Japanese Foreign Capital Policy and the Surge in Japan's Inward FDI

Kenji Akiyama

Contents

1. Recent Trends in FDI in Japan

Foreign direct investment (FDI) in Japan (i. e., direct investment by foreign companies) began to increase in the latter half of 1990 s, increasing particularly rapidly since the 1998 fiscal year. FDI in 1999 was 2, 399. 3 billion yen, a 79% increase over the previous year and a new all-time high. FDI exceeded 1 trillion yen for two consecutive years, in 1998 and 1999. (See Table 1.)

On a flow basis, the imbalance between Japan's outward and inward FDI has decreased as indicated by the ratio between the two, said ratio being 3. 9 in 1998 and 3. 1 in 1999. Prior to this, the imbalance between FDI from Japan and FDI in Japan had created investment friction : Large FDI from Japan contrasting with small FDI in Japan had been criticized as evidence of the closed nature of Japan's investment market.

On a stock basis, the ratio of outward FDI to inward FDI in other major industrialized nations is in imbalance but much closer to parity : 1. 1 in the U. S. (CY 1997), 1. 5 in the UK (CY 1998), 2. 5 in Germany (CY 1995), and 1. 1 in France (CY 1996). In contrast, the same ratio in Japan is 10. 3 (CY 1998), indicating a large imbalance, although the ratio has begun to change recently.

Next, let us consider FDI trends in the manufacturing and non-manufacturing industries. (See Table 2.)

The foreign capital penetration ratio of the non-manufacturing sector has traditionally exceeded that of the manufacturing industry. For example, those ratios were 77% (non-manufacturing) versus 23% (manufacturing) in 1998 and 59% versus 41% in 1999.

Table 1. Changes in the ratio between Japan's outward and inward FDI (flow basis)

(Unit : Hundred million yen).

	FY1992	FY1993	FY1994	FY1995	FY1996	FY1997	FY1998	FY1999
Outward FDI	44, 313	41, 514	42, 808	49, 568	54, 094	66, 229	52, 169	74, 390
Inward FDI	5, 306	3, 586	4, 327	3, 697	7, 707	6, 782	13, 404	23, 993
Ratio of outward to inward FDI	8. 4	11. 6	9. 9	13. 4	7. 0	9. 8	3. 9	3. 1

Source : Ministry of Finance (reported inward and outward FDI).

Table 2. Inward FDI by industry

(Unit: Hundred million yen).

	FY1992	FY1993	FY1994	FY1995	FY1996	FY1997	FY1998	FY1999
Machine	829	781	1,339	182	1,558	1,452	2,129	8,652
Chemistry	931	542	234	1,095	695	740	397	603
Others	321	513	481	135	858	482	600	542
Manufacturing industry total	2,081	1,836	2,054	1,412	3,111	2,674	3,126	9,797
Trade industry	1,554	1,005	1,135	679	1,664	996	1,759	3,485
Service industry	1,067	240	374	491	2,360	888	3,181	2,058
Finance and insurance	190	40	687	1,001	273	1,616	4,569	5,115
Others	414	40	77	113	298	608	769	3,538
Non-manufacturing industry total	3,225	1,325	2,273	2,284	4,595	4,108	10,278	14,196

Source: Ministry of Finance (reported inward FDI).

As evinced by French auto maker Renault's investment in, and participation in the management of, Nissan Motor Corp., the transport machine sector accounts for a large portion of inward FDI in the manufacturing industry.

In the non-manufacturing industry, investments in the finance and insurance industry and the telecommunications industry are conspicuous. Investments in the service industry, as well as commercial and trade-related investments intended to increase exports to Japan, continue to account for the same share as before.

By industry, foreign penetration has increased in industries where accelerated restructuring is underway.

Based on present conditions as discussed above, this paper will consider Japanese foreign capital policy and then examine the causes of the current surge in inward FDI.

2. Japanese Foreign Capital Policy : From Regulation to Attraction

Recent years have seen a rapid increase in the investment of foreign capital in the Japanese market.

Although the foreign capital policy of postwar Japan has gradually moved toward the liberalization of capital transactions, culminating in almost complete liberalization in the 1980s, in actuality, various regulations and barriers remained, making entry into the Japanese market by foreign capital difficult. In the 1990s, however, the Japanese government changed its policy so as to actively invite foreign capital. Let us consider the causes of that change by surveying policy since World War II.

2.1 The Age of Regulation

The cornerstones of the foreign capital policy of postwar Japan have been the Foreign Exchange and Trade Management Law and the Foreign Capital Law, both of which were promulgated in December 1949. The basic policies that these laws embodied were "regulation in principle" and "exceptional freedom."

The Foreign Capital Law set forth the public position of the protection of foreign capital that would further the economic development of Japan. In actual practice, however, the entry of foreign capital was subject to extreme regulation because of fears of foreign control of domestic industries. By means of industrial policy, the government instead sought to promote domestic industry using domestic capital and enterprise, without depending on foreign capital.

Foreign capital was borrowed in the form of loans, and foreign technology was actively introduced. Strong nationalistic tendencies saw foreign capital as a form of colonization. Japanese capital and enterprise, fearing foreign dominance of Japanese companies, minimized foreign participation in management and sought to form a national economy.

2.2 The Progression of liberalization

The liberalization of trade and capital in Japan dates back to a June 1960 Cabinet decision entitled, "General Rules of the Trade and Exchange Liberalization Plan." The liberalization of trade began first, with the liberalization of capital gaining momentum subsequently, in the late 1960 s. A major turning point in the liberalization of capital was Japan's 1964 entry into the OECD.

After the first phase of capital liberalization in June 1967, four additional phases were implemented : the second in 1969, the third in 1970, the fourth in 1971, and the fifth in 1973. The fifth phase of liberalization effected a shift in policy from prohibition to "freedom in principle." However, this liberalization granted exceptional status to certain industries (i.e., petroleum, leather goods, and agriculture, forestry, and fisheries) and provided deferred liberalization for 17 industries (e.g., computers and medical supplies).

The gradual liberalization that Japan pursued was not proactive liberalization, but rather an attempt to delay liberalization as much as possible. Only when absolutely necessary were markets opened-beginning with only those industries thought to have sufficient international competitiveness to withstand the onslaught of foreign capital.

In keeping with this trend toward the liberalization of trade and capital, the Foreign Exchange and Trade Management Law was amended in 1980, replacing the policies of regulation in principle and exceptional freedom with the completely opposite policies of freedom in principle and exceptional regulation.

2.3 The Promotion of Imports and the Penetration of Foreign Capital

In the 1970s, Japan's trade surplus began to grow, intensifying trade friction with other countries. In the 1980s, Japan's trade surplus grew further as the yen appreciated. This led to increasingly strong demands from the West for market opening and the promotion of imports.

The late 1980s saw the further intensification of trade friction. Solutions to Japan's huge trade surplus were demanded, and pressure for the opening of markets increased. In response, the Japanese government implemented import promotion policy.

The avoidance of trade friction and the promotion of imports also facilitated the entry of foreign capital into Japan. Although foreign investors took an active stance to investment in Japan's huge markets, the Japanese government's foreign capital policy was rather passive, welcoming foreign capital only to the extent needed to promote imports and ease trade friction.

Japanese companies invested actively in foreign countries to assuage trade friction and to take advantage of the strong yen, creating a "bubble" economy in Japan and initiating the hollowing-out of Japanese industry. In contrast, foreign companies' entry into the Japanese market failed to progress much, and the imbalance between outward FDI and inward FDI engendered investment friction.

Legally, the liberalization of capital transactions moved ahead, but the introduction of foreign capital was, in actuality, made difficult by numerous "invisible" regulations, such as those governing the cross-holding of shares.

At that time, Japan's marketing channels, business practices, ***keiretsu*** (associations of corporations), and other factors were cited as problems by the U.S. in trade negotiations with Japan. Amendment of the Large Store Law made it easier for companies such as Toys "R" Us to enter Japan's distribution industry, whereas acquisition of auto parts manufacturer Koito by T. Boone Pickens failed because of strong opposition by the keiretsu to which Koito belonged.

2.4 Policies to Attract Foreign Capital : Opening of the Japanese Investment Market

It was the economic recession of the 1990s–triggered by the bubble economy's collapse, massive sums of bad debt, and the hollowing out of industry–that made Japan aware of the important role of the foreign capital in the Japanese economy. Japan saw the speculative bubble burst in 1990s, after having enjoyed lavish prosperity in the 1980s. The large sums of bad debt that came to light were a problem that was difficult to resolve and which made the financial system unstable. A particularly severe blow was dealt to the Japanese economy by the abolition of the special tax reduction, in April 1997, and by an increase in the consumption tax. An economic recession took root, forcing companies to restructure.

In contrast, economic expansion began in the United States after March 1991. Deregulation and the resultant introduction of competition, as well as growth in the Internet and other information technologies, revitalized the private sector. The reversal of the Japanese and American economies became clear in 1995 : U. S. -Japan trade friction decreased after tentative agreements were reached in automobile and auto-part negotiations in 1995 and in semiconductor negotiations in 1996.

It was at this turning point in the Japanese economy that Japan's foreign capital policy transformed into one emphasizing the attraction of foreign capital.

In 1990, the government announced a policy of welcoming FDI in Japan, and liberalization began. Foreign Access Zones (FAZs) were established and investment procedures were simplified under the Import Promotion and FDI in Japan Law, enacted in 1992, and under revisions of related laws. In the fall of 1994, the Conference on Foreign Investment, chaired by the prime minister, was established-one example of the new status of FDI promotion as a basic policy of the Japanese government. This proactive stance toward FDI signified a policy shift to foreign capital attraction for the first time in Japan's history. The opening of investment markets proceeded gradually, although progress in such areas as deregulation was slow and investment conditions could not yet be called adequate.

Japan's Foreign Exchange and Trade Management Law was amended again in 1997, removing the word " management " from the name of the law. This amendment went into effect in April 1998 as part of Japan's financial "Big Bang." The complete liberalization of foreign exchange was effected with the abolishment of such regulations as the requirement of prior reporting to the government for capital transactions and foreign payments. This was followed, in December 1998, by the Financial System Reform Law, which deregulated the direct sale of investment trusts (i. e., mutual funds) by banks and effected the switchover to a system of registration in principle for securities companies.

Japan's financial Big Bang was a series of measures designed to respond to economic globalization by ultimately effecting structural reform of the Japanese economy. This reform greatly accelerated the influx of foreign capital into Japan. Especially prominent were cases in which foreign capital helped Japanese banks that had been struggling under the weight of bad debt.

April 1999 saw the Conference on Foreign Investment issue a statement entitled, "Acquiring Various Wisdom Through Foreign Investment in Japan," reflecting the government's proactive posture toward inward FDI. Under the joint auspices of the U. S. Department of State, the Ministry of International Trade and Industry, and JETRO, a symposium ("FDI to Japan Symposium 2000") was held in March 2000 to consider the problems facing the promotion of FDI in Japan.

3. The Need to Attract FDI in Japan

As described above, the significance of attracting foreign capital to Japan has changed with the times.

First, the entry of foreign capital into Japan was part of import promotion efforts and was significant in that it meshed with the export promotion policies of the advanced nations, especially the United States. However, this significance changed when the inflated-assets bubble burst.

Now, with a revitalized U. S. economy enjoying a prolonged expansion, massive U. S. capital, made highly competitive by information technology, is advancing with the aim of world conquest. It is the age of economic globalization.

Japan, in contrast, faces the opposite situation. Mired in recession, the nation debates how to regenerate the economy. The needed deregulation and structural reform not only were prerequisites for economic regeneration, but also opened the door to the inflow of foreign capital into Japan.

The paramount concern of Japanese companies is restructuring, the ultimate goal of which is to reorganize unprofitable operations but which today is being implemented chiefly through layoffs and the elimination of excessive equipment. Amid this downsizing of Japanese companies, FDI in Japan is a major factor in the revitalization of the Japanese economy.

Attracting foreign capital is indispensable for economic growth and job creation not only in developing nations but in advanced nations, as well. Therefore, deregulation and infrastructure improvement are necessary, as are effective incentives for attracting foreign capital.

In addition to competitiveness-promoting measures, deregulation, and information technology, another factor behind continuing economic expansion in the United States is the country's considerable openness and proactiveness toward foreign capital. As it attracts and actively accepts foreign capital, the United States is also investing in foreign countries.

This is an age for countries to open their markets and for businesses to expand globally. Japanese companies have also actively invested abroad, and now–like it or not–the time has come for foreign capital to invade Japan.

Japan must accept foreign capital proactively, not reluctantly in response to external pressure, and must acquire foreign technology, managerial know-how, and other knowledge to strengthen the country's competitiveness. FDI in Japan revitalizes the Japanese economy and Japanese markets by creating jobs and transferring technology and managerial resources, and can prevent the hollowing-out of industry.

Cooperation with foreign capital is necessary to ensure the survival of weakened Japanese companies by incubating new industries and rebuilding existing ones. Taking advantage of the managerial resources of foreign capital, they must acquire the strength needed to prosper amid global competition. For example, the restructuring of Mazda is being guided by a CEO sent from Ford, and Nissan formed an alliance with France's Renault. These Japanese companies are striving to boost their international competitiveness and ensure their very survival with the help of foreign capital.

In the fields of finance and information technology, which have been protected by the government, foreign capital is expected to revitalize and open markets by bringing in new products, planning capabilities, and managerial know-how, for instance. Companies are compelled to adopt international management systems if they are to compete in the international marketplace. Management must be rationalized and made more efficient and must place greater emphasis on shareholder value.

Reliance on outside capital can also be seen as a way for Japan's economy and Japanese industry to find solutions when the nation lacks the internal vitality needed to overcome the turmoil it faces. In other words, external pressure can generate the power to reform. When the U.S. automobile industry was in dire straits, investments from the Japanese automobile industry helped greatly: The managerial know-how and production technology of the Japanese automobile industry had a demonstration effect and contributed greatly to the reconstruction of the American auto industry.

Japan must now introduce foreign capital actively. High income levels make the Japanese market an attractive one to foreign capital. Further, FDI in Japan can exert a positive influence on Japanese-style management, which faces deepening confusion, and can directly enable the transfer of managerial resources. FDI is also effective in creating jobs.

The Japanese government should promote deregulation to attract foreign capital and should actively utilize foreign capital to reorganize businesses and revitalize provincial areas. This does not mean dependence on foreign capital, but rather the active use of foreign capital.

Although the need to accept foreign capital is widely recognized and the necessary legal changes are being made as described above, it is another issue altogether whether foreign capital actually enters the Japanese market or not. Foreign capital will come only if the Japanese market is seen as sufficiently appealing.

4. Factors in the Increase in Foreign Capital

Previously, the Japanese business environment was not attractive to foreign capital, despite Japan's large markets. High business costs, such as land, office space, personnel, and communications, had a negative impact on investment efficiency.

Government regulation was considerable, and closed business relations, such as the keiretsu, were strong, making entry into the Japanese market difficult. Then why did FDI in Japan begin to increase?

An October 1998 survey by JETRO asked why the Japanese market was appealing. The most common response was "Market scale and growth potential." The second most-cited reason for entering the Japanese market was "The ability to sell expensive, high-functionality, high-quality goods." In other words, Japan is the kind of mature, consumption-oriented society typical of advanced nations, with a huge market and considerable purchasing power. Other common responses were, in descending order, "The high level of technology," "The good quality of manpower," "Access to other Asian countries," and "A well-equipped infrastructure."

In addition, many changes conducive to foreign capital entry have also occurred. Since the collapse of the bubble economy, Japan has had to restructure its economy by resolving bad loans, reorganizing unprofitable operations, and selling off unprofitable subsidiaries, for instance. This has also meant a reevaluation of Japanese managerial style and business customs, such as the cross-holding of shares, the main bank system, keiretsu, lifetime employment, and the seniority system. The end of the lifetime employment system, for instance, has made it easier for foreign capital to employ talented people.

The Japanese recession brought down land prices and stock prices, making both more affordable. Progress was made in deregulation. Provincial areas began to recognize the importance of attracting foreign capital to ensure revitalization and job creation.

Mergers and acquisitions, which previously had suffered a negative image in Japan, became an important method of investment as it was now imperative for Japanese industry to restructure by selling off unprofitable businesses and to enter new fields made accessible to them by deregulation. In addition to acquisitions of Japanese companies by foreign firms, acquisitions by Japanese companies of other Japanese companies and even foreign companies have also become more common.

A survey by Daiwa Securities of official newspaper announcements sheds light on Japanese mergers and acquisitions in 1999: The number of deals was 982, a 28.7% increase over the previous year. Of these, the 442 deals for which the amount of money was officially announced totaled approximately 6.048 trillion yen–a 164.6% increase over the previous year. Both the number of deals and the amounts of money involved have increased sharply.

M&A between Japanese firms account for 64.1% of all deals but only 16.8% in terms of amount of money. Japanese companies are actively pursuing M&A as a means of restructuring by selling off unprofitable operations, for instance. As a result, the cross-holding of shares, once a popular method of corporate alliance, is beginning to fade. M&A in the Internet sector has also begun.

Acquisitions of foreign companies by Japanese firms account for 21.9% of the total by number of transactions and 34.2% by amount of money. A major transaction of this type is the acquisition by Japan Tobacco of the overseas cigarette operations of RJR Nabisco.

Foreign firms' acquisitions of Japanese companies account for 14.0% of all M&A activity by number of transactions but 49.0% by amount of money. Major acquisitions include the transfer of Japan Lease's leasing operations to GE Capital, Renault's capital participation in Nissan, and the capital participation in Japan Telecom by British Telecom and AT&T. Through such transactions, foreign capital can take advantage of local sales networks and business assets.

Although foreign capital was once viewed as negative, it has begun to acquire a positive image as holding the potential for development and providing access to advanced technology and planning abilities. More and more university students are getting jobs with foreign-owned companies, the business environment is improving, and M&A is a more viable tool for foreign capital.

Japanese companies are not so much passively receiving foreign capital as they are actively seeking out foreign capital as a means of effecting their own regeneration and revitalization.

Nissan Motor Corp. staked its survival on an alliance with foreign capital, receiving an investment of 640 billion yen from French Renault and even entrusting Nissan's management to a French CEO sent by Renault. Mazda, Mitsubishi, and other Japanese auto makers are also under the umbrella of foreign capital, leaving only Toyota and Honda without such relationships.

The automobile industry is also working to develop fuel cells and other environmental technologies that require massive R&D expenditures. For this reason, and in response to global competition, the industry must effect reorganization and cut costs considerably.

The finance and insurance industries in Japan, having been closely protected by the government, are weak in terms of international competitiveness and must also settle bad loans that are a legacy of the bubble economy. On the other hand, Japan has massive sums of individual financial assets—amounting to about 1,400 trillion yen—and so is quite enticing to foreign capital wishing to manage those assets.

Japan's financial world has been reformed under the so-called "Big Bang," a series of liberalization measures that include the aforementioned April 1998 revision of the Foreign Exchange and Trade Management Law. With Japan's massive pool of individual financial assets making it easy for foreign capital to enter the Japanese market, joint ventures and alliances with Japanese banks were formed in such specific areas as individual property management and investment trusts.

Moreover, the unstable financial situation that existed at the end of 1997 had forced some Japanese banks into bankruptcy and threatened the viability of others. Internationally powerful Western banks purchased weak Japanese banks on good terms and used their acquisitions to expand and strengthen operations in Japan. For example, Ripple Wood Holdings took over the Long-Term Credit Bank of Japan, Ltd., and Merrill Lynch Securities bought bankrupt Yamaichi Securities to acquire the latter's sales network and clients. On the other hand, some beleaguered Japanese financial institutions have actively sought out foreign capital to increase their capital and fortify their financial standing by making use of foreign companies' funds, excellent know-how, and brand name recognition.

Japan's service industry (e.g., retail and distribution), once protected by competition-stifling regulation, is also being called on to deregulate and open itself up. Service-industry capital overseas sees Japan as an inviting market that promises growth.

With the information revolution now in full swing in Japan, Western information and telecommunications companies are eyeing the Japanese market as some Japanese information and telecommunications companies are forming alliances with foreign companies to acquire funding and technology. Promoting this inflow of foreign capital are the overlapping objectives of Japanese and foreign capital seeking to enter the field of computer-related services.

5. Conclusions

Does foreign capital help Japan recover its international competitiveness? Does it help create jobs or—because restructuring must occur first—increase unemployment? Will American-style management take root in Japan? There are numerous fears concerning the entry of foreign capital into Japan, one being whether Japanese companies will be hastily discarded if alliances with foreign capital go sour.

Japan needs positive structural reform and must create a competitive market through deregulation. Although the entry of foreign capital creates competition, a business world accustomed to government protection may attempt to protect its vested interests by opposing deregulation and the entry of foreign capital. Furthermore, there still exist some regulations and Japanese business customs that deter the entry of foreign capital.

Given today's extensive transborder business activity, the economic role of the nation has declined in relative terms. Entry of foreign capital is now bilaterally accepted between nations. Indeed, this is an age in which foreign capital is actively used to develop a nation's economy.

Japan must view foreign capital as a means of actively promoting restructuring and regeneration. Japanese companies must utilize the managerial resources and technology of foreign companies. Rather than passively accepting foreign capital, Japan must actively invite it as a means of revitalizing the Japanese economy. Further deregulation and the adoption of global standard by business are also urgent issues.

Japanese-style management and business customs such as lifetime employment and the seniority system were once thought as the strength of Japanese business but are now seen as sources of inefficiency. Yet, rather than completely rejecting Japanese-style management, it is necessary to determine which aspects should be reevaluated and which should be retained. Japan must not depend completely on foreign capital, but rather must identify and domestically adopt the advantageous aspects of foreign capital while rejecting the negative ones.

References

(—All works in Japanese unless otherwise indicated—)

Economic Planning Agency, ***The Investigation to expand FDI from foreign countries,*** Government Printing Office, July 1995.

Economic Planning Agency, ***The Investigation of M&A to Promote FDI to Japan,*** Government Printing Office, August 1996.

Foley, Thomas S., "FDI in Japan and Deregulation", ***Nihon keizai shinbun***, 14 March 2000.

Inoue, Ryuichiro, ***Attracting FDI to Revitalize Local Economies,*** Japan External Trade Organization, 1998.

JETRO White Paper on Investment, 2000,1999,1998 and 1997 editions, Japan External Trade Organization.

Ministry of International Trade and Industry, 31 ***st Report on Trends in Foreign-affiliated Firms***, Government Printing Office, 1998.

MITI White Paper ; General Trends, Ministry of International Trade and Industry, 1998, 1999 and 2000.

Okumura, Hiroshi, ***Foreign Capitals,*** Toyo keizai shinpousha, 1969.

"Buying Japan by Foreign Capitals", ***Weekly Diamond,*** May 13, 2000.

"FDI in Japan : active promotion policies to attract foreign capitals", ***JETRO SENSOR,*** February 1999.

"The Impact of sharply increasing FDI into Japan", ***Sentaku***, August 1999.

"The Surge of FDI in Japan", ***JETRO SENSOR,*** February 2000.