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Insights into a Recent Increase in Foreign Direct Investment in Japan

- Theoretical Explanation and Research Based on Actual Developments -

Ryoko Takahashi* and Tsuyoshi Oyama**

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Research and Statistics Department

Bank of Japan

C.P.O BOX 203 TOKYO

100-8630 JAPAN

*e-mail: ryouko.takahashi@boj.or.jp

**e-mail: tsuyoshi.ooyama@boj.or.jp

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Ryoko Takahashi[**] and Tsuyoshi Oyama[***]
Bank of Japan

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[**] Economic Research Division, Research and the Statistics Department, Bank of Japan
(E-mail: ryouko.takahashi@boj.or.jp)
[***] Economic Research Division, Research and Statistics Department, Bank of Japan, Currently Bank Examination and Surveillance Department, Examination Division, Bank of Japan
(E-mail: tsuyoshi.ooyama@boj.or.jp)

Abstract

1. Foreign direct investment (FDI) into Japan, which were extremely low in comparison to other advanced nations traditionally, has showed a dramatic increase over the past few years (Chart 1), largely owing to growth in Out-In M&A (foreign company's acquisitions of Japanese companies). In terms of the industrial distribution, Out-In M&A implemented in the finance, machinery and telecommunications industries as well as greenfield investments (establishment of brand-new subsidiaries or affiliates by foreign parents) in the retail, service and software industries accounted for a large share of the FDI inflows in Japan (Chart 3-2).

2. The growth in FDI inflows is not a typical phenomenon of Japan, having occurred in many advanced countries in recent years. Global consolidation that is proceeding in various industries and multinational companies' strategic emphasis on worldwide reallocation of resources are the two major factors behind the growth in global flows of FDI (Chart 2,5).

3. FDI has two distinctive features: one as a function of capital transfer from a country with abundant capital to a country facing lack of capital, the other as a international movement of a package of resources from an investors' home economy to the host economy. Such resources include tangible and intangible assets, such as management skill, technology, operating franchise (brand loyalty), funding ability, etc. As for the former, even if the nation has ample capital as does Japan, any impediment to the nation's ability to supply risk capital could promote inflows of FDI as an alternative supply of risk capital.

4. FDI to Japan can be classified into the following five groups, i) rescue-type M&A, ii) restructuring-purpose M&A, iii) deregulation-driven M&A, iv) industry consolidation/market integration seeking M&A and v) IT-led greenfield investments. The first four groups, which are carried out through Out-In M&A, have rapidly increased over the past few years, while the last group, "IT-led greenfield investments" started to increase earlier, at the beginning of the 1990s (Chart9).

5. Given the increasing globalization of the economy, the spiral of "FDI to Japan" and "the ongoing structural changes in the Japanese economy" are the major factors influencing the recent growth in FDI to Japan. That is, structural changes in Japanese

industry stimulate FDI to Japan, while FDI to Japan accelerates the speed of structural changes. Concretely, such structural changes include 1) changing the safety-net mechanism in the financial system, 2) changes in corporate governance of Japanese companies triggered by changes in the financial system (increasing share of foreign equity holders → a rise of required rate of return for the Japanese firms → a shift to the globally accepted "level playing field"), 3) Japanese companies' recent focus on business restructuring for the purpose of improving profitability (e.g., Japanese companies' increasing interest in introducing new management know-how developed by foreign firms and restructuring business portfolios through M&A), 4) increasing transparency of Japanese companies as a result of reinforced disclosure requirements, 5) a series of deregulation initiatives lowering or eliminating barriers to new entrants (Chart 8, 10).

In addition to these Japanese specific factors, ongoing global consolidation accelerated by increasing integration toward a single global market and intensifying international competition have been stimulating FDI to Japan (Chart 6).

6. Given the structural changes in the Japanese economy as well as worldwide consolidation in various industries, FDI to Japan is expected to increase over the long term. "External pressure", which occurs as a result of foreign companies' entry, is expected to accelerate the speed of structural change in Japan, and will accelerate drastic restructuring that would not be accomplished through the efforts of existing stakeholders. The expected increase in FDI inflows may create deflationary pressure over the short-term; however, from a long-term perspective, growing inflows of FDI are likely to lead to a strengthening of the growth potential of Japan's economy by improving productivity of various industries, especially regulated industries, and helping develop globally competitive business practices as well as corporate governance.

1. Introduction:

Traditionally, foreign direct investment (FDI) into Japan has been extremely low in comparison to other advanced countries. In contrary to this pattern, FDI inflows have rapidly increased over the past few years. A level of inward FDI is compared to an indicator to measure the attractiveness of each nation's business environments. In this sense, the recent growth in the nation's FDI inflows could indicate that the Japanese business environment, which had been considered to be closed to new entrants, has undergone structural changes.

Accordingly, in this paper, we focus on the factors influencing the growth in FDI to Japan in order to clarify the relationship between inward FDI and structural changes faced by Japanese industry. Our analysis comprises both theoretical insights and research based on actual developments. To be concrete, we first survey recent trends of FDI to Japan and global flows of FDI in Section 2; next we analyze the FDI inducement mechanism from a theoretical approach in Section 3. Subsequently, we review characteristics of recent FDI into Japan by classifying the cases into five groups by the pattern of entry, then focus on factors affecting recent growth in FDI in Japan, trying to clarify the relationship between inward FDI and the ongoing structural changes that Japanese industry is undergoing in Section 4. In conclusion, we show the outlook for inward FDI, and its impact on the Japanese economy as a whole in Section 5.

2. Trends of FDI into Japan and Global Flows of FDI

FDI into Japan has the following characteristics[1].

1) Japan's FDI inflows, which were extremely low in comparison to other advanced nations in terms of a percentage of the nation's GDP or its FDI outflows[2], have soared since 1998. However, the absolute value is still smaller than that of the other G7

[1] In Japan there are two kinds of FDI statistics. One is "inward/outward FDI statistics" which is based on the reports and notification submitted to the Ministry of Finance, and the other is the "Balance of Payments (BOP) statistics" which is complied by the Bank of Japan in accordance with the BOP Manual issued by the IMF. The former adds up newly implemented investments only, while the latter is the net of new investments and withdrawals of investments previously implemented. There are other differences in the definition of coverage and reporting timing.

[2] Outward FDI from Japan increased significantly in FY1999 on a gross basis, reflecting an increase in Japanese firms' acquisition of foreign companies in the communication and food industries. However, on a net basis, it decreased for two consecutive years from FY1998, as Japanese firms actively liquidated and sold weak subsidiaries overseas as a part of restructuring measures.

countries (Chart 1, 2).

2) Looking at the composition of FDI to Japan by investors' region, the U.S. and EU were the two largest investors, accounting for approximately 70% of Japan's FDI inflows in FY1999 (Chart 3, upper).

3) Large-sized Out-In M&A deals (foreign companies' acquisitions of and/or capital participation in Japanese companies) are the major reason for the recent growth in Japan's FDI inflows (Chart 3, lower).

4) In terms of industrial distribution, FDI inflows in financial institutions and the telecommunications, electronics, automotive-related, retail and service industries showed remarkable increases (Chart 3-2). Out of these, FDI in the retail and service industries were implemented mainly through greenfield investments (establishment of brand-new subsidiaries or affiliates), while M&A (acquisitions of shares or units of existing local companies) dominated FDI in the financial institutions, and the machinery and telecommunications industries.

Global flows of FDI, which strongly affect FDI into Japan, have the following characteristics.

1) Global flows of FDI have consistently grown since 1993; the growth rate has risen each year since 1995. Geographically, FDI both into and out of the U.S. and EU have expanded over the past several years, while those in the developing countries remained stable, resulting in a significant increase in shares of advanced countries, particularly the U.S. and EU both into and out of the global flows of FDI (Chart 4).

2) The growing cross-border M&As are the driving force for growth in FDI flows within the U.S. and EU[3] (Chart 5, upper). Unlike LBO[4]s which boomed in the 1980s, under the initiative of investors who aimed at return in a relatively short time horizon, recent

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[3] The unification of European countries to EU is the fundamental factor attributed to growth of FDI involving EU countries. First, consolidation within the EU led European companies to strengthen their economies of scale and their ability to manage M&A in terms of both financial flexibility and managerial skill. Furthermore, reforms of the economic infrastructure (e.g., integration of currency and the financial system) led to a shift to market-oriented corporate governance. Those factors seem to spur cross-border M&As by European companies.

[4] LBO stands for Leverage Buyout, which is an M&A scheme in which purchasers fund acquisitions using the target company's assets as collateral.

M&As are a part of corporate strategies to restructure businesses or conduct alliances with other companies.

3) In industries such as finance, telecommunications, utility (electric power and gas), automotive, chemical, pharmaceutical, oil and retail, global consolidation has made progress through cross-border M&As or business alliances, raising the level of oligopolies in global markets. Lately, many large deals[5] were carried out through a scheme of "equity exchange" in which an acquiring company gives the target company's shareholders its shares equivalent to the purchase price value, instead of cash payment). This has resulted in an increase in FDI that is not accompanied by fund transfer (Chart 5, lower and Chart 6).

3. Theoretical Insights into FDI

The following discussion is to provide an overview of general FDI theories, and we attempt to apply them to explain FDI to Japan.

3-1 Economic Significance of FDI

In general, FDI is defined as capital movements in which a firm in one economy obtains a lasting interest in an enterprise in another through the establishment of a subsidiary, extending loans or purchasing shares of local companies (beyond a certain percentage). If we focus on FDI as an element of a multinational company's global strategy, the FDI is distinctive in that it involves an international transfer of managerial resources, which is to be distinguished from trade, which moves goods only. In comparison with other categories of international transfer of capital, FDI is distinguished from indirect investment such as equity investment, bond purchases or loans extended by financial institutions by the difference in the investors' stance. Namely, FDI involves management of a company that is invested in, while indirect investments do not; instead only focuses on the investment returns in the form of dividends, interest income or capital gain.

As a result of the increasing diversification of ways to handle financial transactions, there has been an increase in the foreign investors' acquisition of management control that is not included in FDI statistics (e.g., M&A implemented through fund investments). Since the

[5] As of June of 2000, the world's three largest M&A deals (Daimler-Benz's acquisition of Chrysler, British Petroleum's acquisition of Amoco and Vodafone's acquisition of AirTouch) were done using equity exchange.

primary focus of our study is analyzing the impact of newly introduced management or resources on the Japanese economy, in this paper we include any transactions involving international transfer of management right in our concept of FDI, regardless of the definition of FDI used in the statistics.

In view of this discussion, the economic significance of FDI can be summarized in the two points:

1. **FDI involves international transfer of decision-making authority regarding how to use capital invested through FDI.**
2. **A package of resources is internationally transferred, accompanied by a parent company's management control over its foreign subsidiaries/affiliates.** Such resources include management skill, technological expertise, patent, operating franchise (brand loyalty), funding ability and etc. These tangible and intangible resources allow FDI to have a strong impact on supply side of the host economy, through intensifying international competition even in non-tradable goods and service industries.

3-2. FDI Inducement Mechanism

Theoretically FDI inducement mechanism can be explained by the following two approaches.

1. **First, if we focus on FDI as a "capital transfer", it can be demonstrated that "capital tends to move from a country with ample capital to one facing lack of capital as FDI seeks a higher marginal rate of productivity per capital".**
2. **Second, if we focus on the "movement of enterprises' resources", FDI is determined by the incentives multinational companies have to engage in operations abroad by transplanting resources to subsidiaries or affiliates.**

Since first approach is based on "a difference of capital accumulation among nations", it is difficult to simply apply this mechanism to explain the recent growth in FDI to Japan which always has much capital. However, in reality, international allocation of capital is affected not only by "productivity of invested capital" which depends on the relative level of accumulated capital, but also by risk-taking ability of the nation's capital suppliers. Taking this point into consideration, lack of risk capital can stimulate inflows of FDI to meet that need.

On the other hand, the latter approach, which considers FDI as a movement of resources,

is based on the idea that multinational companies who have competitive advantages even in foreign markets resort to direct investments abroad. However, even if a company has such strong resources, there are still two questions that must be answered before making a FDI decision.

1. **Why does it need to engage in local operations (typically local production) abroad, instead of exporting goods manufactured in its home country?**

2. **Even if it chooses a shift to local production abroad, why does it need to do so inside its own organization, rather than licensing a third party there?**

For the first question, the goods or services a company handles, i.e., whether or not they are tradable, can shape a company's decision to enter the foreign markets. Quite simply, a company that handles non-tradable goods or engages in services cannot merely export to extend its global reach. In addition, a host nation's **"Location-oriented Characteristics"** strongly influence a company's decision on whether export or local production is more advantageous. The location-bound characteristics are the country-specific features such as natural resources, quality and cost of labor, transportation and communication infrastructure, political situation, cost effectiveness, industrial structure and barriers to trade (import quotas and tariffs).

In FDI theory, the second question is referred to as a matter of **"Internalization",** i.e., managerial decision regarding whether international transactions or foreign businesses need to be done within a single organization or can be licensed to a third party. If it is physically difficult to package and convey resources (like technological expertise or marketing skills that are embodied in a group of individuals in a company) to licensees, or if establishment of a subsidiary can avoid spillover of crucial resources more easily than licensing, a company will internalize its foreign operations, i.e., resort to FDI.

---- When foreign companies have evaluated Japan as a host country for FDI, size and growth potential of the market, its location within the Asian-Pacific region, high levels of technology and labor quality and developed social infrastructure have been recognized as advantages to attract inbound FDI. On the other hand, difficulties in hiring capable people in the midst of careers, complicated distribution channels, customers' requirement for quality, high business costs and competition-restricting business practices have been cited as obstacles (or location-oriented disadvantages) to FDI to Japan. However, an increasing number of foreign companies admitted that

these location-oriented disadvantages have gradually lowered in recent years (see Chart 7 and 8).

4. Analysis Based on Actual Developments: Classification of Inward FDI and Factors Behind the Recent Growth in Inward FDI

4-1. Classification of inward FDI

FDI implemented over the past few years can be classified by the pattern of entry into five groups, i) rescue-type M&A, ii) restructuring-purpose M&A, iii) deregulation-driven M&A, iv) industry consolidation/market integration seeking M&A and v) IT-led greenfield investments. The first four groups, which are carried out through Out-In M&A (acquisitions of Japanese companies by foreign companies), have showed rapid growth over the past few years, while the last group, IT-led greenfield investments, started to increase at the beginning of the 1990's .

1) Rescue-type M&A (mainly in the finance, wholesale and retail industries)

On a value basis, capital injection to troubled Japanese companies by foreign companies mostly contributed to FDI in Japan. Foreign companies have taken an important role as a sponsor or primary supporter in the revitalization[6] of several large Japanese firms that failed, beginning with the financial crisis in 1997. Interestingly, the foreign companies involved in these rescue-type M&As, not volunteering for loss sharing. Instead, they have the long-tem goal to realize a high rate of return by supporting the revitalization of the company they invest in and improving its value and competence. In terms of industrial distribution, these rescue-type M&As took place primarily in the non-manufacturing sector, such as the finance, wholesale and retail industries. Those industries were heavily regulated or isolated from international competition, but they have faced rapid changes in the competitive environment in recent years as a result of deregulation and the recession that followed the collapse of the bubble economy.

2) Restructuring-purpose M&A (mainly in the electronics, machinery and chemical industries)

[6] Specifically, such failures include the closure of Yamaichi Securities, the failure of Long-Term Credit Bank of Japan and the bankruptcies of Toshoku and Nagasakiya.

To restructure business portfolios, many Japanese companies have made efforts to spin off non-strategic business units. In response, foreign companies have actively purchased these business units. In many cases, foreign companies have joined these transactions to get access to the high level of technology and/or the existing distribution channels developed by the Japanese. This type of M&A has been implemented mainly in the electronics and basic material industries, in which many large companies had aggressively diversified in the past.

3) Deregulation-driven M&A
(mainly in the finance, retail, telecommunications and utility industries)

Various regulatory changes implemented in these industries created opportunities for foreign companies to enter or expand business in the Japanese market.

4) Industry consolidation/business integration-seeking M&A
(mainly in the automotive, telecommunications and electronics industries)

Influenced by global consolidation proceeding as a result of cross-border M&A, foreign companies' capital participation in the Japanese companies has increased significantly in the automotive-related (automobile and auto-parts[7]) and telecommunications industries.

5) IT-led Greenfield Investments
(mainly in the information services, software, finance and retail industries)

IT-related companies' direct investments have dominated greenfield investments in Japan. These IT-related companies include not only "IT producers" (suppliers of IT-related equipment, software and/or infrastructure) such as electronics makers, software developers and Internet providers, but also "IT users" who actively utilize information technologies for their business needs, e.g., risk management, demand forecasts, operational management and the like. These IT users have developed and introduced new business models in various industries, and have emerged as new segments of retailers (e.g., SPA[8], outlet, single-category focused discount stores <so called category

[7] Global integration of procurement among auto-assemblers require parts makers to supply products on a global basis. This has encouraged auto-parts makers to make alliances with foreign parts makers, which has accelerated consolidation in the auto-parts industry.

[8] SPA (Specialty Store Retailer of Private Label Apparel) is a new business model involving both production and retail business developed in the U.S. By effectively sharing sales information at its stores with production and product development units, SPA has realized efficient inventory control and a quick response to consumers' preference (through development of brand products).

killers>), investment consultants, business consultants, and various Internet business developers (Chart 9).

4-2. Factors Affecting the Recent Increase in FDI Inflows

Since 1998, FDI inflows to Japan have rapidly increased through the entry patterns identified in the previous section. The increase is likely to have strong links with changes in the structure of the Japanese economy, typically deregulation, changing safety net in the financial system and the resultant shift to market-oriented corporate governance. These structural changes have been mutually reinforcing, like a chain reaction (one factor causing or accelerating others), rather than developing as independent factor. A similar situation seems to happen between structural changes and FDI to Japan. That is, structural changes tend to cause and accelerate FDI inflows and vice-versa, leading to greater structural changes and more FDI inflows (Chart 10). In addition to this Japanese-specific situation, some critical global trends such as i) strengthening risk-taking ability of U.S. and EU companies and ii) worldwide consolidation in various industries, also seem to have a strong impact on FDI to Japan.

(Japanese-Specific Factors Affecting FDI to Japan)

(1) The weakening of the main bank support mechanism, which has been the nation's primary framework providing a safety net for corporate finance for the Japanese companies, caused the supply of risk capital to shrink. Accordingly, foreign companies have stepped in to become suppliers of risk capital, leading to an increase in FDI to Japan, which is a form of risk capital from abroad.

---- Amid declining effectiveness of this safety-net, many troubled Japanese companies seek capital injection and managerial supports from foreign companies. Out-In M&A conducted by investment funds (e.g., M&A fund and/or PEF) have also increased in Japan since last year. Because those investment funds were established mostly by foreign firms or by joint ventures with foreigners, they actually created a new channel of risk capital inflows from abroad. Statistically, these investment funds are not generally recognized as FDI, and are classified as indirect investment. In fact, however, foreigners are actively involving in the management of the Japanese companies in which they acquire a majority of shares, as is the case for FDI.

(2) Increasing inflows of risk capital from abroad have heightened the required rate of return for the Japanese companies as a result of the increasing share of foreign investors in the Japanese stock market. This change has contributed to the development of a globally acceptable "level playing field" where foreign companies compete with Japanese companies on equal terms.

---- Under the traditional economic system which was supported by the nation's economic growth and the main-bank support mechanism, Japanese companies tended to put primary emphasis on expansion of market share, causing severe competition in terms of price and capacity expansion at the expense of profitability. If foreign companies had entered the Japanese market in this environment, they would have been unable to achieve the level of profitability required by investors in their home markets[9]. This situation restrained foreign firms' incentive to extend FDI to Japan. However, Japanese companies have been changing their pricing and investment policies to ensure a certain level of profitability as a result of increasing pressure to meet the target rate of return required by capital market investors.

(3) Increasing influence of foreign investors, who generally set higher required rates of return than do domestic investors, have urged Japanese companies to improve their return on capital (e.g., ROA/EVA), and encouraged them to carry out restructuring such as reinforcing business portfolios and/or liquidating low-profitability assets. Japanese companies' restructuring efforts have led to an increase in FDI inflows through the following five routes:

1. Japanese companies actively sold unprofitable or non-strategic business units to strengthen their business portfolio in the past few years. In many cases, those businesses were sold to foreign companies through Out-In M&A.

2 Amid an increasing consciousness of return on capital, many Japanese companies have been obliged to sell cross-shareholdings. The increasing dissolution of cross-shareholdings has helped prepare the foundation of the Japanese M&A market, making it easier to acquire Japanese firms.

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[9] The fact that average ROE for foreign companies' affiliates and subsidiaries operating in Japan is consistently higher than that of Japanese companies indicates that foreign companies have sought a higher target margin to meet investors' expectation (Chart 11).

3. The number of Japanese companies that have sought capital affiliation with foreign companies has increased over the last several years. The merits of affiliation are: i) they can learn managerial know-how[10] which does not exist in Japan, ii) foreign management is not heavily bound by traditional business relations, which makes it easier to implement drastic restructuring measures such as dissolution of the *"keiretsu"* relationship (the industrial group affiliation and/or sub-contractor relations) and withdrawal of weak business segments.

4. Increasing outflows of human resources as a result of employment adjustments by Japanese firms during the recession in 1997 through 1999 have increased the size and diversity of the labor pool in terms of specialty, technological skill, age and job segment. This has made it easier for foreign entrants to hire various types of experts necessary to commence doing business in Japan.

5. In the vendor selection process, an increasing number of Japanese assemblers have adopted open bidding in which anybody can bid and win based on prices and quality. This is a shift from selective bidding in which limited number of companies are invited and selection criterion emphasize past performance and relations of parts suppliers.

(4) In response to the increasing importance of the capital market within the Japanese financial system as well as the internationalization of investors, various changes in accounting standards have taken place for the purpose of improving disclosure of Japanese companies to satisfy international standards. At the same time, the increasing number of foreign financial institutions has distributed information and analysis regarding Japanese companies and markets worldwide in English, and have aggressively expanded their investment banking business acting as M&A advisors and business consultants in Japan. This progress in information-related infrastructure has made it easier for foreign investors to invest in Japanese companies.

(5) Japanese companies' competitive disadvantage in technology and/or managerial know-how in certain areas (especially in IT utilization and cashflow management) promotes inroads by foreign companies that have "superior resources".

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[10] The Japanese companies' need to learn how to manage resource allocation and cashflow have increased, given the increasing importance on improved return on capital.

(6) Deregulation implemented in the finance, retail, telecommunications and electric power industries has opened the door to new entrants, attracting foreigners to make FDI in Japan.

---- Regulatory changes which encouraged foreign companies' entry include the reform of Foreign Exchange Law that started the financial Big Bang (April 1998), liberalization of the wholesale and retail of electric power (in and after 1995), lifting of restriction on foreign companies to enter the class-I telecommunications industry (1998) and a series of relaxation of the regulations for the large-size stores in the retail industry (1990s).

(7) Sustained declines in asset prices since the collapse of the bubble economy and various expenses as a result of deregulation have considerably lowered business costs in Japan, which had been higher than those in other countries, obstructing inward FDI (Chart 8 previously shown).

(Global Factors Affecting FDI to Japan)

(8) Worldwide consolidation has dynamically proceeded in sectors such as the finance, automotive, telecommunications, pharmaceutical and basic material (chemical, oil and non-ferrous) industries, led by cross-border M&A among U.S and European companies (Chart 6 prviously shown). These movements have extended to Japan in segments such as the automotive and telecommunications industries, encouraging Japanese firms to seek out capital affiliations and/or business alliances with foreign competitors.

The reasons behind the ongoing global consolidation can be described as follows:

1. Given the increasing integration toward a single global market, many multinational companies have emphasized i) strengthening their global franchise by conducting alliances with foreign competitors for shared use of customer bases and brands, and ii) cost reductions by integrating production and procurement with other firms.

2. Furthermore, the recent technological innovation has also stimulated cross-border M&A. First, remarkable advances in information technology have made it easier for multinational companies to manage their international operations beyond borders of

nations or companies. Second, in the communications industry, the expected introduction of global standards in mobile communications technology and rapid penetration of the Internet have accelerated the global integration of the market. Finally, shortening cycle of technology (product life) is making it harder for even large multinational companies to endure increasingly heavy R & D burdens by themselves both financially and technologically; thus, there is a motivation to share the cost with other companies (typically in the automotive and telecommunications industry).

(9) U.S. and European companies have maintained relatively strong risk-taking ability to facilitate M&A, which has been helped by high stock prices[11] in their domestic markets.

5. Conclusion: The Outlook for Inward FDI and its Impact on the Japanese Economy

There is possibility that the growth rate of FDI would decline temporarily, if corporate restructuring were to slow down as the Japanese economy recovers, or should the Japanese people's antipathy to foreign companies increase. However, the factors stimulating FDI inflows, such as deregulation, changing corporate governance, inflows of new technologies or business models especially in the IT area, are likely to remain. Supported by those factors, FDI to Japan is expected to continuously grow, as a result of the mutually reinforcing interaction between the nation's ongoing structural changes and expansion of FDI inflows. Furthermore, the global tendency toward industrial consolidation and market integration are also expected to spur this trend[12][13].

The last question is "what is the impact of growing FDI inflows on the Japanese economy as a whole?" In other advanced countries, growing inflows of FDI have made meaningful contributions to the nation's capital investments and/or labor. In Japan, although inward FDI has soared recently, it still remains quite insignificant as a percentage of the nation's GDP; therefore, its direct impact on macro-economic indicators is likely to be limited.

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[11] Considerably lower stock prices of Japanese companies relative to those at the time of the bubble economy and a widening price gap between strong companies and weak ones (an increase in "value stock") in the recent stock market have also contributed to strengthening foreign investors' risk-taking ability.

[12] Global consolidation also encouraged Japanese companies to acquire foreign companies; thus, in the long-term, outward FDI from Japan is also expected to increase.

[13] Even so, it is to be noted that Japan is still less prepared than the U.S. and EU to be a host country of FDI; therefore, further reform of regulation and infrastructure is required to stimulate inward FDI.

However, FDI to Japan is expected to strongly contribute to an improvement in efficiency of Japanese companies' operations as well as to the nation's economic system by intensifying competition and facilitating the penetration of managerial know-how or business models brought by foreign entrants. In other words, "external pressure", which occurs as a result of foreign companies' entry, is expected to accelerate the pace of structural change in Japan, and will drive drastic restructuring that would not be possible through the efforts of existing stakeholders.

In the short term, increasing harsh competition with foreign companies may create deflationary pressure, by weakening existing companies' performance and shrinking inefficient sectors. In particular, foreigners' entry to the retail industry is likely to directly create downward pressures on consumer prices[14], probably forcing some retailers, which can not keep up with price declines, out of the market. However, in the middle- and long-term, FDI inflows are expected to improve the productivity of many industries, especially regulated ones in Japan. At the same time, they will also accelerate the globalization of Japanese companies by bringing management skills that meet global standards as well as strict managerial discipline under the close watch of international investors[15]. Eventually these effects will increase the growth potential of the Japanese economy through the efficient re-allocation of the nation's economic resources.

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[14] According to survey by the Japan Fair Trade Commission, in the toy market, 70% of retailers answered that they sell products at the prices recommended by makers in 1988. However, in 1993 after Toys"R"Us entered the Japanese market in 1991, 71% answered that they price lower than the makers' recommended prices (JETRO[1999]).

[15] In the retail industry in which inward FDI increased earlier (from the beginning of the 1990s), Japanese companies that adopted foreign retailers' business know-how have rapidly grown, while existing retailers have tried their utmost to restructure their business to compete with emerging firms.

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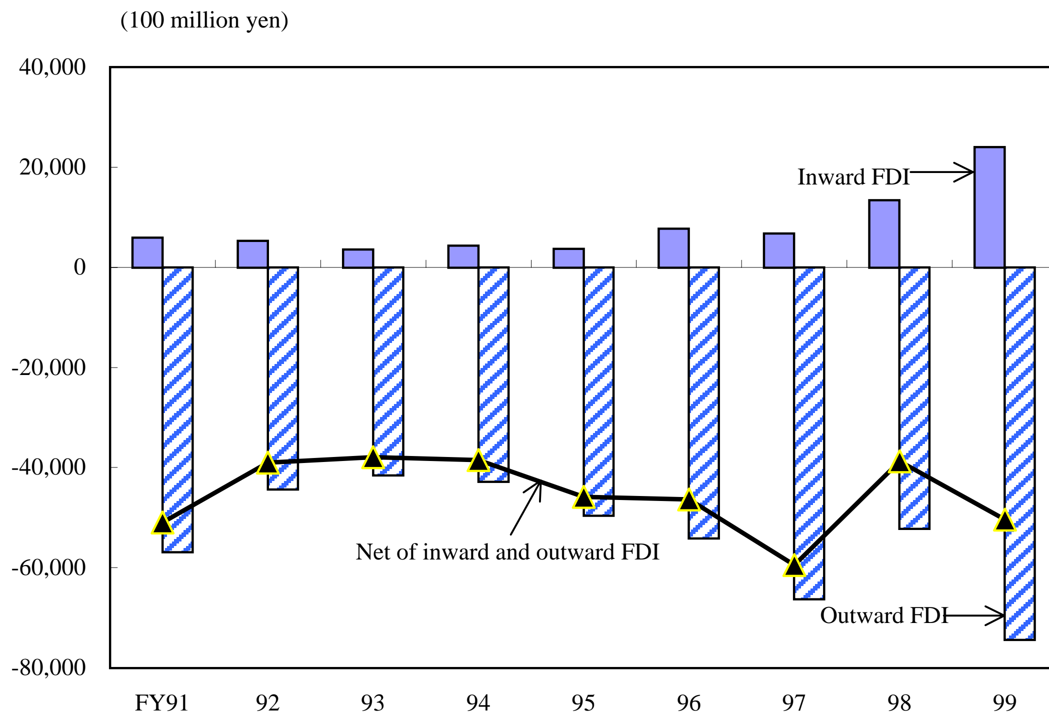
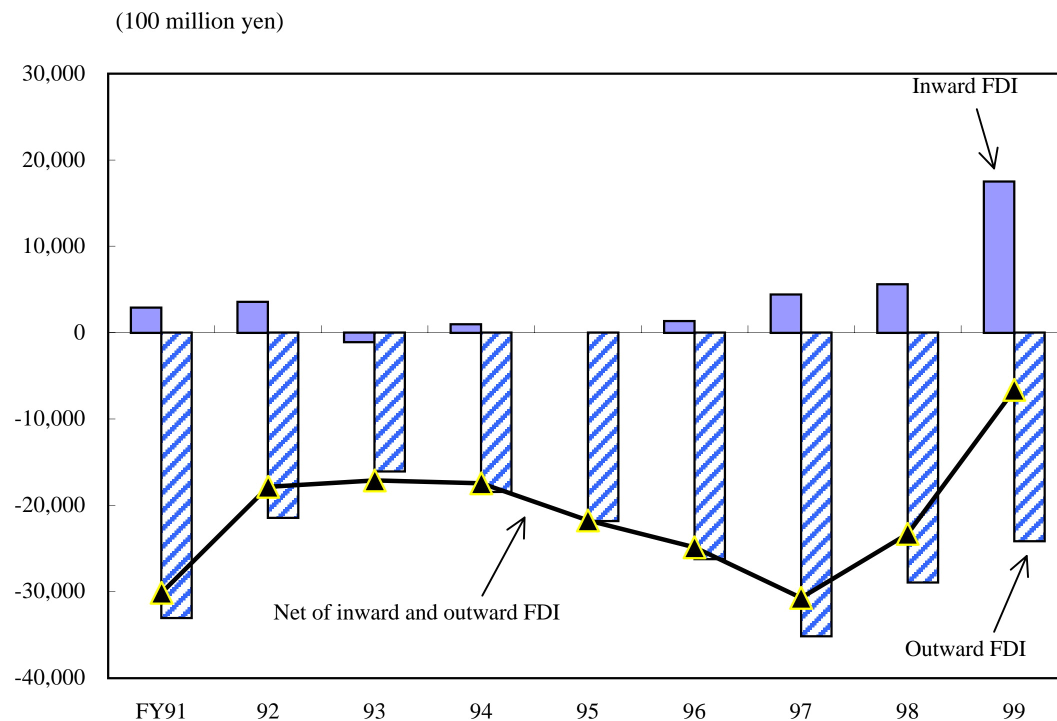
(Chart 1)

Trends of FDI to and from Japan

(1) Gross FDI (Newly implemented FDI based on reports & notifications to the MOF)



(2) Net FDI (Newly implemented FDI - withdrawal of FDI based on BOP statistics)

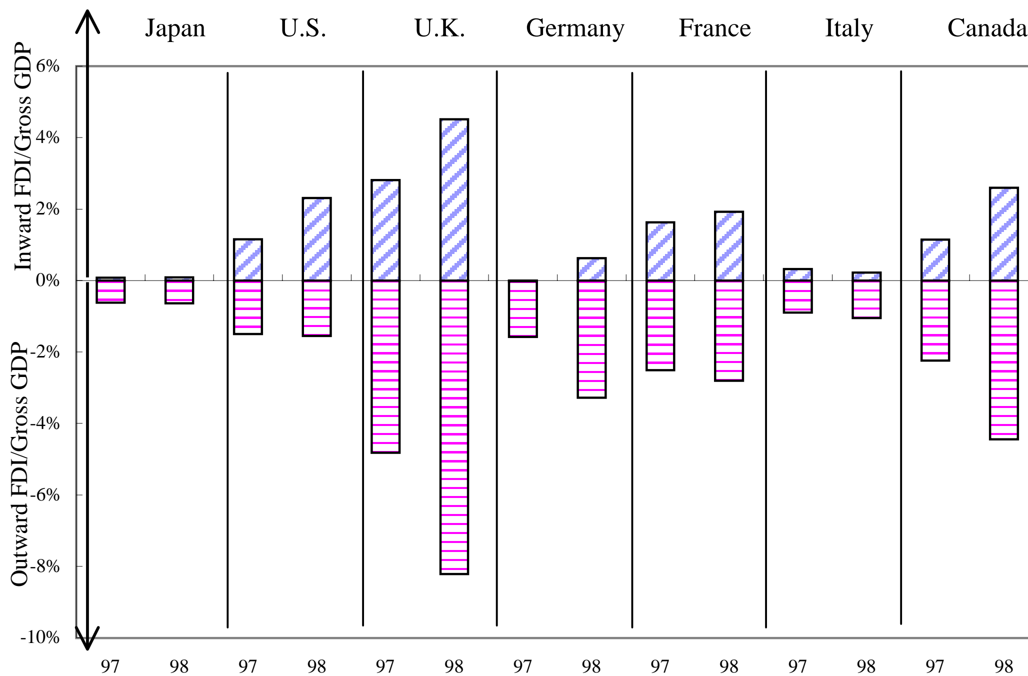


Source: MOF *"Tainaigai Chokusetsu Toshi Tokei"* (Inward/Outward FDI Statistics)
Bank of Japan "Balance of Payments Monthly"

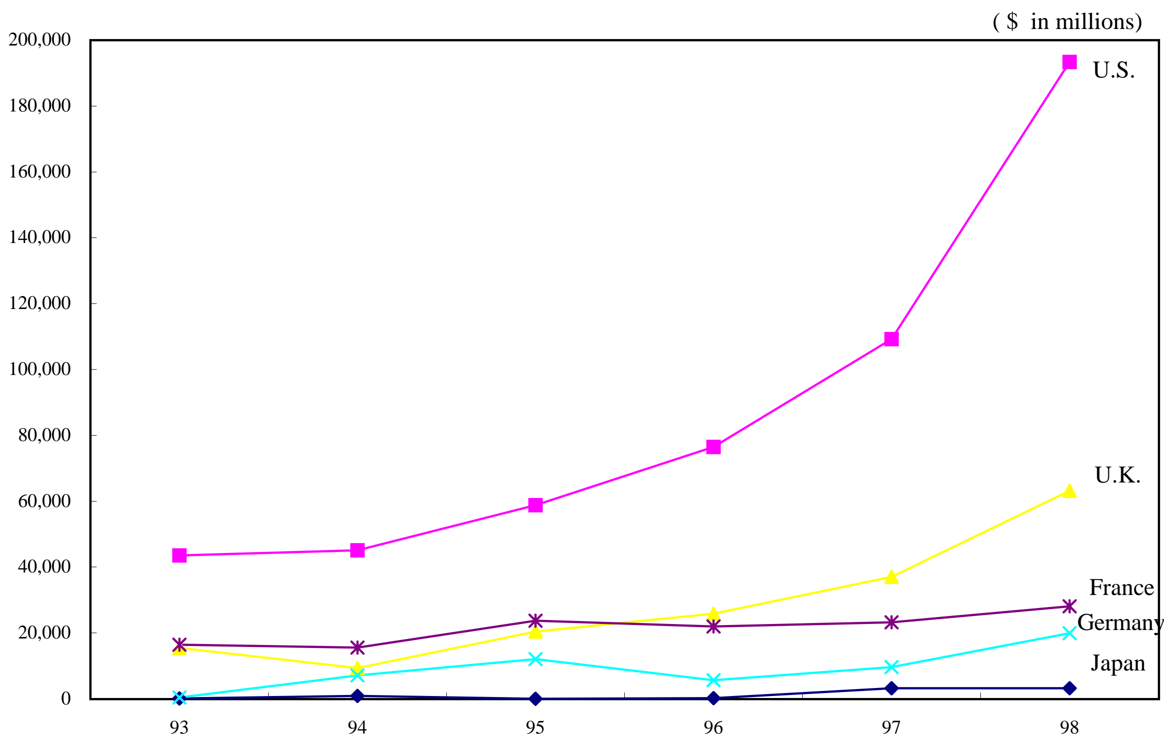
(Chart 2)

Comparison of FDI among the G7

(1) Inward FDI/Gross GDP and Outward FDI/Gross GDP



(2) Trends of Inward FDI in Major Countries

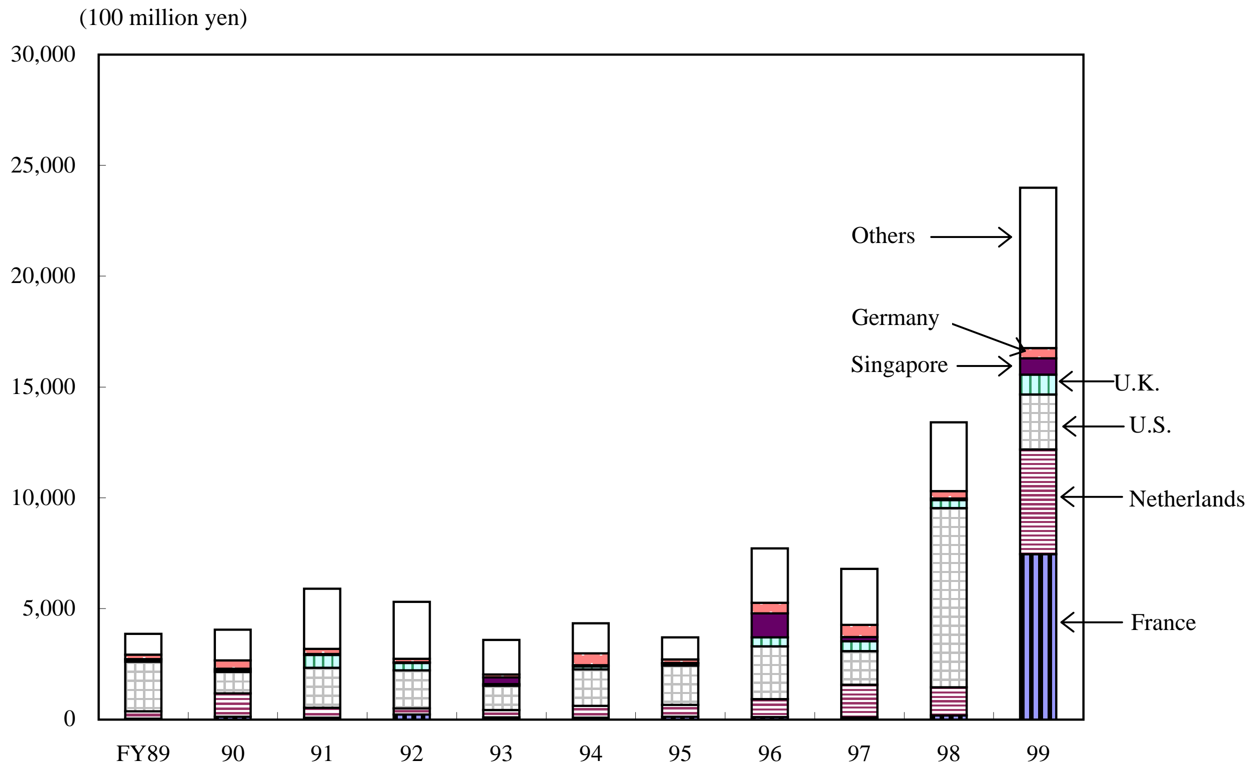


Source: Bank of Japan "Comparative Economic and Financial Statistics Japan and Other Major Countries 1999", UNCTAD "World Investment Report 1999"

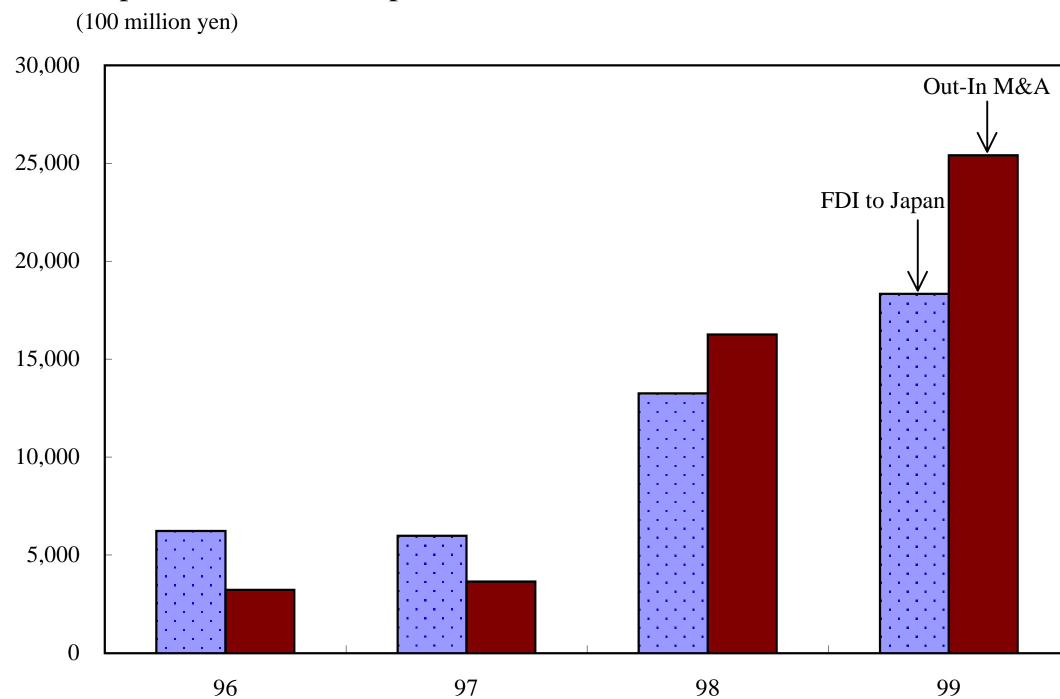
(Chart 3-1)

Breakdown of FDI to Japan

(1) Breakdown of FDI to Japan by investors' country

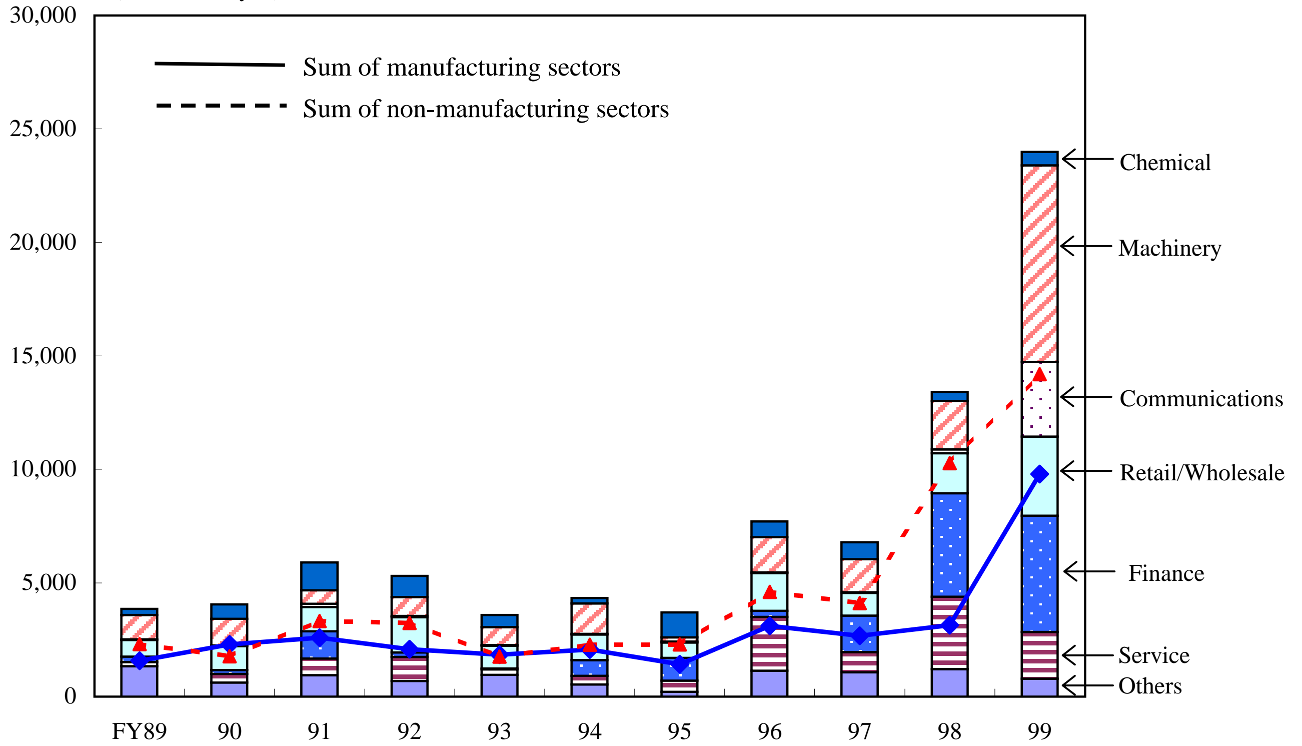


(2) Comparison of FDI to Japan and Out-In M&A



Source: MOF *"Tainaigai Chokusetsu Toshi Tokei"* (Inward/Outward FDI Statistics)
Nikko Securities *"Senryakuteki M&A Tokei"* (Strategic M&A Statistics)

(3) Breakdown of FDI to Japan by Industry

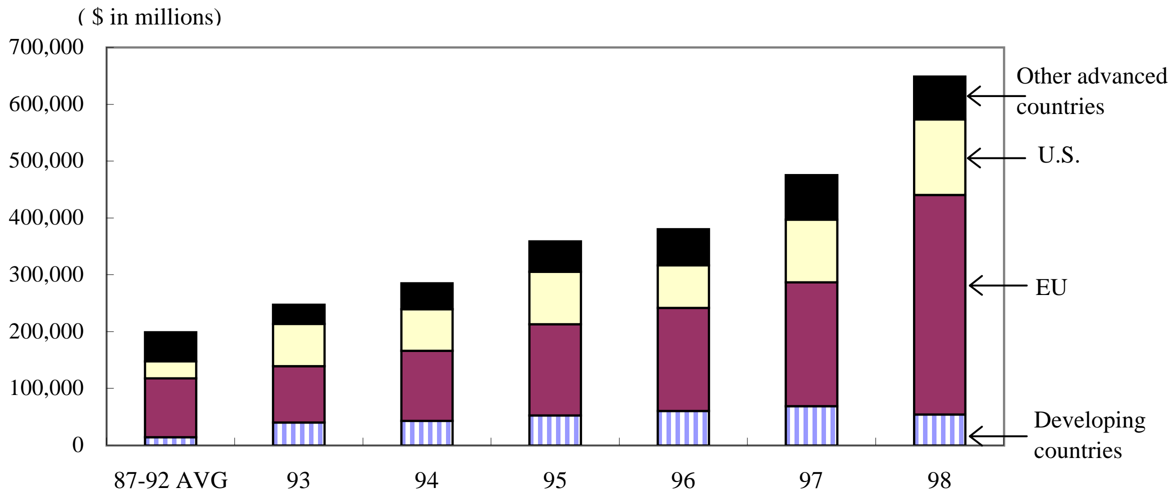


Note: The electronic machinery and automotive industries are included in the machinery industry.
Source: MOF *"Tainaigai Chokusetsu Toshi Tokei"* (Inward/Outward FDI Statistics)

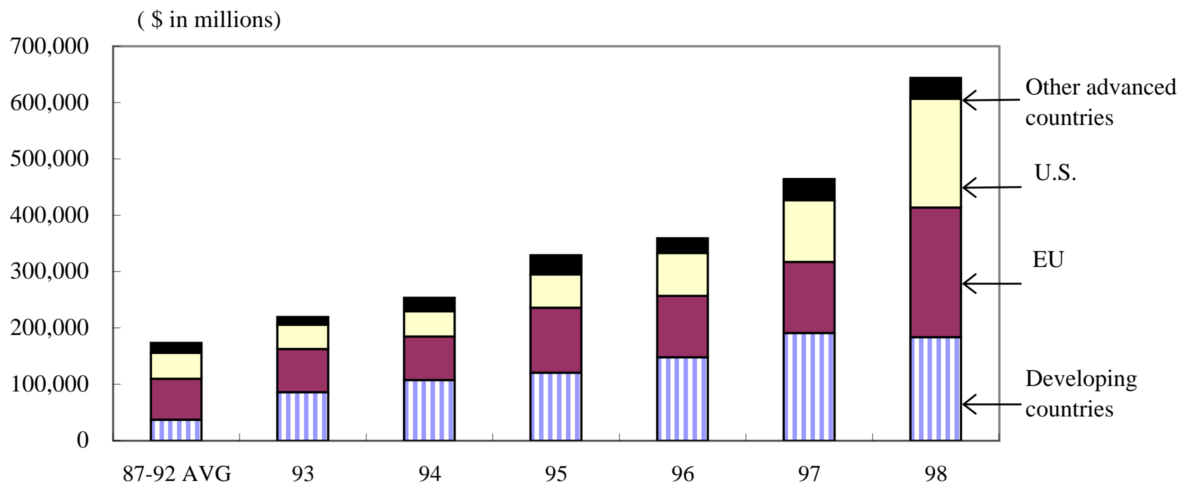
(Chart 4)

Global FDI Flows (1)

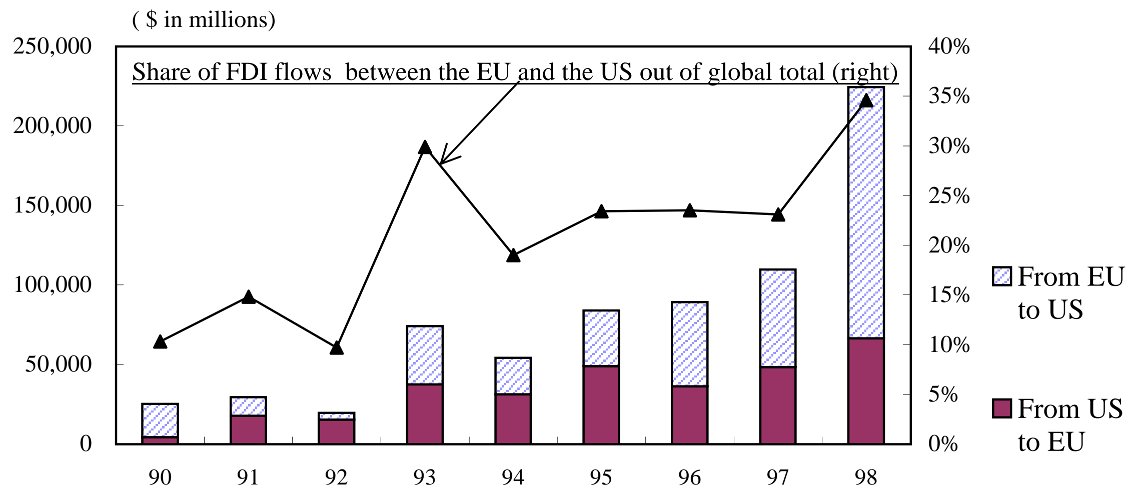
(1) Breakdown of Global FDI Outflows by Home Economy



(2) Breakdown of Global FDI Inflows by Host Economy



(3) FDI between the E.U. and the U.S.

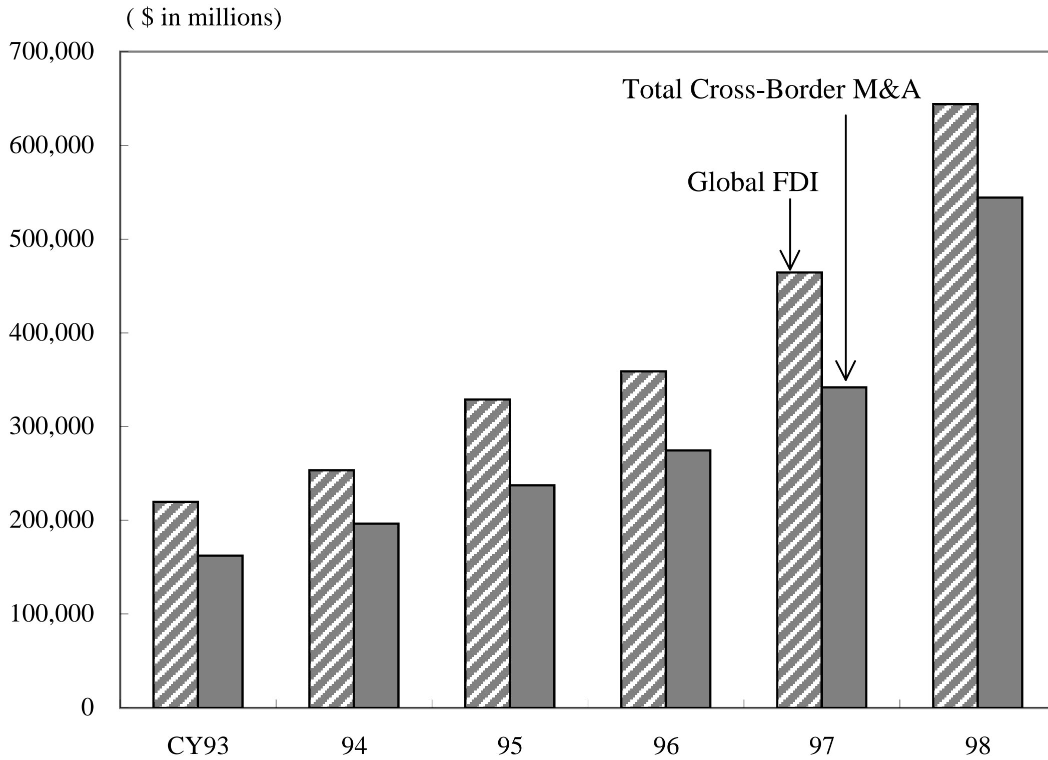


Source: UNCTAD "World Investment Report 1999"
U.S. Department of Commerce "Survey of Current Business"
JETRO "White Paper on Foreign Direct Investment 2000"

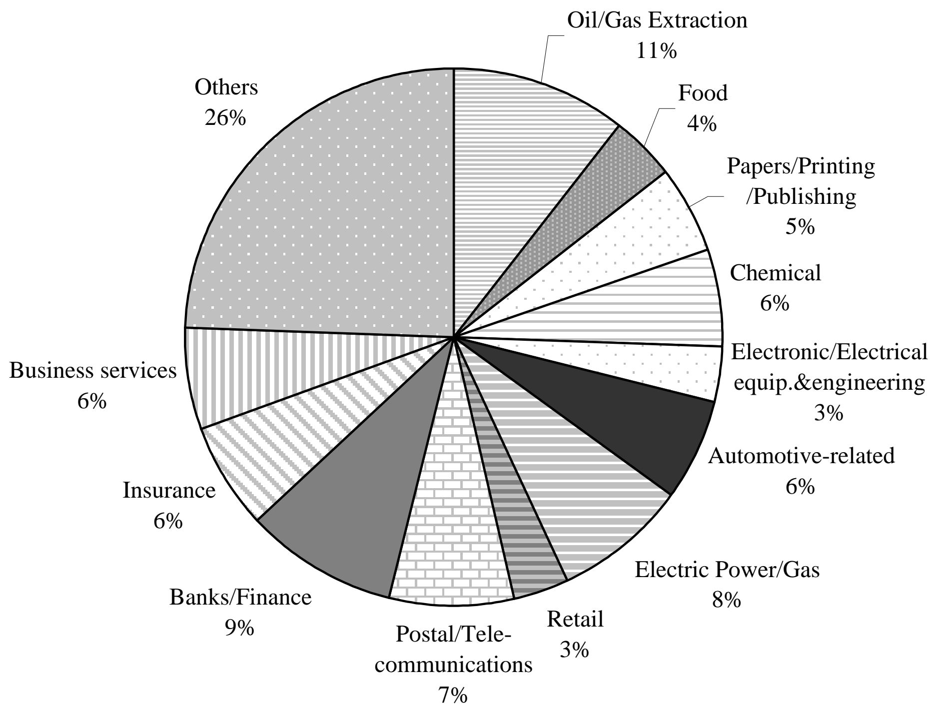
(Chart 5)

Global FDI Flows (2)

(1) Trends of Global FDI and Cross-Border M&A



(2) Industrial Breakdown of Cross-Border M&A Worldwide
(Based on total M&A value from 1996 to 1998)



Source: UNCTAD "World Investment Report 1999", KPMG Corporate Finance

(Chart 6)

Top 10 Industries Involving Cross-Border M&A Worldwide

($ in millions)

1995				1996				1997			
Ranking	Industry	Value	Share%	Ranking	Industry	Value	Share%	Ranking	Industry	Value	Share%
1	Pharmaceutical	21,316	10.7	1	Electricity/Gas/Water	22,192	9.1	1	Electricity/Gas/Water	32,022	9.6
2	Food	16,611	8.3	2	Oil/Natural Gas	15,913	6.5	2	Chemical-Related Products	23,419	7.0
3	Electricity/Gas/Water	12,846	6.5	3	Telecommunications	12,659	5.2	3	Investment/Foreign Exchange	22,464	6.7
4	Banking	11,835	5.9	4	Insurance	12,002	4.9	4	Food	20,900	6.2
5	Mining	9,678	4.9	5	Publishing/Printing	11,521	4.7	5	Banking	18,523	5.5
6	Investment/Foreign Exchange	8,943	4.5	6	Wholesale(Durable Goods)	10,633	4.4	6	Business Services	16,714	5.0
7	Insurance	8,391	4.2	7	Investment/Foreign Exchange	10,203	4.2	7	Insurance	14,934	4.5
8	Business Services	6,980	3.5	8	Banking	9,413	3.9	8	Broadcasting	14,621	4.4
9	Telecommunications	6,720	3.4	9	Metal	8,948	3.7	9	Telecommunications	14,400	4.3
10	Film industry	6,439	3.2	10	Business Services	8,853	3.6	10	Pharmaceutical	12,900	3.9

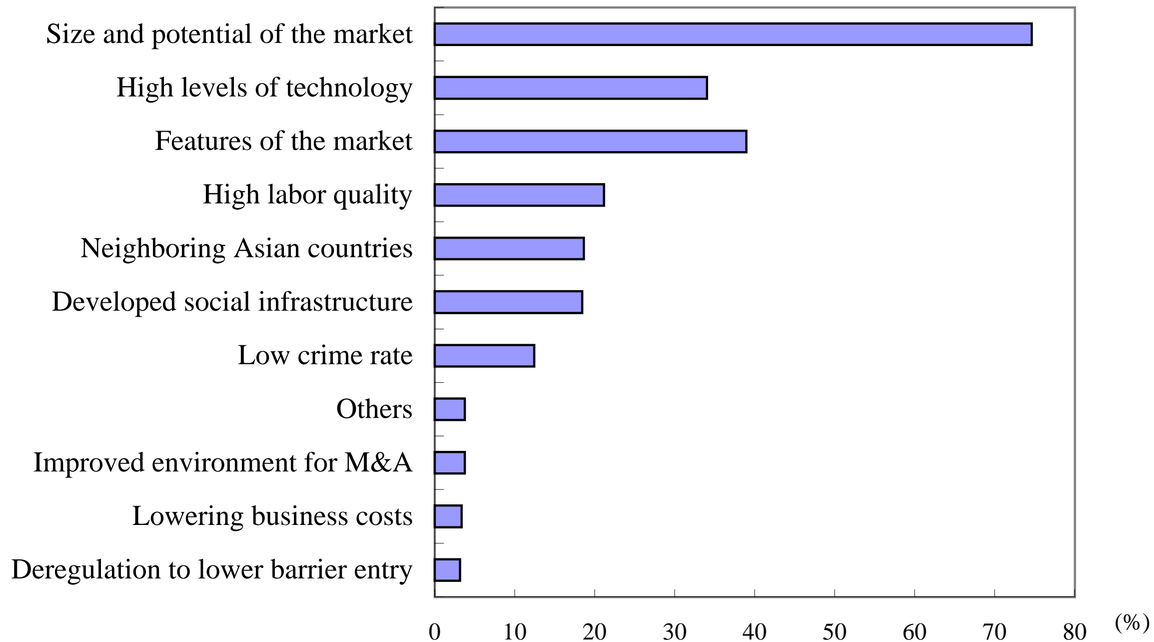
1998				Jan-Sep/1999			
Ranking	Industry	Value	Share%	Ranking	Industry	Value	Share%
1	Oil/Natural Gas	74,753	12.7	1	Telecommunications	109,818	22.0
2	Transport Equipment	49,547	8.4	2	Oil/Natural Gas	39,950	8.0
3	Insurance	44,561	7.6	3	Insurance	33,051	6.6
4	Telecommunications	43,358	7.4	4	Banking	28,679	5.8
5	Banking	33,966	5.8	5	Business Services	21,138	4.2
6	Electricity/Gas/Water	33,610	5.7	6	Electricity/Gas/Water	20,278	4.1
7	Business Services	23,606	4.0	7	General Machinery	17,879	3.6
8	Electronic/Electrical Equipment	17,814	3.0	8	Tobacco	17,860	3.6
9	Food	17,406	3.0	9	Electronic/Electrical Equipment	17,514	3.5
10	Chemical-related products	16,603	2.8	10	Retail(Food)	15,302	3.1

Source: JETRO "White Paper on Foreign Direct Investment 2000"
Thomson Financial Securities Data

(Chart 7)

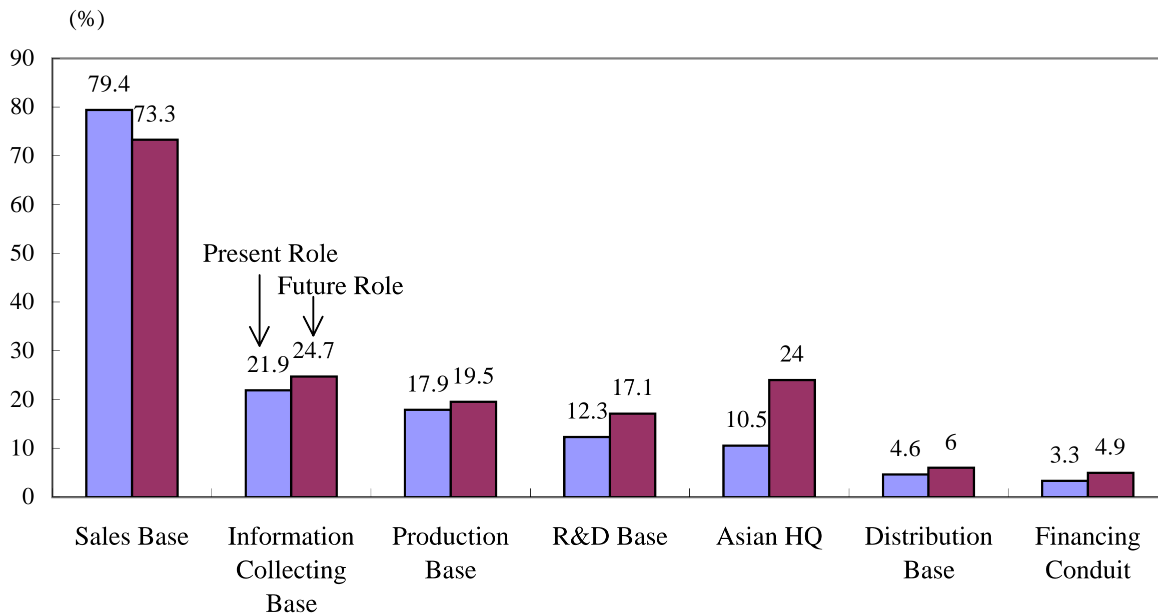
Foreign Companies' Objective for Direct Investment in Japan

(1) What is the attractiveness of the Japanese market for foreign firms?



Note: Multiple Answers. Inquired in Oct. 1998.

(2) What are the roles of foreign companies' subsidiaries or affiliates established in Japan?



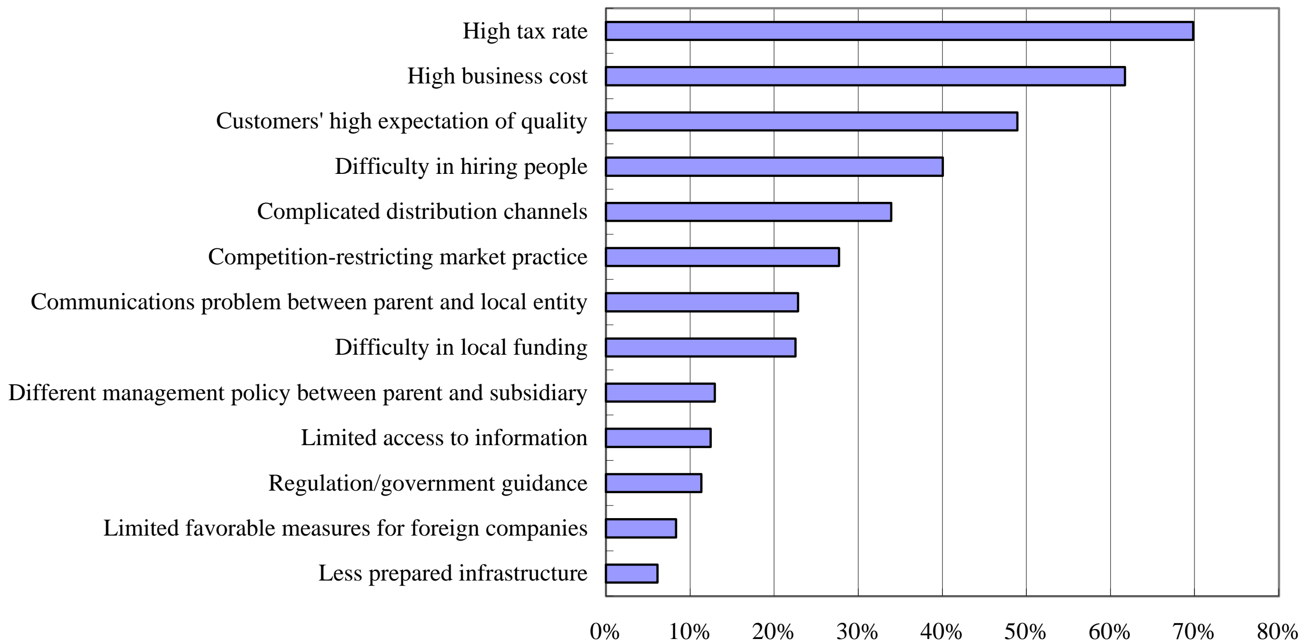
Note: Multiple answers. Inquired in Oct. 1998.

Source: JETRO *"Tainichi Chokusetu Toshi ni Kansuru Gaishikei Kigyou no Ishiki Chosa (98/12)"* (Survey on Foreign Firms in Japan)

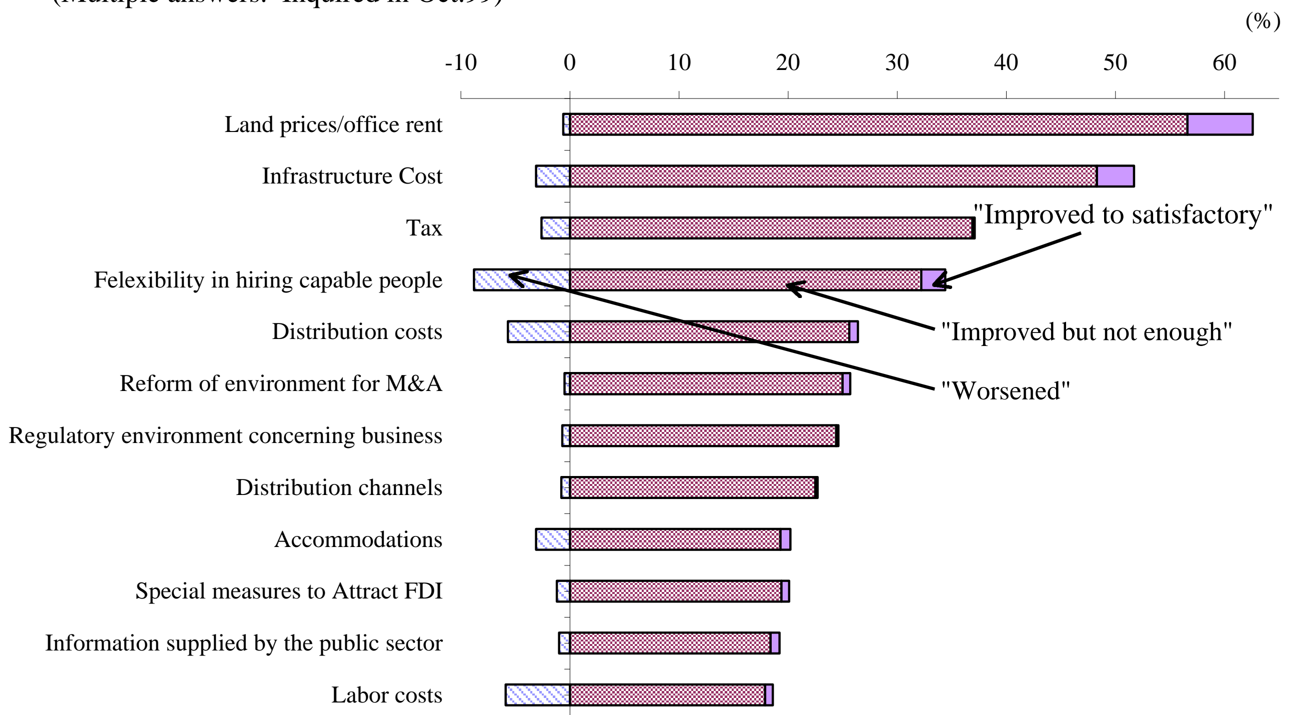
(Chart 8)

Obstacles to FDI in Japan

(1) What are obstacles to doing business in Japan for foreign companies? (inquiry as of Mar. 98)



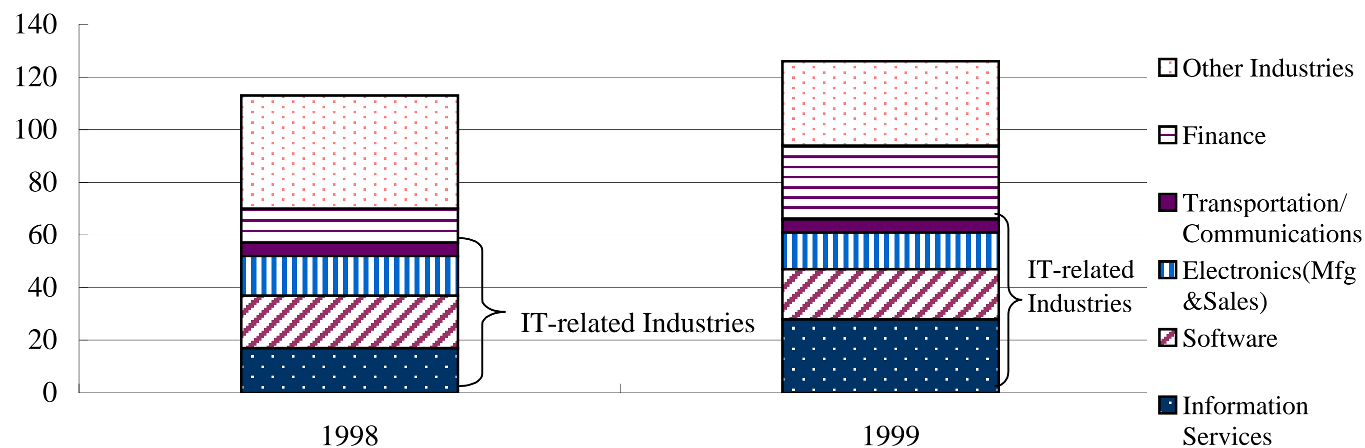
(2) How do foreigners feel about the recent changes in the business circumstances in Japan?
(Multiple answers. Inquired in Oct.99)



Source: MITI *"Dai 32kai Gaishikei Kigyo no Doko"* (The 32nd Ed. Trends of Foreign Companies in Japan)
JETRO *"Tainichi Chokusetu Toshi ni Kansuru Gaishikei Kigyou no Ishiki Chosa (99/12)"*
(Survey on Foreign Firms in Japan)

Number of Foreign Affiliated Companies in Japan Established through Greenfield Investment

"Greenfield Investment Led by IT Innovation and Financial Big Bang"



Source: TOYOKEIZAI INC. *"Gaishikei Kigyou Souran 2000/1999"* (Foreign Affiliated Companies in Japan, A Comprehensive Directory)
Bank of Japan

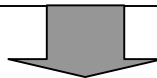
(Chart 10)

Mechanism to Create the Spiral of Inward FDI and Structural Changes in the Japanese Economy

< Japan's Old Success Formula >

The Former Economic System Based on Sustainable Economic Growth

1) Market-share oriented corporate strategies
2) Low "cost of capital" supported by increasing collateral value under the environment of rising land prices
3) The "main bank" system that supports this framework 1)&2)



< New Mechanism to Revitalize the Economy under Low Growth Potential >

Weakening Safety-Net Function of Main Bank System
→ Banks' weakened ability to act as financial intermediary and increased consciousness of credit risk of Japanese firms

Declining Domestic Supply of Risk Capital

Increase in Inward FDI

Increasing Equity Holdings by Foreign Investors
→ Globalization pressure on Japanese companies
→ Shift to market-oriented corporate governance

Increased Required Rates of Return for Japanese Co's
→ Development of "equal-opportunity level playing field"

Reform of Regulation to Meet International Standards in Accounting, Taxation, Bankruptcy Law and Disclosure

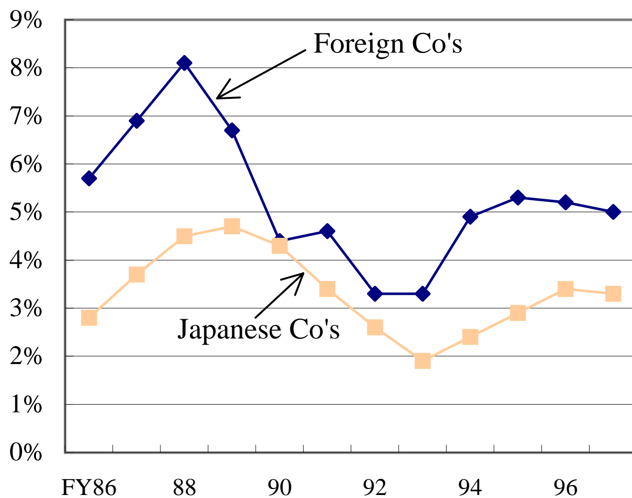
Increasing Pressure on the Corporate Sector to Improve Operating Efficiency
→ Progress of Business Restructuring by Japanese Companies
(Restructuring of business portfolio/dissolution of cross-shareholdings and the "*Keiretsu*" group affiliation/revitalization under the umbrella of foreign organizations)

A series of structural changes stimulates inward FDI, while increasing inward FDI further accelerates structural changes, **causing the "Spiral Effect"**.

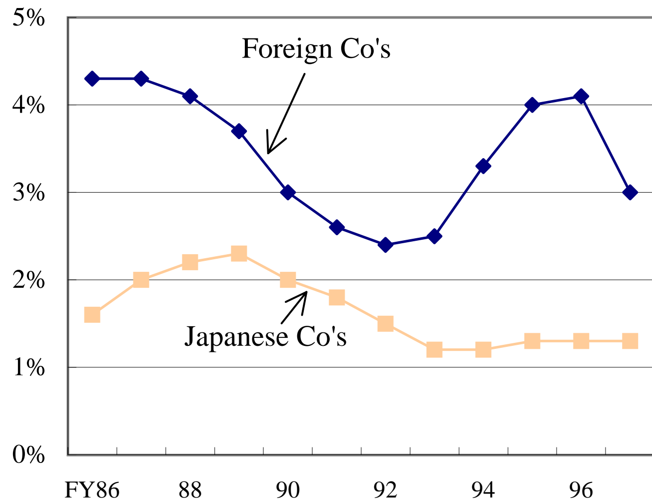
(Chart 11)

Financial Comparison of Foreign Affiliated Companies in Japan and Japanese Companies

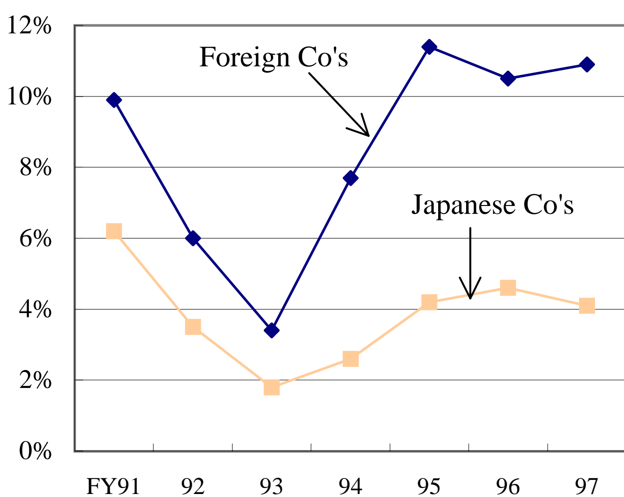
Recurring Profit Margin for the Manufacturing Sector



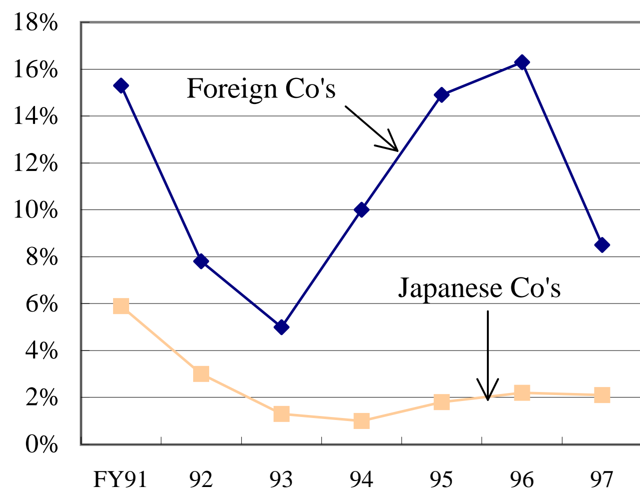
Recurring Profit Margin for the Non-Manufacturing Sector



ROE for the Manufacturing Sector



ROE for the Non-Manufacturing Sector



Note: Ratios for Japanese companies are based on total companies in *"Hojin Kigyo Tokei"* by MOF.
Ratios for foreign companies are based on the *"Gaishikei Kigyou Doko Chosa"* by the MITI.

Source: MITI *"Dai 32 kai Gaishikei Kigyou no Doko"*
(The 32nd Ed. Trends of Foreign Companies in Japan)