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The impact of affinity on world economic integration: The case of Japanese foreign direct investment

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ABSTRACT

This paper finds that a country's affinity with a foreign country has a positive effect on foreign direct investment flows from it to that country, by analyzing Japanese foreign direct investment outflows during the period of 1995–2009. A rise in a country's affinity with a foreign country is thought to enhance its trust in that country and as a result lower the transaction costs of its economic activities with it, thereby helping to promote its foreign direct investment flows to the country. These findings imply that a rise in affinity among countries is likely to facilitate international economic integration.

1. Introduction

International economic integration, or globalization, has intensified greatly in several ways over the past decades. One increasingly salient dimension of this trend is foreign direct investment (FDI).[1] The total volume of global FDI inflows has increased rapidly since the late 1980s especially—growing about 38 times from 55.8 billion dollars in 1985 to 2.1 trillion dollars in 2007. FDI is widely, if not universally, assessed as providing significant economic benefits for the host countries, contributing to their growth through provision of external financing, job creation, technology transfer, etc. A number of countries have adopted diverse policies to attract more FDI, as an important economic development strategy.

What factors determine the locations of FDI? To which countries do more FDI flow? This research addresses these questions as a way of identifying factors affecting the degree of world economic integration. The existing literature on FDI presents diverse factors as significant determinants of FDI location. Economic conditions in the host countries have been traditionally pointed to as the main factors affecting FDI flows, among them those related to market potential, production costs, business operation environment, etc. Host country political conditions have also attracted growing attention. Although this is at times controversial, a good number of studies argue that certain specific political characteristics, such as political stability and political regime type, have significant effects on FDI inflows.

In contrast to such studies, this paper seeks to demonstrate that psychological factors also affect FDI flows substantially. In particular, it argues that one country's affinity (sense of closeness or the positive sentiment of its population) with another country positively impacts its FDI flows to that country, by analyzing the influence of Japanese affinity with foreign countries on Japanese FDI outflows during the years from 1995 to 2009. The mechanism through which affinity affects FDI flows is supposed to be as follows: a rise in one party's affinity with a potential business partner is likely to increase its trust in that partner; this increase in trust is likely to then lower the transaction costs of its economic activities with that partner, in turn boosting the volume of those activities. The findings suggest that increases in affinity among countries may facilitate world economic integration, or economic globalization.

This paper is organized as follows. It first briefly reviews the literature on the determinants of FDI location, and then develops its main argument regarding the impact of affinity on FDI flows. It next discusses the research design of its empirical analysis, after

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[1] A common definition of FDI is "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)" (UNCTAD, 2008, p. 249).

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which it reviews the results of this analysis. In the final section, it discusses the implications and the limitations of its findings.

2. Affinity, trust, and transaction costs

Existing research on FDI has presented diverse factors as important determinants of FDI location. First of all, economic conditions in host countries are generally regarded as salient factors affecting FDI inflows to them.[2] Among these conditions, market-related factors, especially market size, are most frequently indicated as important (e.g., Gastanaga et al., 1998; Lipsey, 1999; Schneider and Frey, 1985). Other host country economic conditions, such as labor costs, tax rates, openness, trade barriers, etc., have been widely studied as factors affecting FDI flows as well, although empirical findings as to their effects are quite inconclusive (e.g., Asiedu, 2002; Billington, 1999; Blonigen, 2002; Culem, 1988; Devereux and Freeman, 1995; Edwards, 1990; Ekholm et al., 2003; Mudambi, 1995; Lunn, 1980; Tsai, 1994; Wheeler and Mody, 1992).

Some political factors have also been analyzed by several studies, mainly in the international political economy field. Political instability is one such variable that many have traditionally addressed (e.g., Büthe and Milner, 2008; Li and Resnick, 2003; Trevino et al., 2002; Tuman and Emmert, 2004). A growing number of studies have paid attention to the effects of political regime type on FDI inflows as well, presenting conflicting theories and empirical findings on the effects of democratic and authoritarian institutions on FDI inflows (e.g., Büthe and Milner, 2008; Feng, 2001; Jakobsen and Soysa, 2006; Jensen, 2003; Jessup, 1999; Li and Resnick, 2003; O'Donnell, 1978; Oneal, 1994; Resnick, 2001).

There could conceivably be other important FDI location determinants, however. This paper focuses on a psychological one, affinity, arguing that a country's affinity with a foreign country positively affects its FDI flows to that country. And there are in fact a group of studies, especially in the international business literature, that address the impact of psychological factors on FDI flows (e.g., Ghemawat, 2001; Habib and Zurawicki, 2002; Johanson and Vahlne, 1977, 1990; Johanson and Wiedersheim-Paul, 1975; Kogut and Singh, 1988; Li and Guisinger, 1992; Loree and Guisinger, 1995).[3] They examine "psychic distance" (the perceived distance between the home and a foreign country, stemming from differences in culture, economy, politics, etc.), or focus more narrowly on "cultural distance" only. They argue that psychic or cultural distance between the home and a foreign country has a negative impact on FDI flows between them. These studies tend not to *directly* address psychological *distance* between the home and a foreign country per se, however, but instead *indirectly* consider their *differences* in culture, economic development, political system, etc. Such differences may affect psychological distance, but whether they necessarily always do so seems debatable. In contrast to such studies, therefore, this paper deals directly with the impact of psychological distance on FDI flows, by explicitly addressing one country's affinity with foreign countries.

A country's affinity with a foreign country is thought to affect its FDI flows to that country through the following mechanism. Firstly, given that social relations are primarily accountable for the generation of trust in economic life (Granovetter, 1985), and that affinity strengthens social relations by fostering a sense of closeness (Moreland and Beach, 1992), it may be reasonable to expect a positive relationship between one's affinity with a counterparty and one's trust in her or him. When one's affinity with others increases, one's trust in them is therefore also likely to grow. Conversely, when one's feeling of closeness to others declines, trust in them will likely follow.[4] Trust in economic relationships is a valuable asset that lowers transaction costs in a number of ways. For example, where high trust between firms exists they will be confident of a fair division of the payoffs on their cooperative business activities, and feel less need for heavy investment in *ex ante* bargaining. Their negotiations may in addition be more efficient, owing to their confidence that information provided by their partners is not misrepresented. *Ex ante* contracting costs will decline as a result. Trust may reduce *ex post* contracting costs as well, as firms' trust in their partners will lead them to devote fewer resources to contract monitoring and enforcement, or to *ex post* bargaining and haggling over problems emerging in the course of the actual transacting (Boersma et al., 2003; Dyer and Chu, 2003). Given that transaction costs have a great impact on economic efficiency, their lowering can affect economic activities significantly (North, 1990).[5] Such functions of affinity in business activities may be of particular significance for FDI, given its objective of obtaining lasting interest, implying therewith a long-term relationship between the investor and the host country.

There are indeed statistical studies whose findings support such a positive relationship between trust and low transaction costs. den Butter and Mosch (2003), for example, show that trust between trading partners significantly enhances trade by lowering transaction costs. Guiso et al. (2004) meanwhile demonstrate that increased trust of importers toward exporters boosts exports in European countries, while Dyer and Chu (2003) find an inverse relationship between trust and transaction costs in their analysis of supplier-automaker exchange relationships in the United States, Japan and South Korea. There is empirical research indicating a significant positive relationship between affinity and business activities as well. Noland (2005a), for instance, shows a significant positive impact of the attitude of the US public toward foreign countries on the volume of US trade, while also (2005b) finding that countries with more favorable views of globalization attract more FDI inflows.

I thus argue that a country's affinity with a foreign country is likely to promote its economic activities with that country, through the channels of an increase in its trust in the country and the resulting decrease in the transaction costs of its economic activities with it. This argument yields the following testable hypothesis regarding FDI flows, all other things being equal:

Hypothesis. The higher a country's affinity with a foreign country, the more likely its FDI is to flow to that country.

3. Data and methodology

To test this hypothesis, I conduct a statistical analysis of Japanese FDI outflows to twelve countries during the period of 1995–2009. The countries are Australia, China, France, Germany, India, Indonesia, New Zealand, Russia, South Korea, Thailand, the United Kingdom, and the United States. They were selected based on the availability of data concerning Japanese affinity with them, while the period of observation was chosen in consideration of Japanese FDI data continuity.[6]

[2] For a good review of the literature on economic determinants of FDI location, see Blonigen (2005). For a typical economic analysis of FDI also see Dunning (1977, 1979, 1980), who has introduced the "eclectic" or "OLI" paradigm in analyzing FDI.

[3] For a review of this literature see Kirkman et al. (2006).

[4] The formation of affinity may be influenced by diverse factors, such as cultural closeness, political ideology, economic reputation, etc. However, study of the sources of affinity is beyond the coverage of this paper, which focuses only on the effects of affinity on economic behavior, in particular on FDI flows.

[5] North (1990) estimates that as much as 35–40 percent of the costs associated with economic activities may be accounted for by transaction costs.

[6] The Japanese FDI data used in this study does not have strict continuity before 1995, due to changes in the dollar conversion method used and the definition of FDI.