Japanese Firms Take Long-Term View on Asian Investments During Crisis

by Kyoji Fukao

Foreign direct investment played an important role in the economic development of Asian countries since the 1980s, not only in the transfer of production technologies but also in providing a stable supply of capital.

Just after the occurrence of the economic crisis that originated with the July 1997 plunge of the Thai baht and spread rapidly to other Asian countries, expectations were strong that direct investment would also greatly contribute to the eventual recovery of the crisis-hit countries. That optimistic view, represented by the World Investment Report of the United Nations Conference on Trade and Development (UNCTAD), can be summarized in three points.

First, declines in the currencies of the Asian countries due to the crisis will lower production costs. As a result, foreign companies will establish new export bases and expand existing export-oriented subsidiaries in those countries.

Second, declines in currencies and stocks will result in fire sale of assets in the Asian countries affected, which will attract foreign companies will not miss these bargains and will actively purchase local companies or make new investments.

Third, unlike in the case of portfolio investments, foreign companies will not easily abandon real assets or intangible assets, such as supplier systems, that because these assets are difficult to sell. Also, reducing operating rates and laying off workers with skills peculiar to the company would entail losses. If, therefore, future improvement in business performance can be expected, parent companies will actively support their local subsidiaries.

Did Japanese companies with investments in other Asian countries act according to these predictions? Their actions in the past two years are reviewed here.

One of three

I would first present my conclusion: Only the third of the three predictions turned out to be accurate for Japanese companies.

Dividing Japanese production subsidiaries located in Thailand, Indonesia and South Korea into the local-market-oriented and export-oriented groups, I compared the changes in their activities from fiscal 1966 to fiscal 1997. The comparison made it clear

that local-market-oriented affiliates were hit hard, while subsidiaries with a 50% or higher export ratio increased sales and doubled profits.

However, even export-oriented affiliates that showed good performance failed to increase employment significantly. The total number of Japanese affiliates (including acquisitions and new capital participation) newly established in Thailand, Indonesia, Malaysia, the Philippines – or the four Association of Southeast Asian Nations (ASEAN) countries – and South Korea declined from 280 in 1996 to 69 in 1998, according to Directory of Japanese Subsidiaries Abroad, a publication of Toyo Keizai Inc.

Sluggish acquisition activities by Japanese companies contrast with active buying by U.S. and European companies. According to statistics of KPMG Corporate Finance, while U.S. companies carried out mergers and acquisitions worth a total $4 billion in the four ASEAN countries and South Korea in the year through June 1998, Japanese companies' M&A amounted to only $500 million.

Japanese companies sharply reduced mew investments, including production-capacity expansion and acquisition, in the four ASEAN countries and South Korea, but their direct investment in the five countries rose 49% in the year through June 1998 from a year earlier on a balance-of payments basis. The main reason for the increase was the financial assistance they extended to local affiliates suffering from deteriorating financial conditions.

Data compiled by Japan's Ministry of International Trade and Industry show that in 15% of Japanese affiliates in Thailand, the parent companies increased their ratio of equity stakes. The Toyo Keizai publication shows only 1.5% of Japanese subsidiaries in the four ASEAN countries and South Korea were closed or sold in 1998.

The persistence of Japanese companies is shown by the fact that even local-market-oriented affiliates barely reduced employment despite sharp declines in sales and profits.

Japanese companies such as Toyota Motor Corp. and Nissan Motor Co. also actively helped local factories expand exports to maintain capacity utilization ratios, Japanese production affiliates in Thailand increased exports to Japan by ¥85 billion from fiscal 1996 to fiscal 1997, according to MITI data.

Interestingly, direct investment by U.S. companies in the five countries declined 47% year on year in 1997 on a balance-of-payments basis. The activities of Japanese and U.S. companies cannot be strictly compared because the U.S. Department of Commerce has not released relevant figures for 1997. It seems the while U.S. companies were active in acquisitions in those countries, there is a high possibility that they did not assist local affiliates that fell into financial difficulties as generously as their Japanese

counterparts.

The serious economic slump in Japan may have been one reason Japanese companies were wary of making new investments, including corporate acquisitions. However, Japanese companies' persistence requires different explanations. Japanese companies, including local affiliates, are said to be making much of long-term customer relationships and the accumulation of skills peculiar to each company. Such long-term commitment may have resulted in Japanese companies' persistence.

Long-term commitments inevitably incur larger losses when investments fail. The emphasis on long-term relationships is thought to have made Japanese companies sensitive to risk. My recent analysis of Japanese companies their selection of countries for direct investment has also found they tend to react very sensitively to country risks related to their investments.

What lessons and policy consensus can be learned from these recent experiences?

For the first lesson, it was confirmed that direct investment is a much more reliable from of capital movement than quick-at-flight portfolio investment and international bank loans in an economic crisis. A World Bank survey of Thailand and the Philippines has also shown that foreign affiliated companies, especially export-oriented ones, maintained employment better than local companies.

For the second lesson, optimistic expectations that weak currencies of the host countries would naturally bring about an increase in direct investment have proved to be mistaken. To return to the desirable conditions before the Asian economic crisis, where direct investment was the nucleus around which the intra-regional division of labor developed and economic growth continued, Japan and other foreign governments would need to actively support direct investment.

Easing regulations

The four ASEAN countries and South Korea have recognized the importance of direct investment since the economic crisis and have been substantially easing regulations on direct investment, including restrictions on the ratio of foreign shareholdings. The fact that foreign, including Japanese, companies, are rebuilding production networks and applying tougher standards for selecting new production locations may also be promoting liberalization.

In Latin America, deregulation for direct investment progressed rapidly in the 1980s after an external debt crisis struck. Liberalization may progress likewise in Asia, which has been backward in deregulation.

The Japanese government has not always been positive, compared with the U.S. and other governments, about urging host countries to ease regulations on direct investment, but Tokyo should make the most of this opportunity to actively promote the improvement of the direct-investment environment in Asia.

While the economic crisis has led to relaxation of regulations on direct investment in Asian countries, it has pushed back their policies of reducing trade barriers, such as quantitative import restrictions and high tariffs.

To recover direct investment, develop the regional division of labor and expand export-oriented direct investment that can be relied upon during an economic crisis, nations need to reduce trade barriers.

It is desirable that a review of tariff and non-tariff barriers be accelerated within international frameworks such as the ASEAN Free Trade Area.