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A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

The Status of Direct Investment in Japan

by Kyoji Fukao

According to recent Finance Ministry statistics, foreign direct investment in Japan has grown approximately four-fold during the past 10 years. Indeed, the investment flow (¥4.3 trillion) in just the past two and a half years has exceeded the total amount invested from 1950 to 1997.

Although direct investment in Japan has dramatically risen, many have noted that compared to that in other nations, it is remarkably small. This modest level has been taken as a symbol of the exclusionary nature of Japan's economy. According to Finance Ministry statistics, the cumulative amount of direct investment in Japan for the non-manufacturing sector (through end-September 2000) is only one-tenth of the cumulative direct external investment by Japanese companies abroad. A 1995 GATT trade policy review of Japan noted that such remarkable asymmetry in investment by Japanese abroad, compared to investment by foreigners in Japan, is indicative of the exclusionary nature of Japan's non-manufacturing market.

Direct investment is captured as an international flow of management resources. Thus, the question is not how much capital has moved across national borders (cumulative direct investment flow) but, rather, the size of production activity by foreign affiliates in Japan.

Significant discrepancies may arise between the cumulative investment amount and the presence of a foreign affiliate for the following three reasons: Firstly, until very recently, the establishment of foreign subsidiaries in the finance/insurance sector was tightly regulated. As a result, foreign companies entered Japan by establishing small branches, for which the capital flow was relatively low, rather than setting up a subsidiary, which require a great deal of capital expenditure. Thus, a foreign company's presence, when measured by the number of employees and the operating profit, was fairly large despite the fact that the cumulative investment amount was rather small.

Secondly, during the bubble period, Japan's external investment in the real estate sector had a strong portfolio investment characteristic. As a real estate activity, even though employment and sales in the local area were not large, the investment amount that crossed national borders was huge. Due to the fact that the subsequent retreat was not calculated as a gross minus figure, according to the statistics made available by the Finance Ministry, the external/internal ratio has appeared disproportionate. And, thirdly, some foreign affiliates expanded production by taking out loans in Japan, rather than by borrowing funds from home.

The question is, what is the size of the corporate activities on the part of foreign affiliates? Compared to the United States, Japan lags significantly behind the U.S.

Continued on page 2

The Status of Direct Investment in Japan

Continued from page 1

The Ministry of Economy, Trade and Industry recently published its findings in the "Corporate Behavior Survey Concerning Foreign Affiliates" report. But that survey is flawed – because the survey did not mandate a response, only 40-50 percent of companies responded. Due to the low rate of response, significant conclusions cannot be drawn with any degree of real confidence. Moreover, investment in key sectors for which direct investment is very active – finance/insurance and real estate – were excluded altogether. Finally, branches and offices directly owned by foreign corporations were not included in the corporate statistical survey.

The most reliable and accurate statistics on foreign affiliates are those published by the Public Management Ministry, because companies are required to respond and because they cover businesses of all types. Although reports by the Public Management Ministry do not break down data specifically for foreign affiliates, the author, together with Ms Keiko Ito of Hitotsubashi University, tabulated individual data according to the ratio of foreign capital involved (thereby calculating the presence of foreign affiliates), and by business type.

Japanese affiliates of foreign firms (JAFF) with 33.4 percent or more foreign ownership in the non-manufacturing sector employed 308,000 workers in 1996. According to the Toyo Keizai Shimposha, non-manufacturing Japanese affiliates of Japanese firms (FAJF) employed 742,000 workers in 1996. In terms of employment, the JAFF/FAJF ratio is 0.34, which is substantially larger than those reported in the Ministry of Finance statistics regarding foreign direct investment. The "Survey of Foreign Affiliate Corporate Activity," published by the Ministry of Economy, Trade and Industry, reports that foreign affiliates whose foreign capital ratio exceeds one-third, the number of employees in the non-manufacturing sector totaled 64,000 as of March 1999. This seems to significantly under-represent the actual level of activity by foreign affiliates.

Table I, based on the new statistics, compares the presence of foreign affiliates (defined as those having more than 50 percent foreign capital) in Japan with those in the United States, according to business type. The cumulative figures for direct investment in Japan through 1996, based on international payments in relative GDP, was 0.7 percent for Japan, compared to 16.0 percent for the US. There was no statistically significant discrepancy between the US and Japan in terms of the number of employees. When I examined companies that are more than 50 percent owned by foreigners, I found that the penetration into Japan by foreign affiliates is approximately one eighth that of the United States (0.61/4.61). The penetration rate for the non-manufacturing sector was one fourth (0.59/2.77).

Although Table I shows that, in the manufacturing sector, the foreign presence in Japan is much lower than that in the United States, this could be due to exclusionary practices in the US concerning imported goods, rather than exclusionary Japanese practices concerning foreign affiliates. If trade barriers were lower, it would be more advantageous and more rational for multinational corporations to produce in developing countries, where production costs are lower, and export to Japan and the United States. The entry into the United States by Japanese and other foreign manufacturers has been, at least in part, prompted by an effort to avoid US antidumping

Continued on page 3

The Status of Direct Investment in Japan

Continued from page 2

policies or to sidestep trade barriers, such as requests for "voluntary" restraints on car exports from Japan and other countries.

Because cumulative figures for direct investment in Japan have historically underestimated the presence of foreign affiliates, there is a danger that the reported increased pace of expansion of foreign affiliates may well be overestimated. For example, according to the Finance Ministry, investment in Japan's non-manufacturing sector increased by 3.2 times from end-1990 to end-1997. By contrast, the Toyo Keizai Shimposha reports that the number of employees of foreign affiliates increased only by 36 percent during the same period.

Let's look into foreign direct investment in Japan's manufacturing sector, using new data published in the Enterprises/Corporations Statistical Survey, by business type.

In the non-manufacturing sector, the foreign affiliates (with a foreign capital ratio of more than 33.4 percent) who employ the most workers include wholesalers, eating/drinking establishments, retailers, finance/insurance, aviation/transportation, and computer software programming. These industries account for 80 percent of foreign affiliate employees in the non-manufacturing sector. Thus, it is safe to say that the foreign presence in aviation/transportation and computer software programming is large, a significant characteristic of direct investment in Japan. Furthermore, since the latter part of the 1990s, as a result of large-scale deregulation such as the abolishment of regulations involving entry into the telecommunications business, coupled with the industrial reorganization of Japanese companies, foreign direct investment in Japan in the fields of telecommunications and finance/insurance has witnessed a sudden rise. According to Finance Ministry statistics, 50 percent of foreign direct investment in the non-manufacturing sector since 1998 has been in these areas.

When comparing investments by foreign affiliates in Japan's non-manufacturing sector with that in the United States, another noteworthy characteristic is that in Japan, direct investment is concentrated in certain industries, while there are a number of other fields, such as medicine, education, utilities, etc., in which foreign investment in Japan has not taken place at all. The US, by contrast, does attract investment, even though it may be small, in those fields. Thus, one might say that in Japan's non-manufacturing sector there still remain a number of so-called "sacred areas" which are not subject to foreign competition.

The recent sudden rise in foreign investment in Japan's non-manufacturing sector is due to several factors: Due to a drop in stock/land prices and a reduction in the value of the yen, Japan seemingly offers "fire sale" bargains for foreigners. At the same time, Japan's finance and telecommunication sectors are undergoing corporate reorganization. In addition, the Japanese government has boldly liberalized several sectors, including finance/insurance, telecommunications, broadcasting. Vertical "keiretsu" relationships and low labor mobility, often identified as impediments to investment, are inclined to be gradually weakened due to a combination of canceled mutual stockholding, the establishment of open supplier systems, and rising unemployment. As of 1996, the share of employment by foreign companies in the non-manufacturing sector reached one quarter of that of the United States. In the next 5 to 6 years, it may reach a level almost equal to that of the United States.

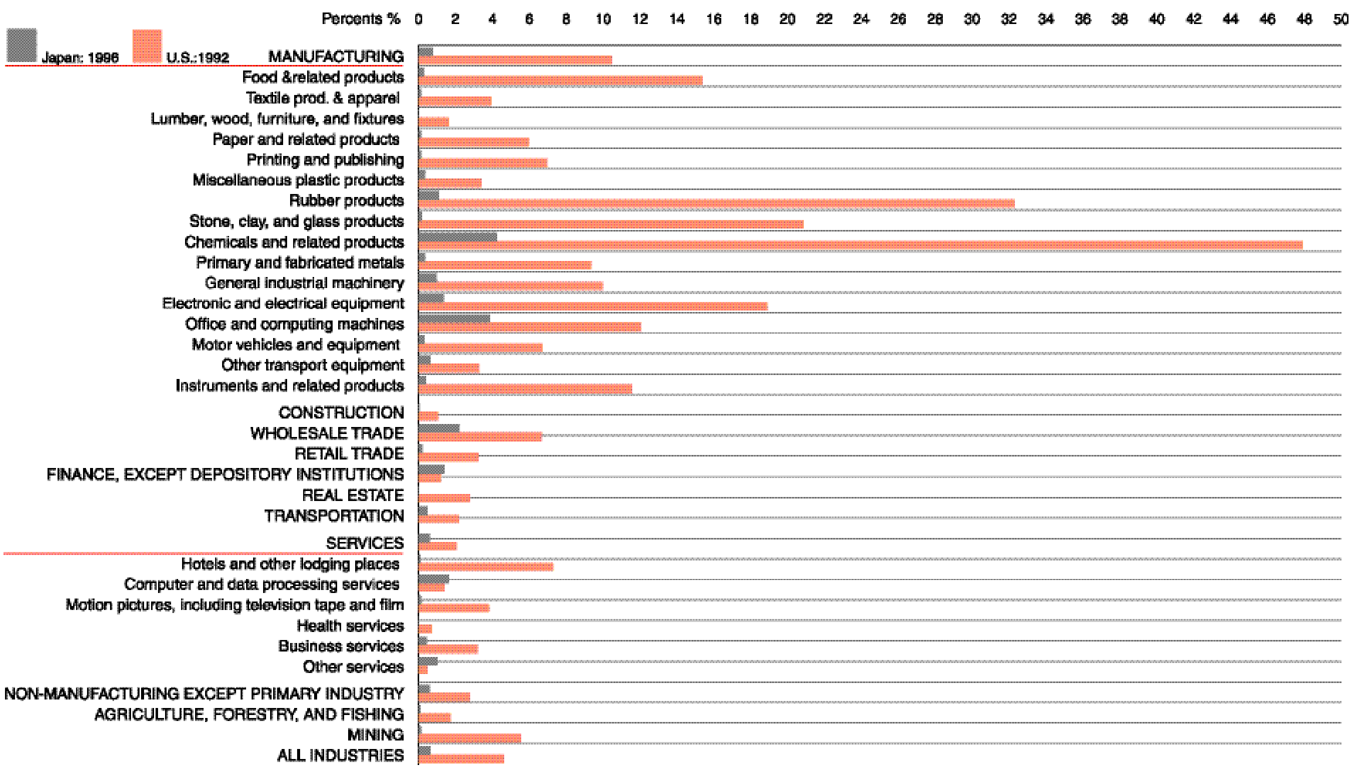
Continued on page 4

In Japan, there is what may be labeled "sanctuary" sectors, such as medical services, utilities, and education. If competition is introduced through the participation of foreign capital in these sectors, it will undoubtedly contribute to Japan's structural reform. The services agreement (GATS) negotiated during the Uruguay Round sets forth how signatory countries should advance liberalization in trade/direct investment in the services sector. APEC has also encouraged harmonized regulations. According to such information, Japan has not welcomed liberalization in the fields of transportation, medicine, mail service, temporary staffing services, agriculture-related services, ship repair, and electricity/gas.

In order to prevent the government from impeding direct investment by foreign companies, not only should the principle of equal national treatment be respected, but restrictions on market access should be eased. In the "sacred" sectors, restrictions on market access, which take precedence over equal treatment, impede direct investment by foreign companies.

Continued on page 6

TABLE 1



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"What's Ahead on Japanese Politics"

Tsuneo Watanabe, Fellow, Center for Strategic and International Studies, Washington, D.C.

Japan's prolonged economic slump has highlighted the nation's leadership problems, Tsuneo Watanabe, a Fellow at the Center for Strategic and International Studies, told attendees of the March 21 Japan Business Dialogue. He attributed the frequent leadership turnover since 1993 and the repeated selection of weak prime ministers to the ongoing transformation in Japanese politics. While it remains unclear exactly how politics will evolve, Mr. Watanabe was optimistic that the current upheaval in Japan ultimately will produce a stronger government and a more responsive political system in the long term.

Former Liberal Democratic Party Secretary General Koichi Kato's failed attempt to mount a no-confidence notion against then-Prime Minister Yoshiro Mori last November is indicative of changes that are occurring beneath the surface, he said. The LDP's faction-based politics is breaking down due to political reforms that have shifted money and power to party leaders.

The diminution of factional power generally is a positive development. But one immediate drawback was that younger, reform-minded LDP members were reluctant to support Mr. Kato's no-confidence motion because they did not want to antagonize party leaders and threaten their source of campaign funds. In short, the party's control over money defused the potential, anti-Mori revolt.

Mr. Watanabe depicted an alarming erosion of public confidence in LDP leadership as the most disliked party. Opinion polls by the Journal "*Ronza*" with Prof. Ikuo Kabashima in January revealed that 44.4 percent of respondents did not want the LDP to gain more seats in the coming election; it was 19 percent in the same poll in December 1999.

Although the Democratic Party of Japan (DPJ), the largest opposition party, has also failed to garner sufficient voter support to seize government control from the LDP, it may be poised to gain seats in the next election since only 4.5 percent of those polled said they disliked the DPJ.

Mr. Watanabe anticipated that the LDP will incur steep losses in

Continued on page 6

Comments by Watanabe after the Koizumi boom:

The LDP chose Koizumi as president to regain its popular support and it is enjoying unprecedented popular support now. This is an interesting revival of quasi-governmental change within the LDP in the absence of the general elections in the 60s, 70s and 80s. The LDP's popularity has not fully recovered. Although the LDP and coalition may not lose the coming election, given Koizumi's popularity, Koizumi may face a contradictory position after the Upper House election; he was not supported by the LDP mainstream who prefer the status quo, but instead, by reform-oriented voices outside the LDP. This could still present a potential for political re-alignment, such as a coalition between reformist Koizumi groups and oppositions against LDP's status quo powers.

The Status of Direct Investment in Japan

Continued from page 4

In fact, even Japanese corporations are sometimes prohibited from participating in those markets because of Japanese medical and fundamental education laws. The postal monopoly, not to mention the very existence of public entities, impedes participation by private companies. In order to encourage market participation by foreign companies in areas in which governmental involvement is high, there is a need to solve difficult issues such as how to introduce competitive principles without violating the public interest. ■

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Japan Business Dialogue

Continued from page 5

the July upper house elections. The LDP and its coalition partners—the New Komeito and the New Conservative Party—still dominate the powerful lower house and

therefore will continue to govern Japan. However, to minimize problems that often arise when the party in power does not control both houses, the LDP will probably seek a way to maintain majority seats after the upper house elections so that the ruling parties can dominate both chambers. But that arrangement would risk further alienating voters and may cause political re-alignment among both ruling and opposition parties, Mr.Watanabe said. ■

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