Trends & Characteristics of Inward & Outward Foreign Direct Investment in Japan

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Expanding Japanese Outward Foreign Direct Investment (FDI)

As of 2015, Japan has been the largest creditor nation for the last 24 years, partly due to the expansion of Japanese outward FDI ("Japan Still Beating China on One Score: World's Top Creditor" by Enda Curran, www.bloomberg.com, May 22, 2015). *Chart 1* presents the Japanese outward FDI stock between 1996 and 2012. It was 30 trillion yen in 1996, declined to 25.4 trillion yen in 1999, and then expanded rapidly afterwards. In 2012, it amounted to nearly 90 trillion yen.

The growing importance of outward FDI is also recognized by the public. In particular, there is considerable public concern about the following three issues. The first issue is whether or not FDI causes a decline in domestic employment. Increased competition with other countries forces Japanese firms to relocate their production sites overseas, which results in disemployment in Japan. It thus is widely believed that the decline in manufacturing jobs is a consequence of globalization.

The second issue is whether or not Japan's dividend exemption in 2009 affected profit repatriation. One of the main concerns for policy makers is the huge stock of retained earnings of Japanese-owned foreign affiliates. The Ministry of Economy, Trade and Industry (METI) estimated that the stock of retained earnings amounted to some 17 trillion yen in 2006. Indeed, METI's White Paper 2015 (Chapter 1, Part 1) also highlights the issue of profit repatriation by Japanese-owned foreign affiliates.

The third issue is why inward FDI in Japan is so low. According to the *Economic Census for Business Activity* in Japan, the share of foreign-owned firms (whose parent firm is located in another country) was only 0.15% in terms of the number of firms and 0.88% in terms of the number of regular workers in 2009. Accordingly, Prime Minister Shinzo Abe's new growth strategy calls for doubling the outstanding amount of FDI from 17.5 trillion yen in 2011 to 35 trillion yen by 2020. Increases in inward FDI in Japan thus is a pressing issue, which is also highlighted in METI's White Paper 2015 (Chapter 2, Part 2 and Chapter 3, Part 3).

Based on this background, this article first discusses the recent trends and characteristics of outward and inward FDI in Japan, and then reviews the studies that have attempted to address the three issues mentioned.

Main Destinations for Japanese FDI

Chart 2 presents the trends of Japanese FDI by region. There are three notable findings here. First, the main destinations of Japanese FDI are North America, Europe, and Asia. These three regions in total have accounted for more than 80% of Japanese outward FDI since 1996. Note, however, that from the early 2000s, the share of Latin America has been increasing. As a result, the share of these three regions in total declined from 90% in 2001 to 81% in 2012.

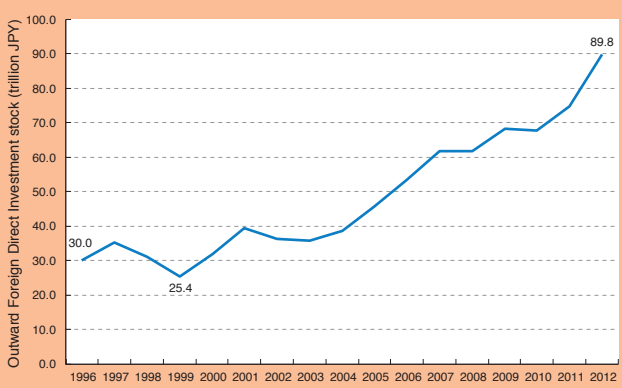
Second, on the one hand, Japanese FDI in North America has declined since 2000. The share of North America was 50% in 2000 but declined to less than 30% in 2012. Third, on the other hand, the shares of Europe and Asia increased from 38% in 2000 to 52% in 2012.

Table 1 presents the top 20 host (destination) countries of Japanese FDI in 2012. The main destination is the United States, followed by the Netherlands, China, the Cayman Islands, and Australia. In particular, the US has a remarkably high share: 30% of all Japanese FDI. Moreover, these top five countries accounted for about 60%, and the top 10 countries accounted for 75.1% of Japanese FDI. This result means that Japanese FDI is concentrated in some specific countries.

One may ask why Japanese FDI goes to the Cayman Islands, or why the share of the Netherlands is higher than that of China. The Cayman Islands is a British Overseas Territory located in the West Indies. In the Balance of Payments Statistics, the Cayman Islands are classified into a Caribbean region (i.e., Latin America). According to the World Bank, the population of the Cayman Islands is currently about 58,000. The islands total 264 square kilometers in area, almost the same size as Iriomote Island in Okinawa Prefecture. Compared with the other top

CHART 1

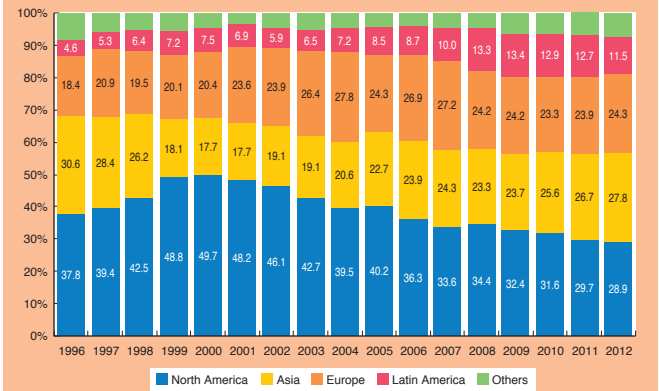
Trends of Japanese outward FDI in Japan



Note: FDI stock is the international investment position as of the end of the year.
Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

CHART 2

Trends of Japanese outward FDI by region



Note: Figures indicate the share of each region. For the definition of each region, see Bank of Japan (2013).
Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

TABLE 1

Top 20 host countries of Japanese FDI in 2012

Rank	Country	Trillion yen	Share (%)
1	US	24.7	27.5
2	Netherlands	8.2	9.1
3	China	8.0	9.0
4	Australia	5.3	5.9
5	Cayman Islands	5.2	5.7
6	UK	4.7	5.2
7	Singapore	3.1	3.5
8	Brazil	3.1	3.4
9	Thailand	3.0	3.4
10	South Korea	2.2	2.5
11	France	1.7	1.9
12	Indonesia	1.6	1.8
13	Hong Kong	1.6	1.8
14	Germany	1.5	1.6
15	Belgium	1.4	1.5
16	India	1.3	1.5
17	Canada	1.3	1.4
18	Taiwan	1.2	1.3
19	Malaysia	1.1	1.3
20	Philippines	0.9	1.0

Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

TABLE 2

Trends of Japanese outward FDI by industry

	2005	2006	2007	2008	2009	2010	2011	2012
Total (trillion yen)	45.6	53.5	61.9	61.7	68.2	67.7	74.8	89.8
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Manufacturing (%)	59.8	58.4	55.4	49.1	47.8	46.3	48.0	47.2
Food	4.3	4.4	6.2	5.2	6.4	6.0	6.2	6.0
Chemicals & pharmaceuticals	9.3	9.3	8.6	8.2	8.2	8.7	10.0	8.4
Electric machinery	14.8	12.8	12.1	9.9	8.8	8.6	8.4	8.7
Transportation equipment	17.8	17.9	14.6	12.5	11.0	9.8	9.4	9.8
Nonmanufacturing (%)	40.2	41.6	44.6	50.9	52.2	53.7	52.0	52.8
Mining	2.0	2.6	3.4	4.7	5.7	6.3	7.5	8.6
Communications	1.2	1.2	0.5	1.1	1.5	2.6	1.8	2.2
Wholesale & retail	11.0	11.2	13.8	14.5	14.2	14.0	12.9	13.5
Finance & insurance	17.2	18.0	19.5	23.6	23.7	23.4	22.2	20.5

Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

five countries, the size of its economy is rather small.

The Cayman Islands are a so-called "tax haven" that offer foreign individuals and firms little or no tax liability. Similarly, the Netherlands is known as a low-tax country. According to Prof. Gabriel Zucman of the London School of Economics and Political Science, half of the profits of US firms are reported in six countries, including Singapore, Switzerland, and the Netherlands. Japanese FDI in the Cayman Islands and the Netherlands can thus be regarded as tax-shelter investments.

Industries Engaging in FDI

Table 2 indicates Japanese FDI from 2005 to 2012 by industry. Three messages are evident from this table. First, the share of nonmanufacturing was expanding rapidly. In 2005, the share of manufacturing was about 60% and that of nonmanufacturing was about 40%. By 2012, however, the share of nonmanufacturing was more than 50%, exceeding the share of manufacturing. The expansion of Japanese nonmanufacturing FDI in the latter 2000s is remarkable.

Second, in manufacturing, the share of electric machinery and transportation equipment declined rapidly. In 2005, the share of electric machinery was about 15% while that of transportation machinery was 18%. However, these shares started declining from 2006. By 2012, the shares of electric machinery and transportation equipment had fallen to about 9% and 10%, respectively.

Third, in contrast, nonmanufacturing industries such as mining, wholesale and retail trade, and finance and insurance expanded rapidly. From 2005 to 2012, the share of mining increased from 2% to 8.6%, that of wholesale and retail trade grew from 11% to 13.5%, and that of finance and insurance rose from 17.2% to 20.5%. In particular, the growth of FDI in the mining industry was remarkably high. This suggests that obtaining natural resources has become a major purpose of recent Japanese FDI.

Is Investment Income Important?

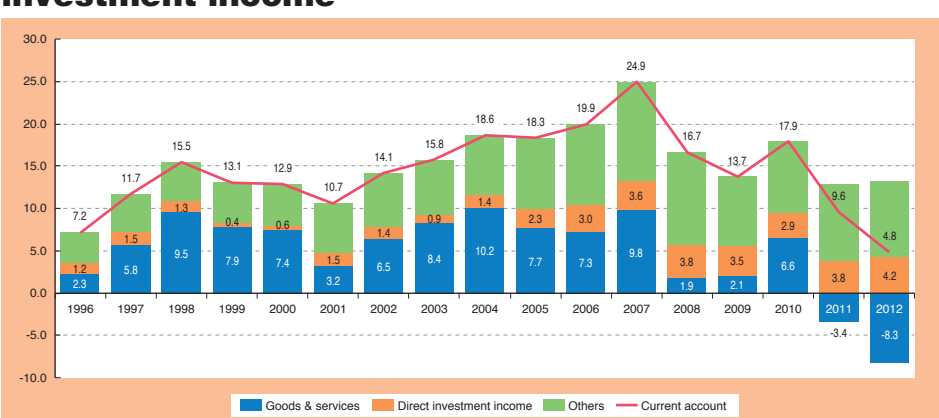
With the expansion of Japanese outward FDI, is investment income increasing? In this article, investment income means the remittances of profits and interest payments from foreign affiliates to a parent firm in Japan. *Chart 3* presents the trends of the current account balance, trade balance, and net investment income from 1996 to 2012. The trade balance is exports of goods and services minus imports of goods and services.

Chart 4 indicates that the current account surplus grew from 7.2 trillion yen in 1996 to 24.9 trillion yen in 2007, and then declined to 4.8 trillion yen in 2012. The trade balance indicates similar trends to the current account balance. The trade surplus increased from 2.3 trillion yen in 1996 to 9.8 trillion yen in 2007, and then declined afterwards. From 2011, due to the increases in liquefied natural gas for thermal power generation, the trade balance went into deficit. In 2012, the trade deficit was 8.3 trillion yen.

In contrast, investment income grew rapidly, from 1.2 trillion yen in 1996 to 4.2 trillion yen in 2012. Half of the trade deficit was offset by investment income. It can be interpreted that investment income is propping up the declining current account surplus in Japan. These results together suggest the increasing importance of investment income in Japan.

CHART 3

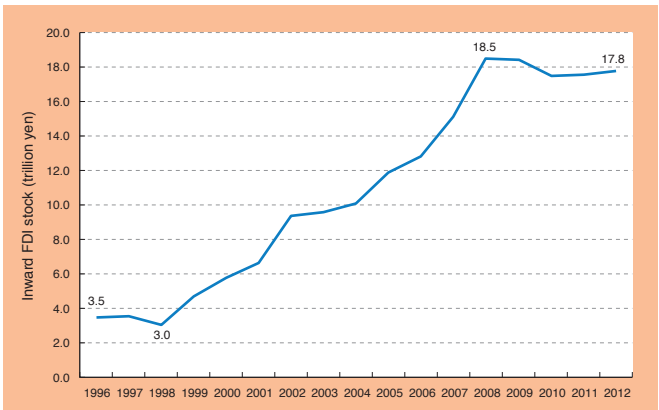
Trends of Japanese current account balance & direct investment income



Note: Unit is trillion yen. Others include income other than direct investment income, and current transfers.
Source: Ministry of Finance (2013) Japan's Balance of Payments, Historical Data, Ministry of Finance website

CHART 4

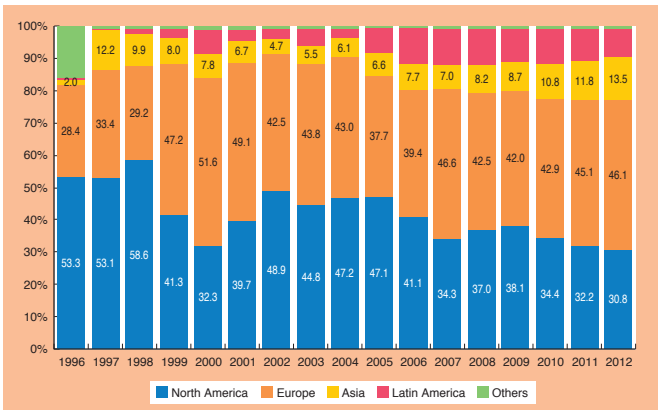
Trends of inward FDI in Japan



Note: FDI stock is the international investment position as of the end of the year.
Source: Bank of Japan (2013) International Investment Position of Japan, BOJ website

CHART 5

Trends of inward FDI in Japan by region



Note: Figures indicate the share of each region. For the definition of each region, see Bank of Japan (2013).
Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

Trends & Characteristics of Inward FDI in Japan

While Japanese outward FDI has been increasing in recent years, inward FDI in Japan is also increasing. *Chart 4* indicates the inward FDI stock for the period between 1996 and 2011. Although the inward FDI stock decreased from 3.5 trillion yen to 3.0 trillion yen in 1998, it increased rapidly from 2000. In 2012, inward FDI amounted to about 18 trillion yen. The expansion of the inward FDI stock is more rapid than that of the outward FDI stock.

One may notice, however, that the size of inward FDI itself is still very low even though it is growing rapidly. Japanese outward FDI stock amounted to about 90 trillion yen in 2012. In contrast, despite the fact that the inward FDI stock in Japan increased to five times as much as 15 years ago, it is still 18 trillion yen, one-fifth of outward FDI. Indeed, inward FDI in Japan is very small compared with other advanced economies. In 2011, the ratio of inward FDI stock to GDP was 16.9% in the US and 12.6% in South Korea. However, it was only 3.7% in Japan.

Which countries do invest in Japan? *Chart 5* presents the trend of inward FDI stock from 1996 to 2012 by region. There are two notable findings. First, the share of North America has declined – from 53.3% in 1996 to 30.8% in 2012. Second, with the decline of the North American share, the share of Asia, Europe, and Latin America has increased. In particular, the shares of Asia and Europe have expanded rapidly since 2005. The share of Asia increased from 6.6% in 2005 to 13.5% in 2012 while that of Europe expanded from 37.7% to 46.3% in the same period.

Table 3 presents the top 20 home (source) countries of inward FDI in Japan in 2012. The top country is the US, followed by the Netherlands, France, the United Kingdom, and Singapore. Like outward FDI, the share of the US is remarkably high. Even though the share of FDI from North America has declined, the share of the US still accounts for about one-third of total inward FDI. Moreover, the top five and 10 countries accounted for about 70% and more than 90% of total inward FDI, respectively. The concentration of inward FDI from some specific countries is higher than that of outward FDI.

Which industries then do foreign firms enter? *Table 4* presents the industry distribution of inward FDI in Japan between 2005 and 2012. Three findings stand out from this table. First, the share of nonmanufacturing was large and expanding, from 55.5% in 2005 to 62.9% in 2012. On the flipside, the share of manufacturing declined from 44.5% to 37.1% in the same period. In particular, the decline in

TABLE 3

Top 20 home countries of FDI in Japan in 2012

Rank	Country	Trillion yen	Share (%)
1	US	5.3	29.9
2	Netherlands	2.7	15.3
3	France	1.6	8.7
4	UK	1.3	7.5
5	Singapore	1.3	7.5
6	Cayman Islands	1.2	6.8
7	Switzerland	1.2	6.5
8	Germany	0.7	4.1
9	Hong Kong	0.5	2.8
10	Luxembourg	0.3	1.4
11	South Korea	0.2	1.4
12	Taiwan	0.2	1.2
13	Canada	0.2	0.9
14	Australia	0.1	0.5
15	Sweden	0.1	0.5
16	Italy	0.1	0.5
17	China	0.0	0.3
18	Malaysia	0.0	0.2
19	New Zealand	0.0	0.2
20	Spain	0.0	0.1

Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

TABLE 4

Trends of Japanese inward FDI by industry

	2005	2006	2007	2008	2009	2010	2011	2012
Total (trillion yen)	11.9	12.8	15.1	18.5	18.4	17.5	17.5	17.8
Total (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Manufacturing (%)	44.5	44.0	37.7	36.7	35.0	35.5	35.3	37.1
Food	1.9	1.5	1.5	1.4	1.5	1.5	1.4	1.4
Chemicals & pharmaceuticals	7.1	11.6	9.3	9.4	8.9	7.7	7.7	7.9
Electric machinery	17.7	15.8	13.3	13.7	13.1	11.7	12.1	13.4
Transportation equipment	13.5	10.9	8.2	7.0	6.6	9.1	8.3	8.2
Nonmanufacturing (%)	55.5	56.0	62.3	63.3	65.0	64.5	64.7	62.9
Mining	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Communications	7.7	6.5	3.9	3.0	2.9	1.8	1.8	2.4
Wholesale & retail	6.6	7.4	7.4	5.9	6.7	7.5	8.7	9.3
Finance & insurance	29.1	33.8	41.5	44.7	45.0	43.9	42.0	39.3

Source: Bank of Japan (2013) Direct Investment Position, Breakdown by Region and Industry, BOJ website

transportation equipment is noticeable.

Second, among nonmanufacturing industries, the share of finance and insurance is remarkably high. It was 29.1% in 2005 and expanded to 39.3% in 2012. Indeed, the share of finance and insurance exceeded the share of manufacturing. Finally, the share of wholesale and retail trade also increased, from 6.6% to 9.3% between 2005 and 2012.

Summary of Characteristics of FDI in Japan

Having reviewed the trends of outward and inward FDI in Japan, the characteristics of recent Japanese FDI can be summarized as follows. First, the destination of Japanese outward FDI is shifting from North America to Asia and Europe. Second, the FDI from nonmanufacturing industries is expanding rapidly compared with that from manufacturing industries. Third, investment income has also been increasing rapidly in recent years. In other words, Japanese firms are more likely to go abroad for their earnings in recent years. In contrast, inward FDI into Japan is growing, especially from Europe and Asia. Nonetheless, the size of inward FDI itself is still very low.

These descriptive statistics are useful to get a picture of the trends and characteristics of FDI in Japan. However, we should note that various factors affect the decisions of Japanese firms to go abroad or the decisions of foreign firms to enter into Japan. In addition, firms are heterogeneous in terms of size, productivity, industry, etc. Therefore, for example, the effects of FDI on domestic employment may be different across firms. To identify the causes and effects of FDI precisely, more rigorous quantitative analysis is needed.

There are a number of important questions about the issue of FDI. Due to space limitations, however, the following sections focus on three questions: 1) Did FDI cause the decline in domestic employment? 2) Did Japan's dividend exemption in 2009 affect profit repatriations? 3) Why is inward FDI so low in Japan?

1. Did FDI cause the decline in domestic employment?

As mentioned earlier, it is widely believed that the decline in manufacturing jobs is a consequence of globalization. However, this argument is not supported by quantitative studies. Indeed, academic studies on this issue have not necessarily confirmed the phenomenon of "exporting jobs". One reason is that FDI usually initiates increases in the production of final goods in foreign countries, which has positive effects on the production of intermediate inputs in the home country, resulting in the maintenance of, or an increase in, the demand for domestic labor. Such positive effects may offset or even exceed the negative effects.

Prof. Ryo Kambayashi of Hitotsubashi University and I estimated the labor demand function, using Japanese firm-level data from 1995 to 2009. The labor demand function relates the labor demand in Japan to the domestic and foreign factor prices. If domestic wages go up, the labor demand in Japan will decline. Similarly, if foreign wages go up, the labor demand in Japan will increase. Whether such relationships are supported by the data is an empirical question. We attempted to ask this question, using firm-level data in Japan.

The main results were twofold. First, the effects of foreign wages on domestic labor demand are negligibly small. Second, in contrast, the decline in the price of investment goods has significantly larger negative effects on domestic employment than on foreign wages. Seen in combination, these results suggest that the disemployment in Japan is mainly driven by substitution between capital and labor, rather than the reallocation of labor caused by FDI.

2. Did Japan's dividend exemption in 2009 affect profit repatriations?

There are two major international tax systems in the world. One is the worldwide tax system which taxes foreign source income (upon repatriation, allowing foreign tax credits for corporate income taxes and other related taxes paid to foreign governments). The other is the territorial tax system which exempts from home taxation dividends remitted by foreign affiliates to their parent firms. In 2009, Japan introduced a foreign dividend exemption that exempts from home taxation dividends remitted by foreign affiliates to their parent firm. As a result, Japan's corporate tax system moved from the worldwide tax system to the territorial tax system.

The territorial tax system permits Japanese resident corporations to deduct from taxable income 95% of dividends received from foreign affiliates in accounting years commencing on or after April 1, 2009. Accordingly, Prof. Eiji Tajika of Hitotsubashi University and his colleagues investigated the impact of Japan's dividend exemptions on dividends received by Japanese parent firms from their foreign subsidiaries. They found that more parent firms, especially those facing greater demand for cash, increased dividends received from their foreign affiliates in response to the enactment of the dividend exemption in 2009.

Unlike Tajika's study, Prof. Makoto Hasegawa of the National Graduate Institute of Policy Studies and I examined the effect of dividend exemptions on dividend payments at the affiliate level and the responsiveness of dividend payments to repatriation tax costs. Each foreign affiliate faced a different tax cost in paying dividends to its parent firm in Japan under the worldwide tax system, depending on the corporate tax payments to the host country and the withholding tax payments on dividends. Thus, the advantage of our study is that the analysis can utilize the variations in the tax costs of dividend repatriations among affiliates to identify the impact of the tax reform on dividend repatriations.

The results indicated that the response of Japanese-owned affiliates to dividend exemption was heterogeneous, whereby foreign affiliates that held a large stock of retained earnings in the previous year significantly increased dividend payments to their parent firms in response to Japan's adoption of a territorial tax regime. This implies that dividend exemption helped fulfill its primary aim of stimulating dividend repatriation from foreign affiliates that had amassed large amounts of foreign profits.

3. Why is inward FDI so low in Japan?

To the best of my knowledge, previous studies have not yet answered this question successfully. Many people have argued that such factors as Japanese corporate governance, high tax rates, cultural and language differences, and high wage rates can be obstacles to inward FDI. However, no studies have quantitatively addressed this issue. Besides, note that high wage rates also mean high income levels. High wage rates thus can accelerate the entry of foreign firms whose main objective is seeking markets.

A study by Prof. Satomi Kimino of Aston University and her colleagues investigated the determinants of inward FDI in Japan. They focused on 17 countries which invested in Japan in the period between 1989 and 2002. One of the interesting findings is that both cultural and geographic distance is only of marginal importance in explaining inward FDI. Furthermore, exchange rates, market size, and wage rates do not have significant effects on inward FDI.

Despite the interesting findings of this study, however, it is still not clear why inward FDI in Japan is so low. Research on inward FDI in Japan remains scarce, and more detailed studies on this issue are needed.

Conclusion

This article presented the trends and characteristics of Japanese FDI, and then reviewed some of the findings of academic studies on the issue of disemployment caused by multinationals, profit repatriation by foreign affiliates, and obstacles to inward FDI in Japan. There are a number of academic studies that have addressed issues relating to FDI. Interested readers may refer to my own book that provides a detailed review of the literature on outward and inward FDI in Japan: *Expanding Foreign Direct Investment and Japanese Firms* (*Kakudai Suru Chokusetsu Toshi to Nihon Kigyo*), Kozo Kiyota (Tokyo: NTT Publishing Co., Ltd., 2015). (In Japanese)

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