Inward FDI in Japan: An Opportunity for Growth
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Abstract
This paper examines the role of inward foreign direct investment (FDI) in Japan’s economy. Foreign direct investment is international capital (as opposed to portfolio) investment by firms, such as mergers with foreign companies or factory establishment. FDI often results in significant ‘spillover’ effects for host economies, including greater competition and transfer of intangible assets. Inward FDI in Japan has traditionally been hampered by a number of non-tariff barriers, and has remained a fraction of that of other developed economies. Since the mid-1990s, however, deregulation and liberalization of financial markets as well as other reforms have allowed inward FDI to grow. By removing remaining barriers to inward FDI, Japan can maximize the positive side effects of inward FDI. When such barriers are removed, levels of inward FDI will likely become comparable to other developed economies.
Compared to other developed economies, Japan has a remarkably low level of inward foreign direct investment (FDI). This is despite the fact that most official barriers were removed decades ago. Today, this is beginning to change. Demographic changes and the increased importance of information technology to the economy are increasing demand in the service sector. This offers opportunities for increased inward FDI, particularly from industry leaders in the US. At the same time, financial deregulation beginning in the mid-1990s has created new markets for foreign investors. In addition to direct benefits like greater employment, increased inward FDI has the potential to produce a number of “spillover” effects that will be beneficial to the Japanese economy. Possible spillover effects from inward FDI include the introduction of new technologies, an enhanced competitive environment, and pressure on Japanese companies to restructure for efficiency. Despite its potential for enhancing economic growth, inward FDI remains low in comparison to other developed economies. The low level of inward FDI and data on the concentration of inward FDI both indicate that impediments to this form of investment remain. In order to take full advantage of the potential gains from inward FDI, Japan must work to lift these remaining barriers.

**General Explanations for FDI Based on the Transactional Model**

A good starting point to understanding inward FDI in Japan is to look at multinational corporations (MNCs) in general and the investment decisions they make. Today, in a world of increasing globalization, the MNC is a familiar presence in our daily lives. Many corporations are not simply exporters to multiple markets but have undertaken operations beyond their home markets. For example, though the line of cars Toyota sells in multiple international markets is broadly similar, it has multiple production facilities outside of its home market. In the case of Toyota a certain amount of this outward FDI can be explained by import restrictions in the US [Ito & Fukao 184], but the same cannot be said for the company’s increased FDI in China. As another example, Microsoft maintains offices in numerous countries, despite the extremely low transportation costs of the company’s products relative to their value. Why do companies like these choose to move operations to foreign markets rather than simply exporting from their home market?

A particular company’s choice to invest abroad depends on the specific goals it aims to achieve by doing so. In his book *Multinational Enterprise and Economic Analysis*, Richard E. Caves uses a “transactional” model to explain FDI. While locational determinants affect how corporate facilities are spread throughout the world, the transactional model is used to explain when it makes sense for disparate corporate facilities to be
under the same management. Caves uses three different models to explain why firms expand to become MNCs. In the first case, companies produce essentially the same products in foreign markets as they do domestically. Dubbed horizontal integration, it is perhaps the easiest of the three models of foreign investment to understand. When companies divide their production of a good between domestic and foreign facilities, they are said to be vertically integrated. For example, a company producing computer monitors might manufacture some components in South Korea before assembling them in a factory in Mexico. Finally, companies with diversified foreign investments produce entirely different and unrelated products in different countries. One explanation for this behavior is simply to minimize risk through diversification of investments. Though these models help to explain why companies expand the way they do, in all three cases the primary goal of a company is to maximize profits. Regardless of how a company chooses to invest abroad, its decision is based primarily on the expected marginal profit that can be obtained as a result of the decision.

When a firm expands horizontally into a foreign market, it must overcome a number of challenges that local firms do not face. Because local firms are by definition already active in their respective home markets, they have better information and more knowledge of market practices than foreign entrants. In adapting to unfamiliar markets, foreign firms are faced with a fixed transaction cost of entry. In order to compete successfully in unfamiliar markets, foreign firms must possess some characteristic that offsets this fixed cost. One such characteristic is a firm’s stock of intangible assets.

Intangible assets represent things like the knowledge or reputation that can be used to increase a firm’s productivity. In general, they cannot be rented out or sold to other corporations. Intangible assets can be things as specific as patented technologies, or as hard to quantify as a firm’s potential to procure funds for future investment. All, however, share some common traits that influence the investment decisions of MNCs. Because most are difficult to sell or trade, their use is usually limited to the company that possesses them. For example, a company with a successful corporate structure and management team cannot easily value and sell these assets to another company. In many cases, knowledge of production processes are public goods, and thus cannot be sold without all players in an industry adopting any benefits. Intangible assets may also be hard to describe convincingly to potential consumers, and may thus be undervalued. [Caves1982 5] For these reasons, it makes sense to try to utilize intangible assets within a firm.

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1 In his 1996 edition Caves uses the slightly more general term ‘proprietary assets’ to refer to assets that fulfill a number of properties. For the purposes of this paper, the distinction is negligible.
While intangible assets may be the primary reason for a firm to enter a foreign market, a number of factors can affect whether it chooses to export or invest in local production. As in the above case of Toyota’s FDI in the US, barriers such as tariffs and import quotas can motivate MNCs to invest in local production. Given a large enough local market, a MNC seeking to maximize profits will be forced to invest in local production facilities if exports from its home country are restricted. Note that this implies that the company has not already located significant production facilities in the country imposing tariffs. Because MNCs will by default choose to locate production facilities in the country with the highest comparative advantage, import barriers can force MNCs to invest in regions that they would otherwise consider suboptimal. Exchange rate fluctuations can also affect a MNCs decision to invest in a particular country. If a particular country’s currency is overvalued, it makes sense for corporations based in that country to invest abroad. Not only will they be able to invest relatively cheaply, but when their base country’s currency returns to its natural level their investments abroad will increase in nominal value. [Caves1982 42-3] If the Chinese yuan is indeed undervalued (as has been charged), potential MNCs would have additional incentive to invest in the country. Finally, for horizontal MNCs in service industries, export may not be an option. While intangible assets, such as relationships with customers, may allow them to compete successfully in foreign markets, firms in sectors like accounting and advertising must often follow their customers into foreign markets. [Caves1996 11-2]

Unlike horizontally integrated MNCs, vertically integrated MNCs’ foreign operations are substantially different from those in their base country. When a company chooses to integrate vertically, in essentially brings producers of intermediate goods under its direct management control. For example, rather than buying windshields on the open market for its vehicles, Toyota might choose to produce them itself. In some ways, this is contrary to a perfectly competitive market. A processed-foods company would have little interest in integrating some of its competitively priced inputs (say wheat), because it would be unable to achieve additional gains from such an acquisition. Indeed, auto makers find it to their advantage to source a number of intermediate goods such as tires from competitive markets, rather than producing them internally.

When a company integrates production of an intermediate product, it does so to lower its cost of obtaining that product in the open market. Though this wouldn’t make sense in a perfectly competitive market characterized by identical products, low costs of switching suppliers, and suppliers facing horizontal demand curves, there are many cases where it is beneficial. If a buyers of windshields, for example, must have special
machinery in order to trade with a seller, costs of switching suppliers will be high. In cases where there are high costs associated with switching suppliers, long contracts are common. Unless these contracts are negotiated in high detail in advance at some cost, however, there is the potential for suppliers to produce at suboptimal efficiency levels in order to maximize their profits. In order to remove this risk, it would be beneficial for a buyer to integrate a producer of an intermediate good. In situations where buyers need access to information that sellers are unlikely to make public, it may also make sense for a firm to integrate vertically. Firms that extract natural resources, for example, might have information about future supplies that it might not release publicly. [Caves1982 16-20]

The final category of MNC is the diversified firm. As the name implies, the primary interest of diversified MNCs is in managing business risks by investing in foreign sectors unrelated to its production in its home country. As long as the same factors do not affect home and foreign investments in the same way at the same time, diversification gains are possible. The more unrelated investments acquired, the more a firm is able to minimize the risk associated with a single foreign investment.

Factors Influencing MNC Formation and Spillover Effects

In addition to factors cited above, levels of research and development (R&D), advertising expenditures, use of skilled labor in management, size, and scales of economy can all affect whether a company becomes a MNC and invests abroad. R&D and advertising are both measured by their ‘intensities’, or ratio of expenditures to sales. R&D, advertising, and use of skilled labor in management are all directly related to a firm’s intangible assets. R&D is an obvious source of proprietary knowledge, and Kimura and Kiyota confirm its importance in influencing Japanese firms to invest abroad.2 [241] Advertising may be key in building intangible assets like brand recognition. Skilled managerial labor become an intangible asset for a firm when a particular team of managers is able to work together efficiently. Kimura and Kiyota also found a positive correlation between a firm’s employment level and degree of FDI. [241] Scales of economy, on the other hand, may be negatively correlated to the decision of whether a firm becomes an MNC. When scales of economy exist, it makes more sense for a firm to expand production at a particular plant than to build additional smaller plants. [Caves1996 9]

FDI has both direct and indirect benefits to a host economy. Direct benefits include increased employment, tax revenue, trade, and capital formation, while indirect benefits take the form of increased

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2 For the most part, these factors are the same as those influencing foreign firms to invest in Japan.
competition in the local market and ‘spillover’ of technologies. [Blomström et al 257] In order to compete successfully in a foreign market, a firm often posses intangible assets that differentiate it from local firms. When these assets are used in a foreign market, local firms are forced to innovate in order to remain competitive with the foreign entrant. In addition to increased competition, aspects of a firms intangible assets tend to spillover into the local market. When companies train employees or demonstrate new technologies, knowledge of their intangible assets begins to dissipate into the local market. Joint ventures with local firms are also a means by which intangible assets are spread. These positive effects on local markets are particularly pronounced when the local market is already well developed, as is the case in Japan. [ibid. 258]

The State of Inward FDI in Japan

Japan’s outward FDI flows provide some context in which to understand inward flows, and indicate a significant shift of manufacturing activities abroad in the past two decades. Though outward FDI remained low for much of the post-war period, appreciation of the yen from the mid-1980s corresponded with increasing outward FDI by Japanese corporations. Along with increases in overall foreign employment by Japanese corporations, affiliates’ share of total MNC production increased from 6.5% in 1980 to 16.5% in 1990. The 1980s also saw Japanese manufactures beginning to shift their production abroad, with a 10% decline in value added by parent firms relative to their foreign affiliates between 1980 and 1992. Foreign sales by affiliates relative to total foreign sales of all manufacturing firms increased by 25% between 1977 and 1995. While affiliate sales in transport equipment industries amounted to only 4% of total sales in 1977, by 1995 they accounted for 45%. [Blomström et al 251-6]

Compared to other developed countries, Japan’s inward FDI is minimal. In 2002, the country managed to attract only US $9.2 billion in inward FDI, 23% of the US level. This is somewhat misleading for two reasons. First, numbers for 2002 reflect a significant decrease in the number of international mergers and acquisitions (M&A), which generally make up a majority of FDI transactions (61% that year). The 2003 JETRO “White Paper on International Trade and Foreign Direct Investment,” notes significant declines in M&A in telecommunications, finance and insurance, and computer-related services, which had contributed heavily to the peak in 2000. Secondly, the annual level of FDI tends to be relatively volatile, because it is highly dependent on a few large M&A. For example, Renault’s investment in Nissan in March, 2002 alone accounted for 19% of the total. Indeed, the 10 major M&A listed in the JETRO white paper accounted for 63%
of the total level of inward FDI in 2002.

Though inward FDI in Japan is still much lower than it is in comparable countries, it has risen significantly since 1990. In real dollar terms, inward FDI in 2000 was five time greater than in 1990. Between 1995 and 1999 inward FDI grew dramatically, from only $390 million (the decade’s low point) to 12.7 billion. [Marubeni Economic Report] Though inward FDI dropped with the worldwide decline, Japan’s share of inward FDI continues to rise. In 2002, when worldwide FDI declined 17.4%, Japan’s inward FDI rose 48.1%. [JETRO2003 8] Proportionally, Japan’s share of worldwide inward FDI rose from 0.78% to 1.41%. By way of contrast, the US share dropped over the same period from 19.1% to 6.1%.

These numbers are indicative of ongoing changes in the statues of FDI in Japan. First, inward FDI continues to increase as the result of policy and structural changes since 1995. Second, there is considerable room for FDI into Japan to grow until it reaches levels comparable with its status as a developed nation and proportion of would output. Both conclusions are detailed below.

**Impediments to Inward FDI**

Japan’s low level of inward FDI is usually explained by the presence of unofficial barriers that prevent foreigners from competing in the market effectively. Barriers often cited include the lack of a strong secondary labor market due to the “lifetime” employment system, difficulties in acquiring firms because of cross-shareholding and *keiretsu* relationships, and government policies on taxation and promotions for small businesses. [Blomström et al 258] As the 2003 JETRO “White Paper on International Trade and Foreign Direct Investment” appraised the situation, there is a “deep-rooted antipathy toward foreign capital.” [40]

Impediments to inward FDI in Japan can be seen in analysis of the number of employees of Japanese affiliates of foreign firms (JAFF) and foreign affiliates of Japanese firms (FAJF). In the service sector, the number of employees of JAFF amounted to 0.65% of the total number of domestic workers, whereas affiliates of foreign firms in the US accounted for 4.03% of the domestic total in 1996. [Ito and Fukao Table 6.7b] In the manufacturing sector there are even more significant differences between Japan and the US, but this can be explained by high labor and land costs in Japan that make it a poor destination for manufactures of easily traded goods. More importantly, in 1996 68% of workers employed by JAFF were concentrated in only three industries in the service sector, wholesale trade, eating and drinking places, and retail trade. [Ito and Fukao Table 6.4b]
also calculate that there is more variation in levels of industry penetration in Japan’s service sector than in the US. [185] Because many services cannot be imported or exported easily, both of these statistics point to impediments to inward FDI.

Rather than the fear of foreign investment cited in the JETRO White Paper, some have argued that it is instead specific policies of the Japanese government that have resulted in high levels of cross-shareholding. David E. Weinstein directly links ‘conventional’ regulatory patterns with high levels of shareholding by insurance companies, banks, and *keiretsu* that have made inward investment difficult. Insurance, for example, was the only tax-free investment option for individuals. Insurance accounted for one-quarter of all financial wealth in 1993, and Japanese insurance companies held around 20% of their assets in stocks (their American counterparts held 11%). Compared with other investors, the equity holdings of insurance companies were fairly stable, with their level of transactions far lower than their proportion of holdings. Weinstein traces this low level of transactions to data indicating that companies tended to purchase insurance from insurers with the largest holdings of the company. When a company purchased insurance, insurers essentially stabilized a proportion of the company’s shares that would otherwise have been traded. Competition in the insurance sector was reduced by both the exemption of the Premium Rating Agency from the Anti-Monopoly Law, which set rates for non-life insurance, and the presence of postal pension and insurance plans, which effectively enforced higher rates in the life insurance industry. Both policies had the effect of ensuring little competition in the insurance industry and high levels of stable shareholding by insurance companies. [Weinstein 11-18]

Licenses required for doing business in Japan have also played a significant role in limiting inward FDI. Though licensing had long been used to protect public health and safety, licensing as a means of industrial policy originated in the Meiji period. Restricted from imposing tariffs by the “unequal treaties” signed between 1857 and 1868, licensing proved to be an effective alternative. [Sohn] In the post-war period the licensing system reemerged, with broadly the same goals of protecting infant domestic industries and limitations of Western restrictions on tariff barriers. In the late 1990s, Japan issued 10 760 different licenses. Of these, 30% were controlled by MITI and MOF, indicating their use as a means of industrial policy. [Sohn 16] For potential investors licensing can present a significant problem, particularly in cases where products must be modified to meet standards specific to Japan.

**Recent Reforms Beneficial to Inward FDI**
Three major changes originating in the political sphere since 1995 have made FDI in Japan easier and more attractive. The June 1997 deregulation agreement between the US and Japan, “Big Bang” reforms to the financial sector proposed by the Hashimoto government in late 1996 and implemented through 2001, and the abolishment of the Large-Scale Retail Store Law have all made the establishment and operation of foreign affiliates in Japan easier and more profitable. [Globerman and Kokko 275] These changes have addressed many impediments to inward FDI, and their effects can be easily seen in the dramatic growth of inward FDI in the late 1990s. Many barriers remain, however, and inward FDI has much room to grow before it reaches levels comparable with other developed countries.

In June 1997, the US and Japan announced an agreement deregulating a number of sectors in Japan with the potential for large FDI inflows. Among its many provisions, the agreement made it easier for telecommunications carriers to connect to local phone networks, eased testing requirements for approval of medical devices and pharmaceuticals, and expanded the range of products that a specific financial company can offer. [Globerman and Kokko 275]

The so-called Big Bang reforms beginning in 1996 deregulated and liberalized Tokyo’s financial markets in an attempt to match those in New York and London. Contrary to what the name might imply, the Big Bang was actually a gradual process, initiated in 1996 and concluded in 2001. The foreign exchange market was the first to be deregulated in April 1998. This was followed by the Financial System Reform Law, which took effect in December 1998 and made up the bulk of the Big Bang changes. In combination, these reforms were intended to make the financial market more efficient, make Japanese institutions more competitive, and untangle vested interests influencing the MOF. [Ito and Melvin 162] Financial holding companies were legalized, controls on market entry and product offerings were relaxed, and the accounting system was updated to international standards. [JETRO2000 1] Banks lost their monopoly on foreign exchange transactions in the deregulation of that market, allowing virtually any institution to covert currency at lower transaction costs.

As a whole, the Big Bang reforms have made the Japanese financial markets more open and accessible to foreign investors. Specifically intended to make markets more ‘international’ and ‘global’, they opened up the possibility of foreign firms increasing their presence. Merrill Lynch’s 1998 takeover of Yamaichi Securities Company, [Cargill 156] Ripplewood Holdings takeover of Long Term Credit Bank, and Lone Star's acquisition of Sowa Bank [State Department] have all been cited as results of the Big Bang liberalizations. These takeovers
indicate that significant changes have taken place, resulting in FDI transactions that would have been unlikely before liberalization.

The abolishment of the Large-Scale Retail Store Law is significant because it represented a number of protectionist measures that have resulted in depressed Japanese productivity in the nonmanufacturing sector since the 1970s. While labor productivity roughly followed the upward trend of the capital-labor ratio (capital stock per worker hour) between 1955 and 1990 in the manufacturing sector, labor productivity in the nonmanufacturing sector diverged from its respective capital-labor ratio between 1965 and 1970. Between 1970 and 1990, labor productivity in the nonmanufacturing sector appears to have grown an approximately half the rate of the capital-labor ratio in the sector. [Yoshikawa 113] In his book Japan’s Lost Decade, Hiroshi Yoshikawa argues that this is due to the high level of small and medium-sized enterprises (SMEs), which owe their continued existence primarily to ‘protectionist policies’ for small businesses. Had it not been for laws like the Large-Retail Store Law, which became active in 1974, most of these businesses might have been replaced by larger enterprises in the 1970s. Instead, the number of self-employed workers (a major component of SMEs) rose by 800,000 to 7 million from 1970 to 1985. [ibid. 119]

While the end of the Large Retail Store Law will diminish the advantages SMEs have over larger enterprises, many other ‘protectionist policies’ for small businesses remain. Even without the effects of the Large Retail Store Law, corporate tax structure offers numerous benefits for SMEs and wholesalers. By Weinstein’s calculations, even excluding the effects of the Large Retail Store Law and other subsidies, SMEs with profits of 10% of total sales had a tax advantage amounting to a 4% price advantage over larger retailers. [26] In fact, the formation of some vertical keiretsu can be explained through the tax-incentives of subcontracting portions of the manufacturing process out to wholly owned subsidiaries. [24-5] Yoshikawa uses the construction industry to illustrate the problems with policies protecting small businesses. In the mid-1980s, a majority of SMEs awarded contracts under the Construction Business Law simply subcontracted their entire projects to others. Existing as construction firms only on paper, these SMEs earned profits simply by serving as an additional layer of bureaucracy. [Yoshikawa 120]

The end of the Large-Scale Retail Store is one factor that has allowed foreign acquisitions of Japanese firms to increase rapidly in recent years. Without the legal protections they had enjoyed, many of Japanese firms are too small to compete successfully. [Blomström, Gangnes, and La Croix 8] In an environment more
friendly to inward FDI, some may also make attractive takeover opportunities for foreign investors. The Marubeni Economic Report “Japan Warming to Inward FDI” notes that those with high levels of specialization in ‘niche technologies’ may make particularly attractive targets.

A final factor in increasing inward FDI in Japan has been the liquidity crises faced by Japanese banks. As liquidity problems forced banks curtail lending, their position at the center of *keiretsu* business relationship was upset. One theory of *keiretsu* operations is that banks have pushed member companies to overproduce, making entry into markets dominated by *keiretsu* especially difficult for foreign companies. [Globerman and Kokko 277] As banks curtailed their cross-shareholding relationships with *keiretsu* companies, [Blomström 259] M&A by foreign companies has become more feasible.

**Future Growth in Service Sectors and Opportunities for Increased Inward FDI**

Aside from the deregulation discussed above, demographic change and growth of service sectors will serve to increase inward FDI in Japan in the coming years. As Japan’s population ages, its demand for health care-related products and services will increase. It has also been suggested the aging population will increase demand in the tourism industry, as well as demand wealth management services in order to maximize the returns to their saving. [Globerman and Kokko 277] At the same time, service sectors including telecommunications, financial services, and consulting are becoming increasingly important to the Japanese economy as its comparative advantage shifts away from manufacturing. Significantly, the US has comparative advantages in all of these sectors, allowing for the possibility of increased investment. [ibid. 277] Because the output of service sectors is in many ways non-tradeable, much of this investment will take the direct form of establishing Japanese affiliates. Additionally, as most of these services have a high income-elasticity of demand, it would also be expected that demand should be high in a country like Japan. [ibid. 282]

Evidence testifying to the growing importance of service sector FDI in Japan can be seen as it begins to make up a larger share of total inward FDI. In 1990 investment in the manufacturing sector accounted for 64% of all inward FDI, but by 2000 it accounted for only 25%. [Marubeni] Note that, because overall FDI increased dramatically over the same period, this does not necessarily mean that inward manufacturing FDI declined in real terms (though service sector FDI certainly grew). This indicates that the ‘tradeability’ of a good is directly linked to a company’s investment decision. Manufactures will choose to locate in areas with low labor and land costs (e.g. China), while companies in the service sector must often locate in the markets they serve (e.g. Japan).
Because of a change in attitude about inward FDI by JETRO and MITI, remaining impediments to inward FDI are likely to be diminished over time. Both organization have recently recognized the potential benefits of inward FDI, and have correspondingly increased their efforts to promote it. JETRO’s Invest Japan Business Support Center and the US-Japan Investment Initiative both promote investment to businesspeople. Though the US has pushed for more open markets for years, significant changes have only occurred since internal attitudes about inward FDI changed. [Marubeni] At a 2001 State Department symposium on FDI in Japan, Noboru Hatakeyama, then chairman of JETRO “reflected on how JETRO's own mission has changed over time, from an emphasis on export promotion to an emphasis on inward investment...” [State Department] The 2003 JETRO White Paper on International Trade and Foreign Direct Investment states the new attitude plainly: “Japan must develop the type of domestic environment that attracts foreign capital and human resources.” [39]

Conclusion

Though inward FDI has much room to grow before it reaches levels comparable with other highly developed economies, recent deregulation and liberalization reforms have opened possibility of increased investment. A recent JETRO study revealed that more JAFF “feel that the local business environment is improving.” [JETRO2003 40] A number of challenges, however, do remain. Non-tariff barriers to investment in the form of licensing requirements and preferential tax-treatment for domestic SMEs, for example, still prevent Japan from maximizing the gains associated with increased inward FDI. These benefits include technology transfer and increased productivity, both leading to increased consumer welfare. Fortunately, attitudes at both JETRO and MITI have changed to become supportive of inward FDI. Through their influence and promotion, these organizations will play a key role in ensuring the inward FDI continues to increase to appropriate levels. For these reasons, inward FDI will play an increasingly important role in economic growth in the coming years.
References