



INTERNATIONAL TRADE CENTRE
1999 Executive Forum on National Export Strategies
Redefining Trade Promotion



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Supplying Multinational Organisations: Opportunities and Recommendations for Developing Country Enterprises*

A significant portion of international trade is managed by multinational companies today. A survey by the United Nations¹ reports data on international trade directly managed by U.S., Japanese, and British companies. About 30% of U.S. manufactured exports was attributed to U.S. companies transferring products and components to their affiliates overseas, and about 40% of U.S. manufactured imports was accounted for by U.S. companies sourcing from their foreign affiliates. For both Japan and Britain, such transactions are estimated to account for approximately 30% of their total trade flows (exports and imports combined), respectively. These intra-firm trade ratios have been virtually unchanged in the past 25 years.²

U.S. and Japanese multinationals, in particular, have developed complex global sourcing strategies to serve markets around the world. Global sourcing strategy encompasses management of 1) logistics identifying which production units will serve which particular markets and how components will be supplied for production and 2) the interfaces among R&D, manufacturing, and marketing on a global basis.³ The ultimate objective of global sourcing strategy is for the company to exploit both its own competitive advantages and the comparative locational advantages of various countries in global competition.

In this position paper, we first compare and contrast the nature of U.S. and Japanese global sourcing strategies. Second, we explore ways in which companies from developing countries can benefit from becoming long-term suppliers for those established multinational companies.

Global Sourcing Strategy and International Trade across the Pacific

U.S. multinational companies are the most experienced in the industrialised world, and sell more than three times as much overseas through their subsidiaries as they export to the world. For U.S. multinationals, the 3:1 ratio of foreign sales to exports has remained largely unchanged since mid-1960s. This ratio for European multinationals has grown from 3:1 in the 1970s to 5:1 by 1990. Similarly, the ratio for Japanese multinationals has increased from 1:1 in mid-1970s to 2.5:1 by 1990. Also, both American and Japanese subsidiaries sell more than 20 percent of their foreign sales in third-country markets (third-country markets defined as markets other than the country where the parent company is based and the country where the particular manufacturing facility is based), including their home markets, while European subsidiaries in the United States and Japan sell approximately 10 percent in third-country markets.⁴

This intra-firm trade, through the management of foreign production by multinational firms, is one of the primary factors leading to the total volume of international trade among the Triad regions (i.e., the United States, European Community, and Japan) increasing more than tenfold in twenty years—to \$514.7 billion in 1995 from \$44.4 billion in 1970—or by more than four times in real terms.

* This paper has been prepared by Massaki Kotabe, Temple University and Carlos Arruda de Oliveira, International Trade Centre for the *ITC 1999 Executive Forum on National Export Strategies*.

Two notable changes have occurred in international trade. First, the last thirty years have observed a secular decline in the proportion of trade between the European Community and the United States in the Triad regions, and conversely an increase in trade between the United States and Japan, and in particular, between the European Community and Japan. It strongly indicates that European countries and Japan have found each other as increasingly important markets above and beyond their traditional market of the United States. Second, newly industrialised and developing countries in Asia, including Taiwan, Hong Kong, Singapore, and Malaysia and in Latin America, including Mexico and Brazil, have dramatically increased their trading position relative to the rest of the world. Not only have these emerging countries become prosperous marketplaces, but more significantly, they have become important manufacturing and sourcing locations for many multinational companies.

From the sourcing perspective, for example, U.S. and other multinational companies were procuring a less expensive supply of components and finished products in Asian newly industrialised countries for sale in the United States and elsewhere. As a result, U.S. bilateral trade with them has increased more than eightyfold, to an estimated \$150 billion in 1996 from \$1.8 billion in 1970. Trade statistics, however, do not reveal anything other than the amount of bilateral trade flows between countries. It is false to assume that trade is always a business transaction between independent buyers and sellers across national boundaries. It is equally false to assume that a country's trade deficit in a certain industry equates with the decline in the competitiveness of companies in that industry. Clearly, an increasing segment of international trade of components and finished products is strongly influenced by multinational companies' foreign production and sourcing investment activities.

Initially, the primary objectives of many U.S. companies were to compete with Japanese companies that had built their strengths on cost competitiveness in the 1960s and 1970s. As Japanese firms had gradually lost cost competitiveness as a result of the yen's appreciation into the 1980s and 1990s, companies from other Asian countries began to strengthen their competitive edge in low cost manufacturing vis-à-vis U.S. companies. Consequently, U.S. companies have had to emphasise cost efficiency in competing with Japanese and other Asian companies. To do so, U.S. companies have increased sourcing of components and finished products from the four Asian Tigers and other Southeast Asian countries, thereby contributing to the increased U.S. trade with the region. So have the Japanese companies.

However, there seems to exist a noticeable difference in sourcing objectives. Generally, U.S. companies have continued to pursue economic *efficiency* by emphasising cost reduction through global sourcing, while Japanese companies have focused more on *effectiveness* in satisfying customers through quality, reliability, and swift product development cycle, rather than simply being cost-driven. Normative implications of this strategic difference between U.S. and Japanese companies are explored in conjunction with their sourcing strategies in the Pacific region (See **Table 1** for summary comparison).

Table 1**Comparison of Global Sourcing Strategies between U.S. and Japanese Companies**

	U.S.	Japanese
Initial Motive	Cost reduction (after the cost pressure builds up)	Cost reduction (in anticipation of cost pressure in the long run)
Mode of sourcing	Offshore sourcing from independent overseas suppliers	Sourcing from offshore subsidiaries and affiliates
Objective	Reduction of fixed assets committed to production at home to lower break-even points	Transfer of engineering and production skills to offshore subsidiaries and affiliates
Management Needs	Capable purchasing managers	Transfer of a sufficient number of engineers and other technical staff
Short-term Consequences	Lower cost and improved profitability	Some cost reduction
Intermediate-term Consequences	Reduced design and engineering capabilities at home	Integration of R&D, engineering, and production skills
Long-term Consequences	Dependence on independent overseas suppliers that could become potential competitors	Transfer of Japanese "keiretsu" network of production arrangements

Source: Masaaki Kotabe, "Efficiency vs. Effectiveness Orientation of Global Sourcing Strategy: A Comparison of U.S. and Japanese Multinational Companies," *Academy of Management Executive*, 12, November 1998, 107-119.

Logistics of Sourcing Strategy

In developing viable sourcing strategies, companies must consider not only manufacturing costs, the costs of various resources, and exchange rate fluctuations, but also availability of infrastructure (including transportation, communications, and energy), industrial and cultural environments, the ease of working with foreign host governments, and so on. Furthermore, the complex nature of global sourcing strategy spawns many barriers to its successful execution. In particular, logistics, inventory management, distance, nationalism, and lack of working knowledge about foreign business practices, among others, are major operational problems identified by both U.S. and foreign multinational companies engaging in international sourcing.⁵ Recent studies⁶ have shown, however, that despite, or maybe, as a result of, those operational problems, *where* to source major components seems strategically less important than *how* to source them for long-term competitiveness. Thus, when examining the relationship between sourcing and competitiveness of multinational companies, it is crucial to distinguish between sourcing on a "contractual" basis and sourcing on an "intra-firm" basis, for these two types of sourcing will have a different impact on their long-run competitiveness. U.S. and Japanese multinational companies' sourcing strategies illustrate this point.

Sustainable Core Competence vs. Transitory Core Competence

If U.S. and Japanese companies had been pursuing their own respective core competencies for competitive advantage, then they should have achieved similar levels of market performance. Obviously, it has not been the case in the past thirty or so years. We submit that there should be some specialisation as a core competence that is inherently more sustainable than others.

Product innovation alone can no longer provide adequate competitive edge and that strong manufacturing and marketing capabilities are of utmost importance for companies to maintain long-term sustainable competitive position. It is primarily because, in today's highly competitive market, legal means of protecting proprietary technology have become ineffective, as new product innovations are easily reverse-engineered, improved upon, and invented around by competitors without violating patents and other proprietary protections.⁷ Time and time again, the most effective ways of securing maximum returns from a new product innovation have proven to be through lead time and moving fast down the experience curve (i.e., quickly resorting to large-volume production).⁸ Production sharing facilitates technology diffusion through official and unofficial channels among competitors. Obviously, the value of owning technology has lessened drastically in recent years, as the inventing company's temporary monopoly over its technology has become transitory.

History has shown repeatedly that many higher cost producers will also begin to outsource finished products from the lower cost producer on a contractual OEM (original equipment manufacture) basis. Although outsourcing may be an easy way out from a short-term perspective of cost efficiency, it tends to prevent outsourcing companies from keeping abreast of emerging product and manufacturing technologies that might be employed for further product and design improvement. Hence it can cause a long-term decline in manufacturing competencies and innovative ability.

U.S. and Japanese companies have established different manufacturing and sourcing networks with Southeast Asian countries. However, one crucial difference lies in what their intended core competence should be. As accused by *Business Week* in the past, U.S. companies had gradually severed part of their value chain⁹ and, in search of cost competitiveness and nimbleness (i.e., cost efficiency), willingly increased their dependence on foreign suppliers for components and finished products that became ever more technologically sophisticated. On the other hand, Japanese companies kept their commitment to manufacturing capabilities (more specifically, quality and reliability of components and finished products) as their primary core competence and competitive weapon irrespective of their actual production location.

Such commitment requires close scrutiny of manufacturing activities in Southeast Asia. Whenever possible, Japanese companies tend to own (partially or wholly) and directly get involved in local manufacturing operations with a large number of Japanese engineers and technical support staff expatriated from home. This is typical of Japanese *keiretsu* sourcing (supply chain) management.¹⁰ Japanese companies tend to emphasise a dual role of the technical expatriates: It is not only to transfer expertise to the foreign plants but also to bring newly gained production expertise back to their parent companies in order to keep internalised the very part of the value chain that many U.S. companies were willing to let go. For Japanese companies, exchange rate fluctuations are viewed rather as a transitory problem--however serious--in developing an "internalised" global sourcing network with the belief that such a sourcing network could absorb the impact of exchange rate fluctuations through better cost containment and consistent supply of superior components within the system.

Aside from the benefit of cost reduction and nimbleness, sourcing from independent suppliers on a “contractual” basis, whether domestically or from abroad, appears to have other long-term consequences. First, a firm tends to assign part of the most important value-creating activities to, and also become dependent on, independent operators for assurance of components quality.¹¹ Second, competition is promoted among independent suppliers to ensure continuing availability of materials and exploit full benefits of changing market conditions. But the suppliers are forced to operate in an uncertain business environment, which inherently necessitates a shorter planning horizon. The uncertainty about the potential loss of orders to competitors often forces individual suppliers to make operating decisions that will likely increase their own long-term production and material costs. In the process, it tends to adversely affect U.S. companies sourcing components and/or finished products from those suppliers.

Third and of utmost importance, the outsourcing firms tend to lose sight of emerging technologies and expertise which could be incorporated into the development of new manufacturing processes as well as new products. The creation of new technology is a gradual and painstaking learning process of continual adjustment and refinement, as new productive methods are tested and adapted in the light of the company’s accumulated experience. Thus, over-reliance on acquisition of technology (in the form of components and finished products) from others may not result in the same sustainable competitive advantages available through internal development.

Trends: Meeting Halfway

The scope of global sourcing has expanded over time. Multinational companies design their sourcing decision based on the interplay between their competitive advantages and the comparative advantages of various sourcing locations for long-term gains. Relatively speaking, U.S. companies have stressed cost efficiency and lower break-even points while Japanese companies have emphasised such non-cost factors as quality, reliability, and product development cycle. Over time, U.S. companies seem to have compromised, while Japanese companies have improved, some crucial long-term capabilities in the value chain.

This implication does not necessarily mean that Japanese companies are fundamentally more competitive across the board than U.S. counterparts. Our position is that Japanese companies’ emphasis on manufacturing capabilities internalised on a global basis has some fundamental long-term competitive advantage over U.S. counterparts that emphasise rather opportunistic product innovations and reduce fixed costs for improved financial performance. In the short run, or in a volatile economic environment exemplified recently by the Asian financial crisis, U.S. companies have proved to be more nimble and swift in adjusting to the changing environments than Japanese counterparts.

In reality, both U.S. and Japanese companies are learning from each other. U.S. companies have increasingly adopted a Japanese-style *keiretsu* support to those established multinational companies. Primary and secondary benefits of becoming long-term suppliers for the multinational companies are i) reduced customer search cost and technical assistance/technology transfer from multinational companies; ii) developing a *keiretsu*-style supply relationship in the domestic market and improving managerial practices. The first two benefits are a direct outcome of the sourcing relationship, and the last two are of secondary nature, and are related to the fact that enterprises are continually learning and changing their processes and systems.

Reduced Customer Search Cost

One of the primary benefits of becoming suppliers for the established multinational companies on a long-term basis is that exporting companies can secure their export customers (i.e., multinational companies as buyers). It is empirically known in marketing that it costs three times as much to find a new customer than to maintain an existing customer.¹² If this finding applies to exporters, exporters would benefit from a long-term supplier agreement in that they would not have to go after different customers on a spot-contract basis. The existing literature on export promotion implicitly assumes that governments assist exporters in finding new customers for on a spot-contract basis.¹³ A new model of government export promotion could be to help developing country exporters become suppliers for established multinational companies on a long-term contractual basis. Such a long-term sourcing relationship is often consummated by multinational companies' having some equity position in the developing country exporters.

Technical Assistance and Technology Transfer

Another primary benefit is in the form of technical assistance and technology transfer from a multinational company to its suppliers. In a long-term sourcing relationship, Japanese companies, in particular, are known to send a large number of Japanese engineers and technical support staff to train local suppliers not only to meet the rigorous Japanese product quality standard but also to improve on their production and delivery capabilities. This practice is gaining popularity among U.S. companies as well. It is to those multinational companies' advantage to have a limited number of world-class suppliers rather than rely on a large number of suppliers on a spot-contract basis.

Suppliers working on a spot-contract basis usually could not invest much in relationship-specific activities (e.g., buying special equipment for their specific buyers and training personnel dedicated full-time to their customers) as they have to be in a constant search for new buyers. Lost customers may cause intermittent production runs, and different buyers may require different product specifications. Either way, production planning tends to become rather short-term oriented.

On the other hand, suppliers working on a long-term supplier basis know that they can maintain their current status as long as they meet the buyer's quality expectations. Therefore, those suppliers have a vested interest in such a long-term relationship and are more willing to invest in relationship-specific activities. The end result is more smooth operations and better products for the buyer (i.e., multinationals) on a long-term contract than on a short-term spot contract. Multinational companies are more willing to invest in such a mutually rewarding relationship by providing their technical expertise to further strengthen the sourcing relationship.

Keiretsu-ization

An important secondary benefit developed between a multinational company and its suppliers is the extension of the supply-customer relationship downstream. Once local suppliers have established their credentials as reliable and quality suppliers, they will further strengthen the relationship with their multinational buyer. Those suppliers may develop second-tier supply relationships with domestic subcontractors for the same reason that the multinational company has built a first-tier supply relationship with them. In such a case, we would expect some technical expertise transmitted to local second-tier suppliers from the first-tier suppliers. To the extent that this takes place, it will benefit the local economy by mobilising local resources and raising production and product quality standards in the long run.

Managerial Improvements

Enterprises and their management learn a great deal by copying practices and processes adopted by other enterprises. Another secondary benefit observed in long term relationships between enterprises from developing countries and their multinational customers has been the transfer of managerial best practices from the multinational corporations to their suppliers.¹⁴

Internationalisation of the Firm

It is clear from the discussion above that government export promotion programs could be developed in ways to help developing country exporters i) develop the managerial/technical capacity to become suppliers of multinational enterprises; ii) identify and attract multinational partners to build long-term supplier relationships. Potential benefits are enormous. Now the question is how companies become engaged in exporting. The academic literature on internationalisation of the firm casts some insight into the dynamic process of how companies tend to develop their export strategy over time.¹⁵

Stages of Export Involvement

A systematic evaluation of export promotion programs mandates identification of companies' export-related skills and needs for improvement. Various alternatives exist to differentiate companies and their level of export expertise. Given the increased research attention the export activities of companies have received, segmentation schemes abound. Some researchers, for example, have focused on managerial attitudes. Others scrutinised the size of the firm, its service orientation, or differentiated between sporadic and regular exporters. It is suggested that companies' export involvement is a gradual learning process, which develops from a series of incremental decisions and overtime draws some companies into the international market.

Table 2 summarises the stages of internationalisation or export involvement. Although the number of discrete stages differs across the classification schemes, the description of the evolutionary pattern of export involvement is essentially identical. Therefore, a five-stage model is employed.

TABLE 2 Stages of Export Involvement

Stage 1: Partial Interest in Exporting

Would fill an unsolicited export order, but make no effort to explore the feasibility of exporting

Stage 2: Exploring Exports

Actively explore the feasibility of exporting, but currently exporting less than 5% of total sales

Stage 3: Experimental Exporter

Exporting on an experimental basis to countries that are geographically close or which share a culture similar to the domestic market.; export sales represent a volume greater than 5% of total sales

Stage 4: Experienced Exporter with Limited Scope

Experienced exporter, with an export sales level greater than 5% of total sales, that adjusts export offerings optimally with changes in the foreign environment (e.g., exchange rates, tariffs, etc.) although still only export to countries that are geographically close or have a similar culture

Stage 5: Experienced Exporter

Experienced exporter with an export sales level greater than 5% of total sales, currently exploring the feasibility of exporting to additional countries that are farther away than previous exports, or have a very different culture

Source: Masaaki Kotabe and Michael R. Czinkota, "State Government Promotion of Manufacturing Exports: A Gap Analysis," *Journal of International Business Studies*, 23, Fourth Quarter 1992, 637-658.

In the early stage of export involvement, the internationalisation process is a consequence of incremental adjustments to the changing conditions of the firm and its environment, *rather than* a result of its deliberate strategy. Such a pattern is due to the consequence of greater uncertainty in international business, higher costs of information, and the lack of technical knowledge about international marketing activities.

Some companies progress to a more involved stage of internationalisation, once three conditions are satisfied. First, the management of the company obtains favourable expectations of the attractiveness of exporting based on experience. Second, the company has access to key resources necessary for undertaking additional export-related tasks. Such availability of physical, financial, and managerial resources is closely associated with firm size. Particularly, small companies may have few trained managers, and little time for long-term planning as they are preoccupied with day-to-day operational problems, and consequently find it difficult to become involved in exporting. Third, management is willing to commit adequate resources to export activities. A high level of export commitment is evident in various ways, such as (i) existence of an export department or personnel, (ii) development of direct export channels, and (iii) frequent executive trips to foreign markets.

The long-term commitment of the company to exporting depends on how successful management is in overcoming various barriers encountered in export activities. These barriers can be distinguished from those faced by companies in the earlier stage of internationalisation. An experienced exporter has to deal with difficulties in maintaining and expanding export involvement. These difficulties include import/export restrictions, cost and availability of shipping, exchange rate fluctuations, collection of money, and development of distribution channels, among others.

Overall, favourable experience appears to be a key component in moving companies along the internationalisation continuum. To a large degree an appropriate measure of favourableness for companies consists of profits. An increase in profits due to a certain activity is likely to increase management's interest in such activity. Since profits are largely the compensation for the risk incurred by the company, degrees of profitability should vary with the amount of risk taken, in order to produce similar levels of profit.

In the context of internationalisation, one should not simply compare degrees of profitability of domestic operations to those of international operations as a justification for whether or not to export. Since international activities tend to involve greater distances, more complexity, and new factors, such as currency exchange rates, they are likely to be seen by companies as resulting in greater uncertainty and probably lower profitability than domestic sales. Then why export? Indeed, exporting does not necessarily result in higher profitability relative to domestic business. However, profitability is just one measure of the firm's competitiveness. In one study of state export promotion programs, many exporters indicated that exporting makes their firms more competitive *domestically* as a result of increased sales opportunities overseas and improved quality of management, among others. Increased foreign sales mean that manufacturing operations will not be as much affected by domestic demand fluctuations as they would be without exports. Overall, executives of local firms become more aware of the competitive benefits of exporting, the more involved they are in exporting.¹⁶

Building Long-Term Supplier Relationship with Multinational Companies

Export involvement is a gradual learning process for many companies. The conceptual model described above assumes that companies are in constant search of new customers to expand their export businesses over time. During the ITC Executive Forum we would like to discuss the possibilities for enterprises from developing countries to build long-term relationships with multinational enterprises. What have decision-makers from the public and private sectors from developed and developing countries done to support individual initiatives or even to assist enterprises building long-term supplier relationships with multinational companies. What could be done? What are the risks and challenges involved?

Endnotes

¹ *World investment report 1996: Investment, trade, and international policy arrangements*. 1996. New York: United Nations.

² Organization for Economic Cooperation and Development. 1993. *Intra-firm trade*, Paris: OECD; Stefan H. Robock, "U.S. Multinationals: Intra-Firm Trade, Overseas Sourcing and the U.S. Trade Balance," a paper presented at the 1999 Academy of International Business-Southeast Conference, June 4-5, 1999.

³ This broad view of global sourcing strategy is investigated in Masaaki Kotabe, *Global sourcing strategy: R&D, manufacturing, and marketing interfaces*, New York: Quorum Books, 1992.

⁴ Dennis J. Encarnation, "Transforming Trade and Investment, American, European, and Japanese Multinationals Across the Triad," a paper presented at the Academy of International Business Annual Meetings, November 22, 1992.

⁵ David L. Levy, "Lean Production in an International Supply Chain," *Sloan Management Review*, 38, Winter:94-102.

⁶ See, for example, Masaaki Kotabe and K.Scott Swan, "Offshore Sourcing: Reaction, Maturation, and Consolidation of U.S. Multinationals," *Journal of International Business Studies*, 25, First Quarter 1994, 115-40; and Janet Y. Murray, Masaaki Kotabe, and Albert R. Wildt, "Strategic and Financial Performance Implications of Global Sourcing Strategy: A Contingency Analysis," *Journal of International Business Studies*, 26, First Quarter 1995.

⁷ Levin, Richard C., Alvin K. Klevorick, Richard R. Nelson, and Sidney G. Winter, "Appropriating the Returns from Industrial Research and Development," *Brookings Papers on Economic Activity*, Issue 3, 1987, 783-831.

⁸ For empirical and historical evidence, see R.C. Levin, A.K. Klevorick, R.R. Nelson, and S.G. Winter, "Appropriating the Returns from Industrial Research and Development," *Brookings Papers on Economic Activity*, Issue 3, 1987: 783-831; and W.J. Baumol, R.R. Nelson, and E.N. Wolff, *Convergence of Productivity: Cross-National Studies and Historical Evidence*, New York: Oxford University Press, 1994

⁹ In the 1960s and 1970s, many U.S. firms had their own manufacturing subsidiaries in Southeast Asian countries. However, when U.S. parent companies increased procurement of components from abroad for production in the United States in the mid-1970s, many of those subsidiaries were either not used strategically for integrated global manufacturing purposes or sold away to local interests. Selling of U.S. assets in Southeast Asia was partly due to the local government's "fade-out" policy, mostly in the 1960s, to gradually increase local participation in U.S.-owned businesses, and also partly due to U.S. firms' desire to reduce fixed cost in order to lower break-even point.

¹⁰ For an excellent treatise on *keiretsu* sourcing, see Toshihiro Nishiguchi, *Strategic Industrial sourcing: The Japanese Advantage*. New York: Oxford University Press, 1993.

¹¹ T. Kumpe, and P.T. Bolwijn, "Manufacturing: The New Case for Vertical Integration," *Harvard Business Review*, 66, March-April 1988, 75-81

¹² Robert D. Buzzell and Bradley T. Gale, *The PIMS Principles: Linking Strategy to Performance*, New York: Free Press, 1987.

¹³ Masaaki Kotabe and Michael R. Czinkota, "State Government Promotion of Manufacturing Exports: A Gap Analysis," *Journal of International Business Studies*, 23 (Fourth Quarter 1992), pp. 637-58.

¹⁴ This unexpected outcome from the relationship between smaller suppliers from developing countries and their multinational customers was observed in the study conducted by Fundação Dom Cabral in Brazil during the early 1990's. See Haroldo Brasil and Carlos Arruda, "Internacionalização de Empresa Brasileiras," Rio de Janeiro: Qualitymark, 1996.

¹⁵ This section draws from Masaaki Kotabe and Michael R. Czinkota, "State Government Promotion of Manufacturing Exports: A Gap Analysis," *Journal of International Business Studies*, 23, Fourth Quarter 1992, 637-658.

¹⁶ Kotabe and Czinkota, 654-655.