Exports and FDI entry decision: Evidence from Japanese foreign-affiliated firms*

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April, 2017

Abstract

Why do aggregate foreign direct investments (FDIs) fall with distance? To answer this question, we examine the behavior of Japanese multinational enterprises (MNEs). We are interested in FDI entry decision given export experience in foreign markets. We postulate that one of the firms' strategies is learning the foreign market potential by exporting first, followed by establishment of foreign affiliates if expected profitability is high enough. We propose a theoretical model and test it empirically using firm-level data from two basic surveys of Japanese companies: the Basic Survey of Japanese Business Structure and Activities and the Basic Survey on Overseas Business Activities for the period 1995-2013. We control for export experience and productivity of Japanese MNEs, and find that the probability of FDI entry decreases in distance. We conclude that trade costs shape outward FDI activity in addition to learning by exporting and productivity channels. Our tentative explanation suggests that trade costs limit firms' ability to reveal the foreign market demand. As a result, they may exit the foreign market before realizing the potential of profitability.

JEL Classification Number: F10, F14, F21

Key words: export dynamics, foreign direct investment, multinational enterprises

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