Is There a Liability of Japaneseness in Least Developed and Developing Economies: A Study of the Japanese FDI in The Middle East and Africa

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Abstract
Given the insularity of Japan and its institutional, economic and cultural framework uniqueness, we postulate the hypothesis that the *''liability of Japaneseness''* will likely hinder the Japanese firms' ability to internationalize in settings drastically different from those found in Japan.

An econometric analysis of the host countries' economic, institutional, cultural and experiential variables was carried out in this paper to assess their impact on the Japanese Foreign Direct Investments inflows. Using the gravity equation of trade, we estimate to which extent the Economic Distance, the Economic Freedom Distance, the Cultural Distance, and the Experiential Learning Effect (main variables) impact the Japanese outbound FDIs in 31 least developed and developing countries (LDDCs) of the Middle East and Africa between 2003 and 2012.

Results suggest that the Economic Distance and the Economic Freedom Distance have negative impacts on the Japanese FDIs inflows in these countries. The Cultural Distance did not show notable negative impacts on the Japanese FDIs levels in these countries. Contrary to previous research findings, host country experience did not show any significance in the increase of JFDIs inflows over time contradicting the Japanese experiential learning argument in these two regions (unlike in developed markets).

Confirming previous research findings, control variables such as the natural resource endowment of the host country did not show empirical support nor did the geographic distance or the openness of a country to FDIs.

Keywords: Japanese Foreign Direct Investments, FDI, The Middle and Africa, The Liability of Japaneseness.

Introduction

Previous research on FDI and institutions were mainly focused on studying the impact of good institutions on FDI inflows (Bénassy-Quéré, Coupet & Mayer, 2007). However and until recently, the impact of the institutional and economic distances (differences) between the source country and the host country of investment have received little attention in the FDI literature. Cultural or psychic distance in the other hand received a broader attention from the international business scholars.

Recent attempts such as Demirbag et al.,(2011), Tsang & Yip (2007) empirically studying two key concepts of the new institutional economics, namely the economic distance and the economic freedom distance showed promising results in terms of explaining the survival rate of companies in distant settings from the firm's home market.

We build the following hypothesis on the argument that differences in terms of economic development, quality of institutions and cultural values between the home and the host market will likely have an important impact on the FDIs. The notion of distance could be particularly salient in the context of Japanese firms, given the insularity of Japan and its unique institutional, economic and cultural framework. We postulate therefore the hypothesis that what we call in this article the *'liability of japaneseness'* will likely hinder the Japanese firms' ability to internationalize in settings drastically different from those found in Japan. The *liability of japaneseness* could be defined as a set of institutional, economic, organizational and psychological barriers impeding the Japanese companies' adaptation process to Developing and Least Developed Economies (DLDEs) characterized by extreme business environments.

The overall objective of this research is to test whether the liability of Japaneseness will deter the Japanese companies from investing in the DLDEs of the Middle East and Africa, and also investigate the Japanese FDIs determinants in these regions of the globe.

Hypothesis development

Hypothesis 1: *The higher the economic distance between Japan and the host country, the less FDIs are expected to occur*

Hypothesis 2: *The higher the Economic Freedom Distance between Japan and the host country, the less FDIs are expected to occur because of higher institutional hazard*

Hypothesis 3: *The higher the Cultural Distance between Japan and the host country, the less FDIs are expected to occur*

Hypothesis 4: *the more experience a Japanese Foreign Investor will accumulate in a country, the more it will further invest in that country*

Hypothesis 5: *the farther the host of FDI is from Japan, the less FDI are expected to occur due to the high transaction cost incurred with the increasing distance*

Hypothesis 6: *Population is expected to have a positive impact on Japanese FDIs providing more market opportunities*

Hypothesis 7: *The natural resources endowment of a country is expected to attract more Japanese FDIs for strategic resources seeking reasons*

Hypothesis 8: *Market openness will have a positive impact on Japanese FDI providing an open and market economy investment opportunities*

Hypothesis 9: *Economic instability will deter Japanese investments because of the risk avoidance characteristics of the Japanese firms*

Hypothesis 10: *Political instability will deter Japanese investments because of the risk avoidance characteristics of the Japanese firms*

Variables description, operationalization and expected signs

Table 1: The determinants of Japanese's FDI

Variables	**Explanation**	**Type of variable**	**Expected Sign**	**Data Source**
FDI	Annual Japan's outward FDI flows to host country	Dependent Variable	n/a	Japanese Ministry of Finance and JETRO
Economic Distance (ED)	Difference in level of development between Japan and country I: Calculated as LN (GDP PC*j*) – LN (GDP PC*i*)	Independent variable	-	World Bank Development Indicators following Tsang & Yip, 2007; Demirbag et al., 2011
Economic Freedom Distance (EFD)	Difference in the economic freedom (EF) between Japan and country I: Calculated as LN (EF*j*) – LN (EF*i*)	Independent variable	-	Wall Street Journal Economic Freedom of countries index: 0 lowest, 100 Highest; following Demirbag et al., 2011

Experience (Exp)	Experience in number of years of operations since the first recorded investment occurred	Independent variable	+	JETRO
Cultural Distance (CD)	Difference in national culture between Japan and country I	Independent variable	-	Adapted from Voyer and Beamish, Hotsfede/Kogut and Sigh: 1 closest, 12 farthest
Geographic Distance (GeoDis)	Distance in KM between Tokyo and The Capital City of Country I	Control variable	-	Geobytes
Natural Resources (NatRes)	Endowment Of country I in Natural Resources	Control variable	+	World Bank Development Indicators
Population (Pop)	Population by country (market size)	Control variable	+	World Bank Development Indicators
FDI Openness (Open)	Openness of country I to inward FDI	Control variable	+	World Bank Development Indicators
Inflation (Inf)	Inflation rate per country	Control variable	-	World Bank
RISK (Risk)	Political, economic and financial risk of country I	Control variable	-	The PRS group indicators for international country risk

Data and sample

We test our hypothesis on a database retrieved from the Japanese Ministry of Finance and the Japan External Trade Organization (JETRO) pertaining to the recorded Japanese Outward Foreign Direct Investments worldwide between 2003 and 2012. The sample is derived from 9 annual reports between 2004 and 2012 from the Japanese Ministry of Finance complemented with two databases from the JETRO in the period 1964-2004 and 2005-2013.

It is worth noting that we removed from the final sample countries that offered during the period under study abnormal investment conditions; namely countries considered by the OECD or equivalent organisms as Tax Heavens. Hence, Seychelles, Mauritius, Liberia and Iraq were removed from our final sample. Iraq was also removed because although it had Japanese FDI stocks before 2002, in the period under study, it had no significant recorded Japanese FDI flows.

The final sample was comprised of 31 developing and Least Developed countries in the Middle East and Africa. These are all the countries in the area where Japan had significant FDIs during the past 10 years (2003-2012):

Algeria, Cameroon, Egypt, Ghana, Kenya, Libya, Madagascar, Mauritania, Morocco, Mozambique, Namibia, Niger, Nigeria, Senegal, South Africa, Tanzania, Tunisia, Uganda, Zambia, Bahrain, Iran, Jordan, Kuwait, Oman, Pakistan, Qatar, Saudi Arabia, Syria, Turkey, United Arab Emirates.

Empirical specification

Based on the above discussion and previous empirical studies, we use a log linearized form of the gravity equation. The Gravity Equation is the most widely used model in economics to assess product, services and financial flows between countries. It allows to accurately predicting trade flows between two nations. The flows of product and services according to this model are likely to gravitate around countries with stronger pulling forces, just like gravity forces (Anderson, 1979; Bergstrand, 1985; Bergstrand, 1989; Helpman & Krugman, 1985).

Following previous empirical research methodology on FDI, the data was transformed into natural logarithm as non-linearities in the relationships is expected (e.g. Buckley 2007).

Log Linear Empirical specification:

$$LN(FDI) = \alpha 1 + \beta 1\ LN(ED) + \beta 2\ LN(EFD) + \beta 3\ LN(CD) + \beta 4\ LN(EXP) + \beta 5\ LN(GeoDis) + \beta 6\ LN(Pop) + \beta 7\ LN(Nat.Res) + \beta 8\ LN(Open) + \beta 9\ LN\ (Risk) + \beta 10\ LN\ (Infl) + \varepsilon i$$

Since some observations included negative values and 0 pairs, transformation to Natural Logarithm was impossible to perform; We had to apply first the following formula to the dependent variable (FDI annual flows) before transformation[1]:

[1] Busse, M., & Hefeker, C. (2007). Political risk, institutions and foreign direct investment. European journal of political economy, 23(2), 397-415.

$y = \ln (x+\sqrt{(x^2+1)})$

Estimation method

Ordinary Least Square (OLS) was used to estimate the model. Regressions were run using STATA 13. Regression 1 in table 2 reports the results on the 31 countries, while regressions 2 and 3 were run respectively by splitting the main sample into 2 sub-samples separating the Middle East/North African (MENA) regions from the Sub-Saharan Africa regions. We separated these two groups of countries because the MENA region is likely to exhibit stark differences with the Sub Saharian African region because of Social, cultural, economic, historical, language and religious reasons.

Table 2: Regressions' results

Variables	(Regression 1) Ln (FDI)	(Regression 2) Ln (FDI) MENA	(Regression 3) Ln (FDI) Sub- Saharan Africa
Ln (ED)	-0.554**	-0.540	-1.050***
	(0.225)	(0.369)	(0.323)
Ln (EFD)	-3.381***	-3.631*	-3.380
	(1.212)	(1.989)	(2.194)
Ln(CD)	-4.041	-4.338	-12.21*
	(2.395)	(2.539)	(6.122)
Ln (Exp)	-0.158	-0.292	0.294
	(0.191)	(0.432)	(0.543)
Ln (GeoDis)	0.738	0.252	-6.596*
	(1.308)	(1.995)	(3.087)
Ln (Pop)	0.782***	0.959**	0.255
	(0.243)	(0.368)	(0.150)
Ln (NatRes)	0.105	0.340	0.101
	(0.146)	(0.239)	(0.204)
Ln (Open)	0.110	0.206	-0.0136

	(0.116)	(0.140)	(0.186)
Ln (Inf)	0.0236	0.00952	-0.0410
	(0.140)	(0.228)	(0.146)
Ln (Risk)	-0.413	0.144	-1.370
	(0.912)	(2.794)	(0.892)
Constant	2.578	7.253	91.35***
	(11.49)	(18.11)	(29.65)
Observations	300	170	130
R-squared	0.224	0.211	0.356

Robust standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Table 3: Correlation matrix

	LN(FDI)	*LN(ED)*	*LN(EFD)*	*LN(CD)*	*LN(Exp)*	*LN(GeoDis)*	*LN(Pop)*	*LN(NatRes)*	*LN(Open)*	*LN(Inf)*	*LN(Risk)*
LN(FDI)	1										
LN(ED)	-0.22858	1									
LN(EFD)	-0.12436	0.23906	1								
LN(CD)	-0.36419	0.596033	0.210681	1							
LN(Exp)	0.146352	-0.01663	-0.28869	-0.20399	1						
LN(GeoDis)	-0.19386	0.56502	0.133503	0.576239	-0.21133	1					
LN(Pop)	0.18258	0.503595	0.348764	-0.03643	0.287663	0.071527	1				
LN(NatRes)	0.069123	-0.44109	0.177408	-0.05299	-0.11174	-0.29154	-0.2140745	1			
LN(Open)	-0.02887	0.196771	-0.00965	0.139913	-0.01999	0.19939	-0.0517976	-0.1364736	1		
LN(Inf)	0.07889	0.202973	0.140099	-0.0596	0.1147	0.009013	0.3449135	0.00335119	0.145445	1	
LN(Risk)	0.132421	-0.64714	-0.38391	-0.46136	0.102285	-0.54723	-0.3936874	0.04981964	-0.02601	-0.08138	1

Discussion

Hypothesis 1 regarding the impact of the economic distance on Japanese FDIs was found significant (at the p<0.01 and p<0.05 levels) and negatively signed across regressions 1 and 3 (table 2) and was therefore accepted. The economic distance between Japan and the host country of investment seem to play an important role in the investment decision made by Japanese foreign investors. The higher the economic distance between Japan and the host country of investment, the less outbound FDIs will occur.

Regarding hypothesis 2, economic freedom distance shows significance across 2 regressions with a negative sign. We therefore accept hypothesis 2 and deduce that economic freedom distance is an important factor in the FDI allocation decision for Japanese corporations. Countries with low economic freedom will deter Japanese investments. Regarding the Sub-Saharan Africa sample, the reason why it was not found significant is because these countries exhibit very low overall levels of economic freedom not allowing for an accurate measurement. Hypothesis 2 was therefore accepted.

As for Hypothesis 3 pertaining to the Japanese FDI and cultural distance, it showed significance only across one regressions out of 3. Hypothesis 3 was not therefore accepted. The cultural difference per se does not seem to play a determinant role in Japanese FDIs decision in the Middle East and African region; but rather, the overall economic development and institutional quality of the host country have a more important impact on the investment decision made by Japanese operators.

Hypothesis 4 is probably the most streaking one as it contradicts most of the literature on Japanese firms, both in the international business and knowledge management field. While we were expecting that experience and learning would be a factor that allows the increase of Japanese FDI overtime, all the regressions carried out did not reach the significance levels. Japanese firms in the Middle East and Africa do not seem to increase their investments over time by increasing country specific knowledge. These results starkly contradict previous research findings that states that Japanese firm learn and incrementally increase their commitment while investing in a country. This might stem from the Japanese risk aversion and tendency to avoid private and institutional risk.

Regarding the control variables, only population was found significant. The absolute size of the market seems to influence the Japanese FDI allocation decision. Large markets seem to attract Japanese firms confirming the market seeking internationalization argument found in previous literature. This allows accepting hypothesis 6.

Conversely, geographic distance, natural resource endowment, FDI openness, inflation, and overall country risk do not seem to influence positively or negatively Japanese FDIs. These results are in line with previous literature on Japanese FDI and allow therefore to reject hypothesis 5, 7, 8, 9 and 10. Japanese firm do not favor countries with high endowment in terms of natural resource. This finding is quite counterintuitive given the scarcity of natural resources in Japan.

Conclusion

The empirical analysis results from this article indicate that among the main independent variable used in the model, the Economic Distance (ED) and the Economic Freedom Distance have a strong negative impact on the Japanese FDIs' decision. Both the overall economic development level of a host market and the quality of institutions will severely hinder the Japanese ability to invest in a country.

These two findings tend to confirm the *Liability of Japanese* argument put forward in our research. Japanese firms because of their unique economic and institutional framework will refrain from investing in settings drastically different from those found in Japan.

The cultural difference argument however does not find empirical support. That is, Japanese investors will be hindered by the Economic Distance and the Economic Freedom distance but not much so by the cultural distance. The cultural difference on its own does not deter the Japanese investors from investing in a country.

The Experiential Learning variable results are probably the most important finding of this article. Contradicting previous research on the 1) Japanese gradual internationalization process following the Upssala model; 2) And to some extent the knowledge creation (and use) theory put forward by Nonaka & Takeuchi (1995). In the context of developing and least developed countries knowledge operations, Japanese firms do not seem to exhibit any sort of absorptive capacities or experiential learning over time regarding how to operate in difficult business setting. Although Japanese firms started investing as early as in the 1960s in the Middle East and Africa, they do not seem to put into use this long experience to increase their commitment.

This might stem from the lack of global mindset and the notorious risk avoidance (aversion) that are deeply rooted in the Japanese corporate culture, and in the Japanese society in a more general manner. These could also be explained by the fact that the Japanese society in general, views Africa and the Middle East as very far away, exotic, and often unsafe places.

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