hearings before the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the Committee on Energy and Commerce, House of Rep., 101st Cong. 2d sess. June 13 and July 31, 1990.

²⁹ *Ibid.*, p. 72.

³⁰ Japan was often criticized for not shouldering a heavier share of the costs of the military alliance. In effect, the claim was that the U.S. had subsidized Japan's economic success by covering the costs of its defense. In this vein, Congressman Richard Gephardt once quipped that the United States and the Soviet Union fought the Cold War and Japan won. China does not carry this type of baggage into its trade and investment relations with the United States. But this factor would scarcely offset the increased skepticism with which Chinese investments in the U.S. are likely to be viewed on account of the potential military rivalry between the two countries.

³¹ See, e.g., *New York Times*, Nov. 5, 2007.

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Moreover, if a growing Japanese and Western European commercial presence in the 1980s provoked fears that the political process in Washington was being tainted, such concerns will surely be magnified by any significant lobbying efforts on behalf of Chinese business interests in the United States.

Employment practices

By the end of the 1980s, about 300,000 Americans worked for Japanese affiliates in the United States.³² As noted previously, one distinctive feature of Japanese FDI was tight control over foreign affiliates, particularly with regard to the employment of high-level managers. Employment-related disputes were a constant source of trouble for Japanese firms in the United States in the 1980s and early 1990s. According to a *New York Times* article in 1990, Japanese firms commonly had at least one employment lawsuit pending against them, and losing a case cost at least \$20 million in damages and legal expenses.³³ Japanese firms were most often hit with claims that they discriminated against non-Japanese and against women, including by engaging in sexual harassment, and were also accused of discriminating on the basis of race and age.³⁴ One such case, *Sumitomo Shoji v. Avagliano*,³⁵ was decided by the U.S. Supreme Court and generated the important ruling that a wholly owned subsidiary of a Japanese firm operating in the United States is a U.S. corporation and thus is subject to Title VII's anti-discrimination provisions. The U.S. Equal Employment Opportunity Commission was also involved in several cases against Japanese firms. Public perceptions of Japanese employment practices at the time were very negative. A national survey commissioned by Japanese firms in 1989 found that most Americans believed Japanese companies were more likely to discriminate against women, to be less open to advancement for Americans and to provide less job security than American firms. It also found that Americans were less willing to work for a Japanese firm than for a Canadian, British or German company.³⁶ It is impossible to know how much of this negative perception was attributable to wrongful conduct as opposed to misunderstandings about unfamiliar Japanese organizational practices, work habits and cultural norms. But Japanese employment practices undeniably generated a significant amount of ill will in the United States.

To date, we have insufficient experience with employment practices of Chinese foreign affiliates to draw comparisons with the Japanese situation. Indeed, a lack of literature on Chinese employment and managerial practices generally makes it difficult to assess whether this aspect of Chinese FDI potentially poses problems for Chinese affiliates in the United States. But given the continuing sensitivity of the U.S. legal regime (and plaintiffs' attorneys) to employment discrimination in its various forms,

Chinese foreign affiliates operating in the U.S. would be well advised to take a cautionary note from the Japanese experience. Similarly, Chinese affiliates should scrupulously avoid any operational practices that could reinforce negative impressions about Chinese products or corporate conduct, such as unsafe labor practices, shirking on product quality standards or failure to respect intellectual property rights.

C. Responding to Friction

This part of the booklet examines the responses to friction over Japanese FDI in the United States. Of course, responses varied by actor and audience, and many strategies to defuse tension were pursued on a firm-level basis. It is difficult to gauge the full range and effectiveness of the efforts undertaken in this period, particularly at the firm level, since two decades have passed and there seems to be limited institutional memory of this particular aspect of Japanese FDI in the United States. What follows is the most complete overview of the landscape I was able to assemble from the sources available. I have separated the discussion of responses into three parts: national level, state and local level, and firm level.

At the national level, the U.S. and Japanese governments attempted to deal with the trade and investment imbalances through a series of negotiations in the late 1980s known as the Structural Impediments Initiative (SII). The SII talks were premised on the notion that many of the obstacles U.S. firms investing in Japan faced were informal — tied to Japan's distinctive business structures and practices rather than legal or regulatory restrictions. A GAO report (1990, p. 18, Appendix III) stated:

These informal barriers include a business environment in which Japanese companies are rarely sold; there are virtually no hostile takeovers; and cross-shareholding among allied companies leaves a low percentage of companies' common stock available for sale on the stock market. In addition, Japan's long-term supplier relationships, close ties between government and industry, and complex distribution system are considered imposing barriers, particularly to start-up investments.

The SII negotiations were launched in the fall of 1989 in an attempt to identify and solve "structural problems" that contributed to the trade and payments imbalance. While ostensibly the talks sought to identify problems in both countries, they focused most attention on impediments to trade and investment in Japan, such as the *keiretsu* system, shareholders' rights, the complex distribution system, and exclusionary trade practices; they even delved into Japanese saving and investment patterns. The talks resulted in a list of action steps to be taken by both governments. The U.S. commitments focused on reducing the budget deficit and increasing the savings rate. The Japanese committed to a range of actions including increasing public spending, encouraging the formation of new businesses, deregulation, and reviewing its antitrust policy. This is not the place to provide an in-depth assessment of these talks. Whatever the talks may have substantively achieved,³⁷ they did succeed

³² Jim Schachter and Nancy Yoshida, "U.S. workers tested: bosses from Japan bring alien habits," *Los Angeles Times*, July 19, 1988.

³³ Deborah L. Jacobs, "Managing: Japanese-American Cultural Clash," *New York Times*, Sept. 9, 1990.

³⁴ See, e.g., Leon Daniel Upi, "Americans Charge U.S.-based Japanese Firms with Bias," *United Press International*, September 24, 1991 (reporting on testimony by American workers before Congressional panel).

³⁵ 457 U.S. 176 (1982).

³⁶ William Armbruster, "Cultures Clash as Japanese Firms Set up Shop in the U.S.," *Journal of Commerce*, March 1, 1989.

³⁷ Perhaps a fair summation is that they resulted in a motley assortment of deregulatory measures and legal reforms in Japan of some — though probably modest — value, while

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in shining a spotlight on many idiosyncratic Japanese business practices that contributed to the country's extremely low levels of inbound FDI and strong preference for domestic products over imports. Today, the U.S. and China are engaged in similar talks to address frictions in the bilateral economic relationship. It seems safe to conclude that, while such negotiations may on balance be helpful in mitigating tensions, they are unlikely to alter the environment dramatically for inbound FDI in the United States.

It is important to recall that frictions over Japanese FDI at the time were cabined within the larger, generally healthy, U.S.-Japan relationship. Japan had strong supporters within the U.S. government to emphasize the mutual interests of the two countries as well as Japan's contributions to the bilateral relationship. These supporters helped counter negative rhetoric and dampen protectionist sentiment. To cite just two examples: First, at the peak of public perception that the Japanese were "buying up America," at the end of the decade, Elliot Richardson (who at that time was the chairperson of the Association for International Investment — see below) pointed out in congressional testimony that Japan was covering all of the costs of the U.S. military presence in Japan and was working to increase access for U.S. products. He contrasted the emotional nature of popular reaction to highly visible investments such as Rockefeller Center with the "steadier and clearer" perception of U.S. and Japanese leaders concerning mutual interests and responsibilities.³⁸ Second, Mike Mansfield, Ambassador to Japan throughout the period of trade and investment friction, coined the phrase that "the U.S.-Japan relationship is the most important bilateral relationship in the world, bar none." This became the standard mantra for a succession of Presidents and other high-level U.S. government officials, ensuring that the rough spots in the economic relationship were viewed in the context of an otherwise close and crucial partnership. The U.S.-Japan alliance also gave the U.S. leverage in its approach to trade and investment problems with Japan — leverage that it may not have with respect to China.

Public relations efforts by private and public organizations acting on behalf of Japanese interests in the United States were also strengthened. The Association for International Investment (subsequently reorganized as the Organization for International Investment (OFII)) was established in the wake of Fujitsu's aborted acquisition of Fairchild. Elliot Richardson was its founding

signaling the seriousness with which the Japanese took the need to address the trade and investment imbalance to avoid damage to the bilateral relationship.

³⁸ Statement of Elliot Richardson, Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance, and Urban Affairs, House of Representatives, 101st Cong., 1st Sess. Nov. 15, 1989, pp. 6–12.

chairperson. The organization participated in the legislative process with respect to the Exon-Florio amendment, helping to shape the legislation in a benign way from the perspective of foreign investors.³⁹ The Keizai Koho Center, known in English as the Japanese Institute for Social and Economic Affairs, was established as an independent, nonprofit organization in 1978. It is supported by Japanese firms, individuals and foreign affiliates. The Center engages in public relations efforts overseas, particularly with respect to the Japanese economy and business.⁴⁰ The Japanese government established the Japanese External Trade Organization (JETRO) in 1958 to promote mutual trade and investment between Japan and the rest of the world. In the 1980s, JETRO was active in gathering information about legal and political developments that might affect Japanese trade and investment opportunities abroad and published its findings in an annual white paper, which included detailed surveys of the investment climate in the United States and elsewhere. In this period of trade and investment friction, JETRO sought to position itself as a resource for U.S. businesses seeking to pursue investment opportunities in Japan, a mission it still highlights today. Keidanren (Japan Business Federation) maintains a Washington, D.C. office "to promote greater understanding in the United States of the importance of the bilateral trade and investment relationship to the U.S. and Japanese economies, and to support policies that strengthen bilateral trade relations."⁴¹

Private-level diplomacy was another important strategy employed by Japanese firms in the 1980s (Yoshida 1983, pp. 139–142). Beginning in the 1960s, a number of organizations were established to foster communication between U.S. and Japanese businesspeople. Such groups include the Advisory Council on U.S.-Japan Economic Relations and the Japan-U.S. Economic Council. In 1983, the U.S.-Japan Advisory Commission, composed of seven private citizens each from both sides, was formed at the request of President Reagan and Prime Minister Nakasone to review comprehensively the bilateral relationship. The Commission prepared a report stressing the prospects for long-term cooperation based on common interests, and endorsed direct investment as a means of increasing the flow of goods, capital, information, and skills, thereby strengthening the economic relationship (*ibid.*). In addition, numerous forums were established for exchange of ideas and information among business people and local, state, and federal government officials. The U.S.-Japan Business Council is perhaps the most prominent example. It has several regional associations that provide opportunities for interaction among state government officials and business people.⁴² These associations have annual meetings which alternate between the U.S. and Japan. The governors of the states involved often attend these meetings, which are used to promote understanding of the benefits of FDI for the states, such as employment, increased tax revenue and technology transfer to local industries.

³⁹ Interview with lawyer active in the establishment of the Association for International Investment and its reorganization as OFII.

⁴⁰ http://www.kkc.or.jp/english/about_center/index.html. The Center says it "strives to close gaps in perception between Japan and other countries and between the business community and society at large."

⁴¹ <http://www.keidanren-usa.org/about/keidanrenUSA/default.asp>.

⁴² <http://www.jusbc.gr.jp/eng/index/html>.

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In contrast to the mostly critical tone of debate at the federal — and more specifically Congressional — level, state and local governments in the 1980s were generally very welcoming toward Japanese FDI (JETRO 1990, pp. 74–76). Although a number of bills were introduced in state legislatures to regulate or restrict foreign investment, only one state actually enacted such a bill into law. A Japanese government report attributes the contrast in climate to the fact that the beneficial effects of FDI in the form of job creation and tax receipts are felt most directly in regional economies (JETRO 1990).

In fact, states actively competed to attract Japanese FDI. The most common incentives were preferential tax treatment and low cost financing, though some states offered free land, new roads and schools for the children of Japanese managers. By 1990, more than 40 states had established offices in Tokyo to promote themselves as investment destinations (JETRO 1990, p. 77). Japanese MNEs skillfully played this competition to their benefit. For example, as noted above, although all the major Japanese automakers set up assembly operations in the same region of the United States, each was located in a different state, suggesting a bargaining strategy in which a later entrant leveraged the incentive package obtained by an earlier entrant. Kong (1992, p. 136) concluded that the Japanese auto manufacturers successfully “applied a strategy to maximize their political capital by spreading out the location in different states.” He found that “all the winner states are in the high rank of number of tax and financial incentives available to industry” (*ibid.*, p. 127). The upshot: “With so many available incentives, foreign investors clearly have the upper hand, using it to squeeze as much as they can out of the state” (*ibid.*, p. 135).

This is not to suggest that the environment was completely welcoming to Japanese affiliates at the state and local level. As we have seen, Japanese used greenfield investment in many industries to avoid or defuse protectionism in the United States. Greenfield investment is often thought to be the less politically problematic form of entry because it creates new jobs and tax revenues as opposed to the “mere” change of ownership entailed in an acquisition.⁴³ But greenfield investment can generate its own frictions. In the case of Japanese assembly and production affiliates in the United States, as noted, employment practices were a source of considerable tension. Also, local communities in the U.S. sometimes argued that the entrance of foreign affiliates created excess capacity in an industry, resulting in the closure of U.S. factories. Moreover, the public was sometimes critical of what it viewed as excessive incentives provided by state and local governments to woo foreign investors (JETRO 1990, p. 75).

At the firm level, concerns over community reaction sometimes shaped Japanese acquisitions of U.S. assets. Public commitments to maintain existing headquarters, plants and facilities were sometimes made part of an acquisition agreement in order to allay local fears.⁴⁴ It was common for Japanese affiliates to retain public relations firms and undertake media campaigns to shape local sentiment toward their business activities in the community. Hitachi, embroiled in a number of U.S. controversies in the



1980s, established an action program in 1985 that included efforts to expand production in the United States and to increase procurement from U.S. sources. Similar steps were taken by other Japanese firms to defuse trade and investment tensions.

Another effort to engender good will at the local level entailed corporate social responsibility campaigns by Japanese affiliates. The affiliates made efforts to integrate into the local community by becoming involved in community affairs and making donations to local charities. A number of Japanese firms or corporate groups active in the United States at the time established foundations in support of education, endowed chairs at major universities,⁴⁵ and made other high-profile philanthropic gestures. For example, the Hitachi Foundation was established in 1985, with Elliot Richardson as its founding chairperson.⁴⁶ The Mitsui USA Foundation was established in 1987 to promote higher education and care for the disabled. The Toyota USA Foundation, also founded in the 1980s, promotes K–12 education, particularly in math and science. These efforts reflected the unanimous advice given to Japanese affiliates by their supporters in the United States: if you want to be accepted, you must be good local citizens and demonstrate a commitment to the market and society as a whole.⁴⁷

For all the controversy it engendered, studies have shown that Japanese investment in the United States in this period generally exhibited lower returns than comparable investments in the United States or Japanese investments elsewhere. Several reasons have been advanced to explain this result: an inability of Japanese firms to transplant the *keiretsu* network of suppliers and affiliates to the United States, misguided attempts to employ Japanese human resource policies and practices in their U.S. affiliates and the rushed or speculative nature of many investments in the 1980s as a response to

⁴³ The author holds the Fuyo Professorship at Columbia Law School, which was established in 1980 by the Fuyo Group (one of the six major keiretsu corporate groups then in existence).

⁴⁶ The Hitachi Foundation describes its mission as assisting economically isolated people in the United States.

⁴⁷ Interview with advisor to the U.S. affiliate of a major Japanese high-technology firm.

⁴³ This view is simplistic, as pointed out by Gliberman and Shapiro.

⁴⁴ Author interview with legal counsel for a Japanese acquirer in the 1980s.

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anticipated trade restrictions in the United States and the growth of the bubble economy in Japan (e.g., Bergsten et al. 2001, p. 123).

By the early 1990s, the friction and rhetoric over Japanese FDI in the United States had quieted considerably. The causes were likely several. Some or all of the strategies discussed above may have been successful in defusing tension. The eventual acclimation of the U.S. public to Japanese products, brands and corporations may also have played a role. Japanese affiliates may have learned how to adapt better to their local environment — to overcome “the liability of foreignness.” The overriding factor, however, was the bursting of the “bubble economy” in Japan. The Nikkei index peaked at the end of 1989 and eventually fell to one-third of the peak. Land prices declined steadily. A serious nonperforming loan crisis occurred in the banking sector. Japan's serious economic problems caused a major retrenchment in overseas activities. As figure 1 indicates, many Japanese firms shrank or withdrew altogether from U.S. operations. During the post-bubble period, Japanese investment in the United States was on the same order of magnitude as that of Switzerland (Bergsten et al. 2001, p. 123). Japanese FDI in the United States ceased to be a major topic of public debate after about 1991.

D. The climate for Japanese FDI today

Today, the topic of Japanese FDI has completely disappeared from the U.S. media and Congressional chambers. But Japanese investment in the United States is robust. By the end of 2007, the stock of Japanese investment in the United States was approximately \$233 billion, second only to the U.K. and roughly 11% of the total stock. As of 2005, Japanese companies accounted for 614,000 jobs in the United States (about 2/3 of which were attributable to the automotive sector), and for about 1% of private sector GDP (U.S.-Japan Investment Initiative Report 2008, p. 13–14).

The bilateral investment relationship is continuously being reexamined and lubricated by a thick network of governmental and private sector actors. Several of the links in this network were described in Part C of this booklet, including the U.S.-Japan Business Council and its regional associations. An important recent example is the United States-Japan Investment Initiative, launched in 2001 within the framework of the U.S.-Japan Economic Partnership for Growth. The Initiative seeks to enhance the investment climate in both countries and to implement activities to facilitate FDI. Issues related to improving the investment climate in the United States raised by Japan include visa problems and the Exon-Florio/CFIUS review process. Public outreach activities under the Initiative include investment seminars held in various cities of both countries.

Below the national level, states continue to woo Japanese foreign investment through their offices in Tokyo, while localities tout the opening of Japanese production facilities. A high profile recent example is the 2006 opening of a \$1.3 billion Toyota production facility in San Antonio, Texas.⁴⁸ Statements of the chairperson of the San Antonio Chamber of Commerce indicate that the local hosts were anxious to accommodate the needs of Toyota and ensure that Toyota remained satisfied with its location decision.⁴⁹ As one of the world's premiere companies, Toyota may be exceptional, but the case indicates that high quality foreign affiliates enjoy a buyers' market in the United States with respect to their location decisions.

Thus, from a long-range perspective, despite considerable early frictions, the U.S. not only remains open to Japanese foreign investment, but the climate at both the national and local levels could even be described as welcoming. The frictions of the 1980s have given way to a much calmer investment relationship characterized by emphasis on economic issues as opposed to political, cultural or national security concerns.

E. Possible lessons for China

Is the U.S. ready for FDI from China? Perhaps from the perspective of Japan's experience in the 1980s, the inquiry should be recast as a three-part question: First, have circumstances changed sufficiently to expect that a spike in Chinese FDI will create fewer frictions than was the case two decades ago with Japanese? Second, are Chinese

⁴⁸ See http://www.sachamber.org/councils/ecodev/toyota/toyota_overview.php.

⁴⁹ http://www.sachamber.org/councils/ecodev/toyota/SA_to_Toyota_Trip_Report_062603.PDF.

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firms prepared to help defuse the tensions that will inevitably arise out of a major influx of Chinese investment? Third, can we expect eventual normalization/maturation of investment relations between the United States and China?

As to the first question, nothing in the review of U.S. reactions to the boom in Japanese FDI suggests that the experience will not be repeated in the case of another formidable East Asian nation, particularly one that does not share many of the strategic, political and military common interests with the U.S. that muted and cabined the investment friction vis-à-vis Japan. Congress appears ready to play the “threat” card in respect of China at every opportunity, and large trade imbalances always create tempting targets for politicians. Moreover, it is easier for the media to report on trade wars, exchange rate controversies and political or human rights abuses in China than to undertake a nuanced assessment of the U.S.-China economic relationship. It might fairly be asked whether the attitudes of the U.S. public and its political leadership have been tempered by the Japanese experience so that the next time around — with China — will be smoother. My own inclination is to conclude that any possible tempering effect will be offset by the fact that China is a potential adversary of the U.S. on many levels, which will heighten suspicions of Chinese motives and exacerbate cultural misperceptions or racist undertones to the debate. Certainly it will not help that any forthcoming boom in Chinese FDI will follow massive media attention to Chinese product safety problems, a difficulty the Japanese did not face by the time investment flows into the U.S. increased significantly. Another possibility is that Chinese FDI will be so qualitatively different from that of Japan in the 1980s that it will prove less politically and culturally sensitive. While some preliminary evidence might be interpreted as suggesting that Chinese FDI will prove to be different,⁵⁰ it is useful to bear in mind that patterns of Japanese FDI ultimately followed the theoretical models very closely, despite predictions that it would be distinctive and uniquely uncontroversial.

Thus, my rather pessimistic bottom line conclusion to the first question, supported by FDI theory and the many background parallels between the Japanese and Chinese situations, is that history will repeat itself. Chinese firms will find many of the same motivations as the Japanese for a rapid expansion of U.S.-directed FDI, and that surge — which will take place against a similar background of trade and exchange rate friction and charges of unfair business practices — will generate frictions at the national level very similar to those we experienced two decades ago with Japan.

How might Chinese firms mitigate these forthcoming frictions? Here the Japanese experience offers a potentially more optimistic road map for China. Economic equivalence aside, greenfield investment is a less politically sensitive mode of entry than mergers and acquisitions. To the extent feasible, greenfield investments should be promoted and acquisitions — particularly unsolicited bids and deals involving aggressive tactics — should be avoided. Perhaps investments through sovereign wealth funds may also

⁵⁰ For example, it might be argued that non-controlling investments through a Chinese sovereign wealth fund will be less controversial than outright acquisitions by state owned enterprises or even private Chinese firms. And it might plausibly be argued that Chinese firms are likely to avoid high-profile cultural irritants such as the purchase of Pebble Beach Golf Course by a Japanese investor in the 1980s, simply because such investments have little strategic value to the Chinese economy.



prove to be less politically sensitive than outright acquisitions of U.S. corporations or assets. (China Investment Corporation's equity stakes in U.S. investment banks following the subprime mortgage crisis is one example.) But it is too early to reach this conclusion firmly, particularly since sovereign wealth funds have begun to draw negative attention about their nontransparency and potential for politically motivated investments. Acquisitions should include measures to assuage public concern over transfer of sensitive technology or predatory investment practices. On this point, it is instructive to note that, in spite of such measures, Huawei's joint bid with Bain Capital for 3Com was withdrawn in early 2008 because it could not clear the CFIUS review process.

Regardless of mode of entry into the U.S., it will be important for Chinese affiliates to integrate quickly and deeply into local communities and to demonstrate their good corporate citizenship and respect for the U.S. legal and market processes.⁵¹ Scrupulous attention should be paid to avoiding even the appearance of employment discrimination or mistreatment of employees. Chinese affiliates should adopt best practices of corporate governance and appoint prominent and knowledgeable Americans as independent directors. Philanthropic activities should be undertaken where possible. Lobbying efforts should be low-key and pursued through collective organizations such as OFII rather than on behalf of individual Chinese firms or interests. Efforts should be made to create good relations with state and local governments in the areas in which Chinese affiliates are located or consider locating. Private-level diplomacy should be assiduously pursued through existing or new forums for discussion and debate between U.S. and Chinese business people. Whenever feasible, policy makers, academics and members of the media should be included in these forums to increase information flow and reduce cultural distance between the two countries. The U.S.-China Business Council is certainly an important start in this regard, but to date the number and penetration of

⁵¹ Toyota, one of the largest and most successful Japanese foreign investors in the United States, is widely viewed as a “great corporate citizen” by the communities in which it has invested. See, e.g., the report of a study tour of Toyota's Indiana plant, available at http://www.sachamber.org/councils/ecodev/toyota/SA_to_Toyota_Trip_Report_062603.PDF.

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such organizations across the country is far lower than those of counterpart organizations for U.S.-Japan business relations.

Whether Chinese affiliates and their political supporters in China are prepared to undertake these steps remains to be seen. Several questions deserve attention by those concerned about China's readiness for large-scale FDI in the United States. For example, will Chinese firms have sufficient political leeway to undertake the sort of integration into U.S. communities and business associations that proved helpful to Japanese firms? Chinese firms are accustomed to receiving direction and guidance from political authorities, in Beijing or elsewhere.⁵² Will Chinese executives have sufficient autonomy to respond flexibly to local conditions in the United States? Can Chinese firms effectively lobby policymakers in Washington without triggering a backlash of criticism that agents of a communist regime are infiltrating the U.S. political process? Will Chinese corporate governance practices in the United States be significantly better than those practiced domestically, or will the problems (or at least perception) of poor disclosure, corruption and insider dealings follow Chinese firms to the U.S.? Will the stigma of low or even dangerous quality that currently attaches to Chinese products exacerbate negative public reaction to Chinese FDI? Will Chinese firms (and their political managers) resist the temptation to acquire high profile or sensitive assets in the United States that will enflame public opinion?

These questions are impossible to answer at this stage because they remain largely hypothetical. But Japan's experience suggests that Chinese executives and political leaders would do well to focus on these important questions as they contemplate investments in the United States.

From a long-term perspective, the Japanese experience in the United States should provide some grounds for optimism to Chinese investors. Despite the turbulence of the early boom years in Japanese FDI, today Japanese affiliates operate and thrive in the United States, while engendering virtually no political or media controversy. Thus, while the duration of the process may depend heavily on how well Chinese affiliates adapt to the U.S. environment, Chinese investors can look forward to eventual normalization of the investment relationship.

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⁵² For example, the General Chamber of Commerce of China in the United States is directed by the Chinese consulates in the U.S.

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