Reverse Importing and Asymmetric Trade and FDI: A Networks Explanation

Theresa M. Greaney[1]
Department of Economics
University of Hawaii at Manoa
2424 Maile Way, SSB 542
Honolulu, Hawaii 96822
(808) 956-7521 (phone)
(808) 956-4347 (fax)
email: greaney@hawaii.edu

September 28, 2001

Abstract

In an international environment where contracts are not always enforceable and product information is imperfect, the importance of networks or relationships between buyers and sellers matters. In some countries and cultures, it seems to matter more than in others. Japanese *keiretsu* groups are often cited as examples of networks that matter for international trade. This paper examines the impact of business and social networks on international trade and on foreign direct investment (FDI). I propose that differences in the strength of network effects across countries can produce asymmetric trade and investment flows that may lead to trade friction. This proposition is examined using a model of multi-product firms that choose to be either national or multinational in production of a differentiated product. The firm from the country with strong network effects has a cost advantage in selling to buyers from its own country. This advantage results in lower inward FDI, lower total imports but larger volumes of so-called reverse imports (i.e., imports from overseas affiliates of that country's own firms) into the country with strong network effects. The model's predictions match observed asymmetric trade and investment flows that sometimes lead to US-Japan trade friction in some industries, such as autos and auto parts.

[1] The author thanks Gary Kikuchi, James Roumasset and seminar participants at the University of Hawaii Economics Department for providing helpful comments and the East-West Center for providing funding and research accommodations during the early stages of this project.