The Competitive Advantage of Nations

By Kojima Akira

The World Competitiveness Yearbook 2002, released by the International Institute for Management Development (IMD) in April listed the United States as the most competitive economy in the world, as in the previous year, followed by Finland in second place. (Figure 1) Japan tumbled further to 30th place from 26th in 2001, with China close behind in the 31st spot, up from 33rd.

The Swiss business school based in Lausanne has issued the annual report since 1989 to rank the competitiveness of now 49 industrialized and emerging economies. It is based on 314 different criteria and on hard data from international organizations and countries concerned as well as opinion surveys of corporate leaders and knowledgeable persons.

IMD's 1991 report ranked Japan as by far the most competitive country, followed by the United States in second place and the just unified Germany in the third spot among the members of the Organization for Economic Cooperation and Development. The year 1991 marked the beginning of the collapse of Japan's bubble economy, which had reached its peak in the late 1980s. It also marked the start of the longest economic expansion for the United States, which pulled itself out of its worst period after prolonged stagnation.

The year also witnessed the outbreak of the Gulf War, in which U.S.-led multilateral forces scored a resounding victory over Iraq, as well as the disintegration of the Soviet Union, which put an end to the Cold War that shaped the world in the latter half of the 20th century.

Though the bubble had burst, Japan still retained the legacy of its strength and talk about the Japanese economic threat was still going around.

The World Economic Forum of Switzerland, which sponsors the Davos Conference, has annually released similar rankings on global competitiveness containing almost the same data.

Countries of the world are increasingly interested in this kind of comparison of competitiveness, as the global economy continues drastic changes at an unprecedented pace and the division of labor in the global economy also undergoes dynamic changes, amid the cyclical ups and downs of individual economies.

Since the end of the Cold War, the world is trying to introduce a system under which "competitiveness" is ensured. It seems as if countries are engaging in mega-competition in reforming their systems. In many countries, competitiveness is becoming the catchword for their economies and system reforms.

Competitiveness has become a global catchword for two reasons. Firstly, as the Cold War ended in the form of the collapse of the socialistic economic system, countries became aware of the fact that their success or failure depend on their choice of system. Secondly, the days are gone when a country's competitiveness is automatically determined, or granted, through the division of resources including production resources, as the world has entered a new era when countries' competitiveness depends on their creativity based on the systems they introduce.

The title of this article was borrowed from that of a major work written in 1990 by Michael E. Porter, a professor at Harvard Business School who is hailed as a genius in business strategy.

In his *The Competitive Advantage of Nations*, Porter argued that rich production resources could cut a country's competitive edge rather than enhance it.

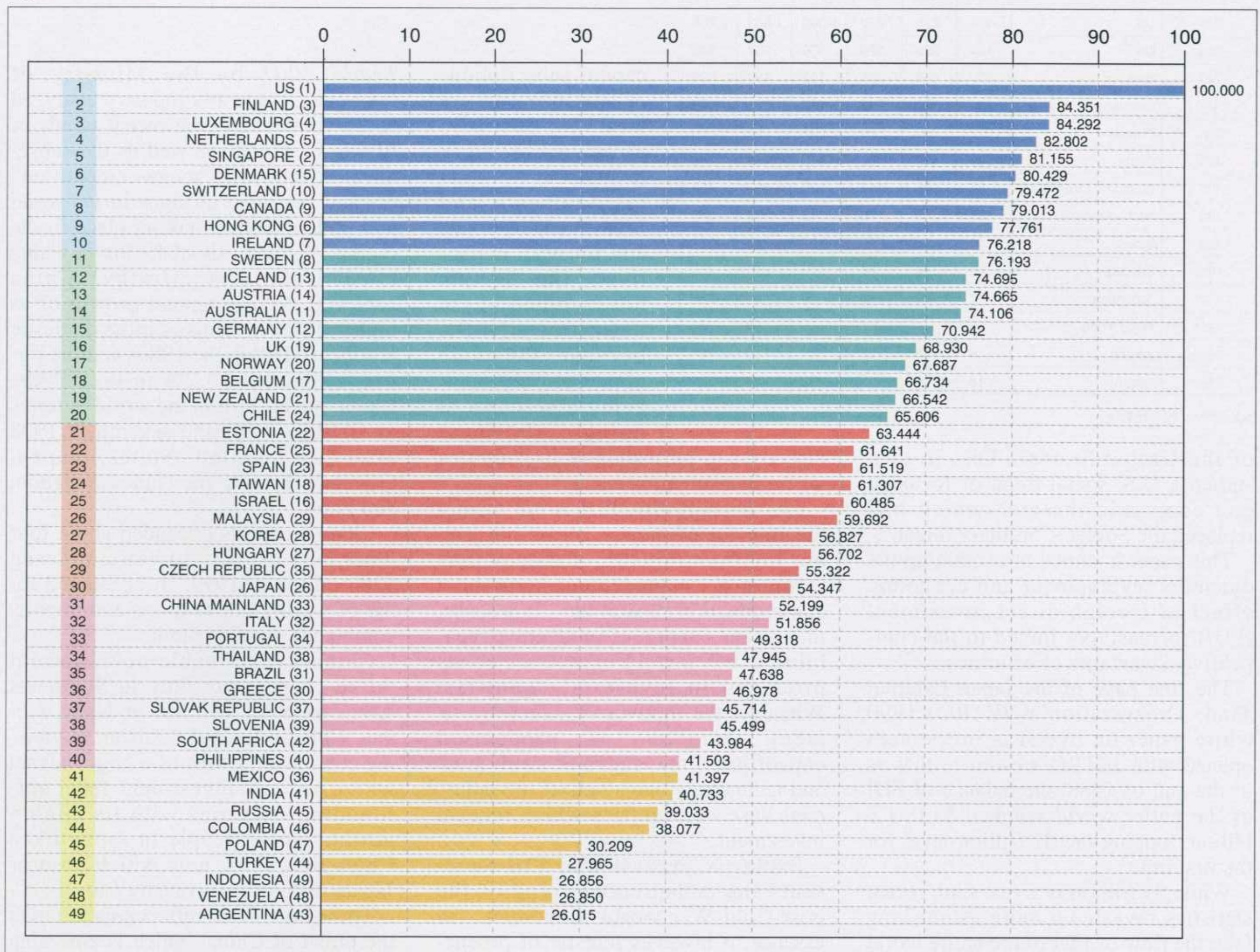
He said, "The standard theory of trade rests on factors of production. According to the theory, nations are endowed with differing stocks of factors. A nation will export those goods which make intensive use of the factors with which it is relatively well endowed ... But the role of factors is different and far more complex than is often understood. The factors most important to competitive advantage in most industries, especially the industries most vital to productivity growth in advanced economies, are not inherited but are created within a nation, through processes that differ widely across nations and among industries. Thus, the stock of factors at any particular time is less important than the rate at which they are created, upgraded, and made more specialized to particular industries. More surprising, perhaps, is that an abundance of factors may undermine instead of enhance competitive advantage."

As an example of "most surprising" event, I can recall how Japanese industries, particularly the auto industry, responded to the oil crisis in the 1970s. Japan has virtually no domestic petroleum resources. This fact motivated the Japanese auto industry to develop the world's most energy-efficient engine, light and super-strong steel plate and extremely strong plastic materials, through technological innovations. As a result, the Japanese auto industry further boosted its competitiveness and remarkably expanded its share in the auto export market.

On the other hand, rich petroleum resources in the United States and the U.S. government's restraints of rising oil prices at the time of the first oil shock deprived the U.S. auto industry of the incentive to develop a highly efficient engine.

Porter, who participates in the analytical work for the World Economic Forum's competitiveness comparison, says "Competitiveness is the most important economic issue in the world today. For that reason, understanding,

Figure 1 The World Competitiveness Scoreboard 2002



Note: 2001 rankings are in brackets
Source: *The World Competitiveness Yearbook*, IMD

creating, and sustaining competitiveness is a fundamental task for responsible company managers and government officials at any level."

Looking back on his past experience, Porter admits, "Although I was intensely interested in international competition, I had not paid much attention to the role of government in the equation. That began to change in the mid-1980s, when U.S. President Ronald Reagan appointed me to serve on the President's Commission on Industrial Competitiveness."

As soon as he became a member of the panel, he started studies on industries of major countries. For his studies, he chose 10 countries that had different features and whose combined exports accounted for half of the world total. More than 30 researchers joined in his studies, which covered Germany, Denmark, Japan, South Korea, Italy, Singapore, the United Kingdom, the United States, Switzerland and Sweden. The studies culminated in his *The Competitive Advantage of Nations*.

Incidentally, Porter's major work was preceded by *Made in America*, a book written by Robert M. Solow and other scholars of the Massachusetts Institute of Technology (MIT), which similarly discussed competitiveness. More than 10 specialists in biology, electrical engineering, computer science, atomic engineering, political science and other fields participated in the research and studies for the book. It was the first research project in which MIT specialists from such a wide variety of fields worked together. They were concerned about the weakening of the competitiveness of U.S. industries and tried to reform the United States by themselves at a time when a wide sector of American society was talking about the Japanese economic threat. They surveyed 200 companies in Japan, Europe and the United States, and conducted several hundred interviews to find out where U.S. problems lie.

The end of the Cold War signified the disappearance of the Soviet Union, which was the biggest enemy and threat

Table 1 Trends in value of inward FDI (Unit: US$ 100million)

1999 ranking	Economy	1990	1995	1996	1997	1998	1999
1st	US	479	675	770	1,060	1,863	2,755
2nd	UK	324	225	324	370	637	848
3rd	Sweden	20	149	55	103	194	594
4th	Germany		120	−32	117	201	522
5th	France	132	237	220	231	295	388
6th	China	35	359	402	442	438	388
7th	Belgium / Luxemburg	81	105	147	120	227	384
8th	Netherlands	123	115	78	118	372	342
9th	Brazil	10	49	99	197	319	327
10th	Canada	76	108	64	118	217	251
11th	Argentina	18	42	43	88	67	236
12th	Hong Kong					148	231
13th	Ireland	6	15	25	27	110	191
14th	Japan	18	0	2	32	33	123

Source: IFS (IMF)

of the United States. This in turn started a U.S. social trend of focusing on "economic threats" which had replaced the Soviet's "military threat."

This paper is aimed at examining the dynamic development and economic effect of foreign direct investment (FDI) increasingly linked to the competitive advantages of countries.

The first page of the Japan External Trade Organization's (JETRO) 1990 white paper on overseas investment opened with JETRO's estimate that as of the end of 1988, the balance of FDI of the entire world reached $1,031.8 billion, topping the $1 trillion level for the first time.

While $1 trillion is a vast sum, recent statistics revealed a more astonishing fact: the flow of FDI of the entire world in 2001 alone totaled colossal $1,270.7 billion. Moreover, the flow investment in the previous year had already reached $1,075 billion, exceeding the balance of the world's direct investment as of the end of 1988.

The term "foreign direct investment" used here is the same as the one used by the International Monetary Fund. It refers to the total of 1) so-called greenfield investment, that is, investment in a country for such purposes as the construction of factories or offices, and 2) investment for the purpose of participating in the management of a company (including a subsidiary) through the purchase of stocks and other interests, more specifically capital subscription of more than 10% of the total of company shares.

There are other types of FDI, such as capital subscriptions of less than 10%, as well as portfolio investment like stock investment for asset management and investment in bonds and financial derivatives. But they are not included in the definition of FDI, because they are aimed at only managing assets, not at doing business directly and permanently in countries where investment is made.

Characteristically, FDI is not merely the transfer of money across borders, but involves transfer of money plus technology, management know-how and production capabilities. In a sense, this means exports of production capabilities, not merely exports of goods produced in investors' countries. Whatever the motives of direct investment, transfer of production capabilities, management know-how and technology helps bolster the industrial base of countries which receive investment.

Explosive expansion of FDI represents the conspicuous trend of the post-Cold War world economies. In essence, it involves transfer of production capabilities, management know-how and technologies, which in turn has been changing the global distribution of production capabilities and transforming the global division of labor in a dynamic way.

In the latter half of the 1980s, the overall currency adjustment through the Plaza Accord and the subsequent appreciation of the yen prompted Japan to transfer production plants (in greenfield investment) to other Asian countries boasting low production costs. As a result, manufacturing industries in recipient countries have achieved phenomenal growth. China saw its manufacturing industries develop remarkably in the late 1990s after FDI in the country from all over the world increased substantially.

The White Paper on International Trade 2001 by the Ministry of Economy, Trade and Industry analyzed in the first chapter the recent trends of FDI in East Asia, as well as the subsequent advent of a "mega-competition" era and the rapid changes in industrial and trade structures taking place in the region. Its analysis of trends in China is particularly noteworthy. China achieved average annual growth of as high as 9.7% in terms of gross domestic product (GDP) in the 1980s and the figure jumped to 10.2% in the 1990s. China ranked 11th in the world in terms of GDP in 1990, and seventh in 1998 after the United States, Japan, Germany, France, the United Kingdom and Italy.

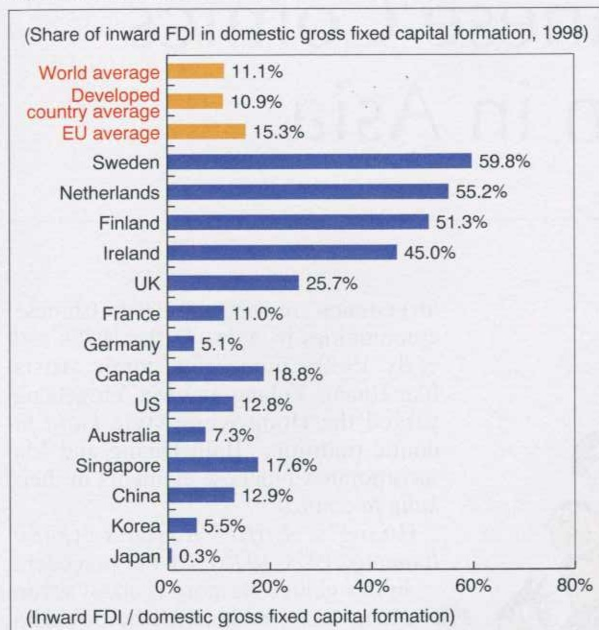
China's exports expanded about four times over the past 10 years, reaching $200 billion in 1999. It accounted for 3% of world trade (exports and imports combined), ranking ninth.

China's remarkable development raised concern not only in Southeast Asian countries but also in Japan over the "Chinese threat." Taiwan is viewing continental China as a huge magnet which attracts investment from surrounding countries with its mighty power. Some people in Japan liken China to a black hole which absorbs Japanese companies one by one.

These arguments reflect concern over the threat of China, which is emerging as a major power. The Chinese government refutes such arguments, emphasizing that 1) per capita incomes in China are still extremely low, and economic conditions in China's inland farming regions are similar to those in least developed countries, and 2) China and other countries, such as Japan, will very likely supplement each other even after China becomes a developed economy. At the second Boao Forum for Asia held in China's Hainan Island in April with top Asian leaders participating, Chinese leaders ruled out the possibility of China becoming a threat and emphasized China's supplementary roles.

But China is becoming increasingly confident of its economic future. One Japanese specialist on China has expressed the view that China is acting

Figure 2 International comparison of inward FDI received



Source: *WIR* (UNCTAD)

with a long-range strategy envisioning the resurrection of Great China by 2050. Accordingly, China is placing strategic focus on (1) the stabilization of diplomatic relations with major powers, (2) the acceleration of reform of its domestic economic systems by taking advantage of its accession to the World Trade Organization, and (3) the maintenance of the flow of direct investment from other nations, he argues.

During the Cold War, Eastern Bloc countries were extremely cautious of FDI from capitalist countries, which they regarded as a Trojan horse sent by Imperialists and tended to reject. Now that the Cold War has passed into history, however, China, Russia and almost all former Eastern Bloc countries are striving to induce high-quality FDI from the West.

Let us examine changes in the amount of FDI in China from other countries.

China's acceptance of FDI stood at $3.5 billion in 1990 and at $35.9 billion in 1995. It jumped to $40.2 billion in 1996, when China became the second largest recipient of FDI after the United States, which received $77 billion. The figure further rose to $43.8 billion in 1998 but slightly declined to $38.8 billion in 1999, with China's ranking lowered to sixth place. (Table 1)

Besides developing countries, the United States and other industrialized countries are also trying hard to induce FDI from abroad. While U.S. outbound FDI totaled $152.4 billion in 2000, the United States received $287.6 billion in inbound FDI, becoming a $135.2 billion net recipient of inbound FDI. But inbound FDI benefited the growth of the entire U.S. economy. The U.S. government highly evaluates the inducement of foreign capital, as business operations by excellent foreign capital stimulate local U.S. companies and helps bolster their strength.

In stark contrast, FDI in Japan from abroad has remained very limited. In 1996 Japan's outbound FDI totaled $23.4 billion, but inbound FDI stood at only $200 million. Inbound FDI in Japan jumped to $8.2 billion in 2000, but it was still far below the country's outbound FDI, which totaled $31.5 billion.

The White Paper on International Trade 2001 contained shocking comparison data regarding FDI. The world average of the share of inward FDI in domestic gross fixed capital formation in 1998 was 11.1%, while the average in industrialized countries and the European Union stood at 10.9% and 15.3%, respectively. The country-wise average was 12.8% for the United States, 12.9% for China, 5.5% for South Korea. Among European nations, Sweden registered 59.8%, the Netherlands 55.2%, Finland 51.3% and the United Kingdom 25.7%. Japan's share was staggeringly low at 0.3%. (Figure 2)

Given that the sharp increase in FDI is a phenomena characterizing the post-Cold War world economy, with developed and developing countries alike placing strategic focus on the inducement of FDI from abroad, Japan's lopsided focus on outbound FDI against small inbound FDI indicates that the country is left out of the global trend.

Since its bubble economy burst in 1991, Japan has remained mired in "great stagnation" for more than 10 years. There is a growing mood among Japanese policy-makers to focus on the inducement of inbound FDI as a strategic policy option to break the current stalemate. In fact, the government has set up an advisory panel chaired by the prime minister tasked with studying the promotion of inbound FDI.

A country must be attractive as a site for investment if it is to induce high-quality FDI from abroad. In an economy attractive enough for foreign companies to make FDI, domestic companies will also find it worthwhile to invest actively. If a country has no attractiveness for investment, it must change its systems and practices to make itself attractive.

The case of the so-called "Chinese threat" diverts Japanese people's attention away from the need for their own country's structural reform and may give politicians and bureaucrats an excuse to skirt such reform.

Any country will be practically abandoning its future if it turns its back on the global trend or the mega-trend of the globalized world economy. Lately, the Japanese government admits that an era has arrived when companies choose countries. As the government can boost the country's competitive position through proper policies, it should provide good companies and competent, motivated people with an attractive environment. This is structural reform in the real sense of the word. JJTI

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