Investing in Japan: Why Now?
Japanese Economy Today, Its Strengths, New Investment Trend

By Yasuhito NII

Introduction

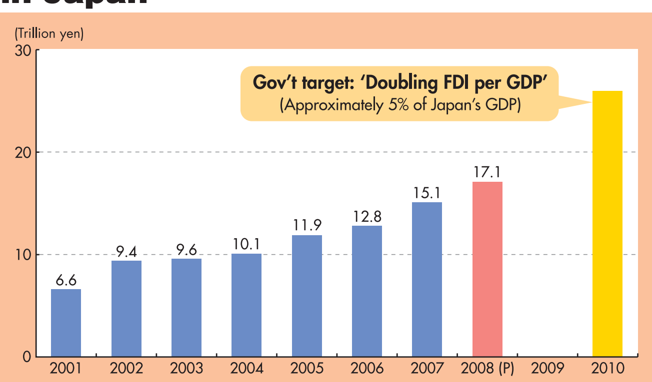
The world economy is now confronted with a dire situation in the aftermath of the global financial crisis that broke out last fall, as is the Japanese economy. Amid the plight, some foreign businesses and investors may be skeptical about investing in Japan, saying in no way can they afford to do. They may also say Japan is not lucrative enough for investment in light of its limited growth potential and that their investment and presence in Japan may not be welcomed because Japan is an inward-looking country. But the answer to these concerns is "NO." The reasons are as follows:

1. Current State of Japanese Economy & Policy Measures

The Japanese economy contracted at an annual rate of 12.1% in terms of inflation-adjusted gross domestic product (GDP) in the October-December quarter of 2008, according to government data released in February. The figure represents a bigger fall than those for the United States and European countries where the financial crisis emerged. This stems from a steep drop in external demand. With Japan's economic recovery driven largely by exports since 2002, the cooling of overseas markets has led to an abrupt drop in exports, sending GDP growth into a tailspin.

Meanwhile, internal demand weakened by a marginal 0.5% (in terms of the rate of contribution to GDP growth). Despite the dramatic shrinkage in GDP, internal demand remained firm relative to exports as is the case with Germany mainly because of a high share of net exports (exports minus imports). What is more, the balance of foreign direct investment (FDI) in Japan increased by nearly ¥2 trillion to an estimated ¥17.1 trillion, or 3.4% of GDP, at the end of 2008 from ¥15.1 trillion a year before, or 2.9% of GDP *(Chart 1)*. The relatively firm internal demand indicates there is still some pilot-burner for refueling domestic demand, although it is necessary to watch future developments.

CHART 1
Growing foreign direct investment in Japan



Source: Ministry of Finance

To deal with the global recession, reportedly the worst in a century, it is an urgent challenge to minimize a downturn in economic activity while maintaining growth in internal demand. Since last fall, the Japanese government has successively unveiled economic stimulus packages dubbed a three-stage rocket. The packages prioritize securing employment and operational funds for businesses. Other pillars of the packages include support for households, small and midsize companies and local areas. The pump-priming measures are worth ¥75 trillion in overall spending, in which ¥12 trillion, equivalent to 2% of GDP, earmarked in fiscal measures. The packages, if implemented, are projected to push up the nation's real growth rate by nearly one percentage point in fiscal 2009.

Optimism is not warranted, however, with no sign of improvement seen in economic indexes for January and thereafter. The Japanese government is making preparations to work out additional economic stimulus measures. For its part, the Ministry of Economy, Trade & Industry is contemplating a new economic growth strategy to create new internal demand and spur innovation focusing on three industrial areas – a low-carbon society, health/long life and soft power.

2. Japan's Prowess: Technological Strengths

As mentioned above, the overriding challenge facing Japan is to minimize a downturn in economic activity with those emergency stimulus packages. Then why is Japan an attractive country for foreign businesses to do business and make capital investment?

Aside from factors often cited abroad but nothing special to Japanese people such as a high level of safety enabling even children to board trains alone at night and a stable legal system, let me focus on four factors behind Japanese industry's technological prowess.

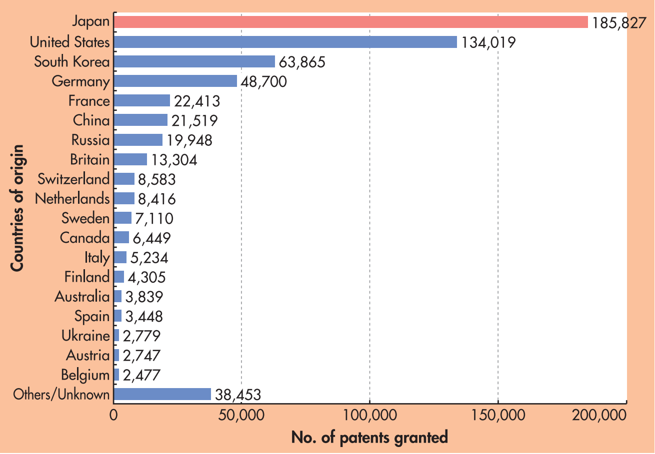
The first strength lies in component and material technology. The widespread perception is that Japan is strong in the fields of final products such as automobiles and information and telecommunication equipment. Notable, however, is the fact that Japan commands the lion's share of nearly 100% in the areas of numerous components that are essential for development of final products, such as cells and materials. They are not visible to consumers as they are incorporated into completed products, but they are essential for final products. Japan boasts strength in that field.

Coming second is the number of patents granted. Japan ranked top with 186,000 cases in 2005, compared with 134,000 for the United States, 64,000 for South Korea and 49,000 for Germany *(Chart 2)*.

A third strength is environmental and energy-saving technology. Japan is the runaway leader in the efficiency of environmental and energy-saving technologies, with its carbon dioxide (CO_2) emissions per unit of GDP standing at 0.24 kg CO_2/US$ (in 2005) *(Chart 3)*.

CHART 2

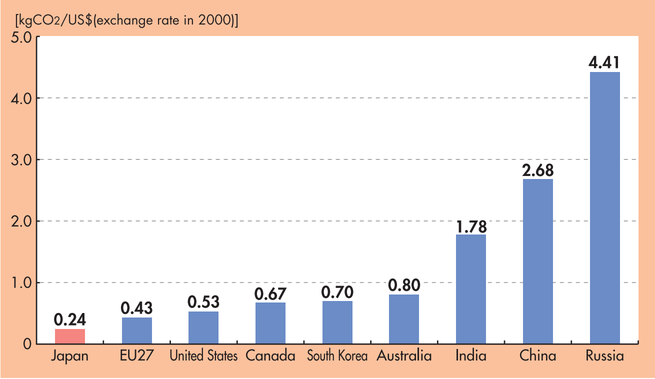
No. of patents granted worldwide by country of origin of applicants (2005)



Source: WIPO Statistics Database

CHART 3

CO_2 emissions per GDP (2005)



Source: "CO_2 emissions: from fuel combustion 1971-2005," IEA(2007)

During the two oil crises in the 1970s, Japanese businesses made strenuous efforts to overcome the crises with the result that they have established a robust, resilient energy-saving management structure, thereby achieving a leading low-carbon society. This attests to Japan's abilities to turn challenges into opportunities.

Fourth is the strength of small and midsize companies. Though there is no extra space available in this article to introduce specific examples, there are numerous small and midsize companies which, though based in provincial cities, have state-of-the-art technologies that have enabled them to command high market shares across the globe. It is not world-famous companies alone in Japan that boast high technologies.

The strengths of Japanese companies, including those in component/material and environmental technologies, have been nurtured by the fact that Japan has numerous demanding users and abundant human resources with high-level technologies. By establishing business bases in Japan and doing business with Japanese companies, foreign firms from around the world ought to be able to enhance their international competitiveness. Deals with Japanese companies may develop into technological and capital alliances. The global economic slump seems to be providing foreign businesses with good opportunities for making inroads into Japan.

3. Promotion of Investment in Japan

To facilitate FDI in Japan, what has the Japanese government done – and what is it planning to do hereafter?

Since the 1990s, the Japanese government has strenuously implemented measures to ease regulations through revisions to the Foreign Exchange and Foreign Trade Act, permitting corporate reorganization by share exchange/transfer, cutting the corporate tax rate and creating a preferential taxation system for corporate restructuring. In 2003, it set forth a goal of doubling the balance of FDI in Japan for the first time. To attain that goal, the Japanese government is carrying out a wide variety of steps under an action program. The results of such efforts have been mentioned above. The latest example is the updating in December 2008 of a program designed to facilitate FDI in Japan, with the Cabinet Office serving as coordinator for government ministries and agencies concerned. The updated "Program for Acceleration of FDI in Japan" focuses on, among others, regional activation, improvement of an investment environment and extensive publicity. Of the three pillars in the program, efforts are expected to center on formulating wide-area partnerships among multiple municipalities/prefectures, facilitating secondary investment in regional areas by foreign companies already having bases in Japan, utilizing investment funds, and expanding Japanese business operations abroad through mergers & acquisitions (M&As).

Introduced from now on are policy measures to be carried out in and after April in favor of investment in Japan by foreign companies and investment funds (some of them under deliberation in parliament as of March).

The first step is the revision of tax breaks for investment funds. The revision comes in two kinds. One is a special treatment of Direct Permanent Establishment (PE) taxation. In case foreign investors make investment in Japan via funds which have business bases in Japan, they are not taxed if they meet certain conditions such as not being committed to the investment business of the fund involved. The other is a special treatment of the so-called 25/5 rule. A foreign investor who holds an equity stake of 25% or higher in a Japanese company is taxed in Japan when the investor sells 5% or more of his/her shareholding. Under certain conditions, however, the basis for counting the 25% shareholding is changed from the fund as a whole to individual investors. No tax is imposed on individual investors unless each holds 25% or more.

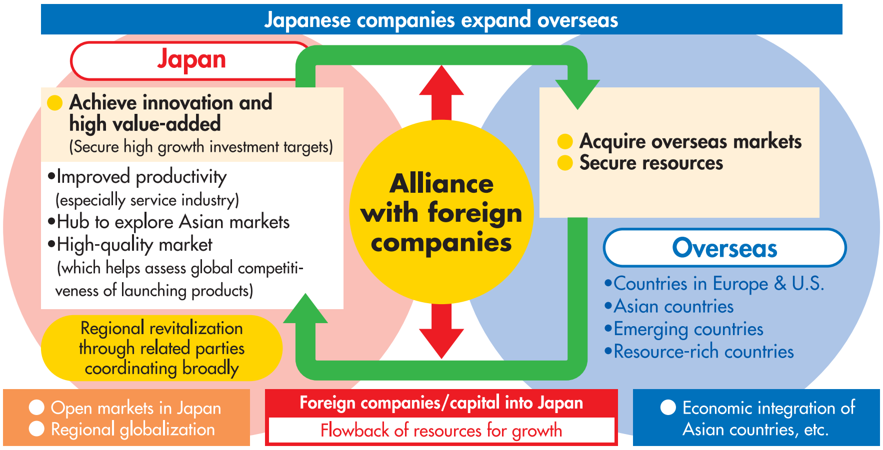
Second is the inauguration of the Innovation Network Corporation of Japan (INCJ), aimed at reinforcing innovation originating in Japan. As a stock company , the INCJ, together with private-sector investors who offer patient risk money, sets up sub-funds to invest in cutting-edge technologies in Japan.

The third step is the opening of TOKYO AIM, a market for professionals, scheduled for April 2009. The market is limited only to professionals, with listed companies to be allowed to disclose information in English and adopt international accounting standards. They are not obliged to submit internal control and quarterly financial reports. These features make it easier for foreign businesses to raise funds in Japan.

Fourth is the dispatch of a mission in March 2009 aimed at luring more funds into Japan from the Middle East. The measure is meant to arrange for business deals between Middle Eastern countries aiming to invest not only in the United States and Europe but also in Asia and Japanese venture businesses and funds that have sophisticated technologies but lack risk money. The Japanese government considers it important to offer opportunities for face-to-face business deals.

In addition , the government took measures to enable businesses to depreciate 100% in the first year of the value of energy-saving and new energy equipment in which they make investment, starting from fiscal 2009, although the step is applicable not only to foreign companies but to Japanese ones as well. Moreover, the corporate tax rate for smaller companies, capitalized at ¥100 million or less, is set to be lowered from 22% to 18% up to a certain amount of income . The tax incentive

CHART 4
Growth strategy & FDI : Creation of virtuous circle



Source: METI

will bring benefits to foreign companies planning so-called "greenfield investment" in Japan by setting up their business bases.

As mentioned above, the Japanese government is taking positive policy measures to spur foreign investment in Japan.

4. New FDI Trend & Future Policy Direction

Let me explain anew why the Japanese government is trying to facilitate foreign investment in Japan. Generally speaking, the answer is to revitalize regional areas, improve productivity and raise the quality of life. More specifically, let me explain what foreign investment in Japan means for the country and what direction foreign investment in Japan will follow in line with the country's economic growth strategy that has been worked out based on current Japanese social and economic conditions.

Given the inception of population shrinkage and the strong growth of emerging economies in Asia and elsewhere, there are two main directions of policy measures Japan should follow from now on: "business expansion of Japanese companies overseas/integration of the Japanese economy with those of Asian countries" and "higher value-added in Japan/making Japan the hub for technological innovation." The two directions are positioned in the same circle. Specifically, policy measures will be directed toward creating a virtuous circle in which Japanese companies' overseas operations are boosted with the result that the outcome of such efforts flows back to Japan where innovation is created. And further steps will be taken to make Japan the hub of Asia and a test market where there are numerous highly demanding consumers and businesses, and eventually make it a base for creating higher value-added.

In the crossover area of the future direction of Japan's economic growth strategy and facilitation of FDI in Japan, there are two key concepts: "alliances between Japanese and foreign companies" and "revitalization of local areas on the back of wide-area partnerships between municipalities/prefectures" *(Chart 4).*

The first key is alliances between Japanese and foreign businesses. Many Japanese companies, including smaller ones, believe it their challenge to expand into growing overseas markets by making full use of their technologies. Forming alliances with foreign companies that have marketing networks there provides them with a short-cut approach.

Introduced below are examples of Japanese companies that have built up win-win relations with foreign firms. An Okayama Prefecture-based company, which is engaged in the development and manufacture of computer application systems, has concluded an agreement with an Italian company under which the Japanese firm had the Italian partner purchase a 65% equity stake in itself and thus obtained marketing channels worldwide. Another Japanese company, which has a 20% share in the global touch-panel display market, is boosting its sales in the markets of the BRICs (Brazil, Russia, India and China) on the back of its alliance with a French company.

In the business community, the two Japanese companies are described as "acquired" in M&A deals. In both cases, however, the corporate names and employees remain unchanged. They have not been "taken over" but have "strategically formed alliances" with foreign companies. It might be better to take the "M" of M&A as meaning *Mutual* rather than merger and the "A" as *Alliance* rather than acquisition.

What is important on the side of Japanese businesses when strategically taking in foreign capital is to be fully aware of their strengths in selecting foreign partners and conduct negotiations concerning managerial policies and other matters until they are fully convinced it is the way to go. Meanwhile, foreign businesses need to place weight on building win-win relations and on the bonds of trust with Japanese companies.

The second key is the revitalization of regional economic activity on the back of wide-area alliances between municipalities/prefectures. Given that smaller Japanese companies based in regional areas are not known well among foreign firms and governments and that their business scale is limited, it is effective for multiple prefectural governments to try to form alliances with an eye toward integrating their respective industrial clusters beyond prefectural borders. They should aim to collaborate with foreign companies, which have ideas and know-how of different nature from those of Japan, thereby creating locally based innovation. This is because innovation is created through fusion and new connection with "alien elements."

Already some regions have launched such initiatives. The Chubu region in central Japan has launched the "Greater Nagoya Initiative" and the Kansai region in western Japan has initiated the "BioBridge Kansai" project. In addition, the Industrial Cluster Project is under way to promote alliances between regional industrial clusters in Japan and their overseas counterparts. Advancing and bolstering such alliances between Japanese and foreign regional areas will help spur exchanges of visits by not only tourists but by businesspeople and researchers as well, leading to internationalization of and greater foreign access to local areas in Japan. This will bring great benefits to provincial regions and Japan as a whole. The word "glocal" – a combination of *global* and *local* – may become the keyword in the future. JS

(This article was written at the end of March.)

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