

# Closing the Investment Gap

By Chikao Tsukuda



Foreign direct investment in Japan remains marginal compared with Japanese direct investment abroad (Table 1). According to statistics compiled by the Ministry of Finance (MOF) on a notification basis, Japanese investment abroad totaled \$253.9 billion in fiscal 1950-1989. In the same period, foreign investment in Japan came to only \$15.7 billion, just one-sixteenth the Japanese figure.

Now this "investment imbalance" is emerging as a major source of friction between Japan and other countries. Japan's poor investment environment was cited in a report on foreign trade barriers prepared by the Office of the U.S. Trade Representative in April 1989. In the recently concluded Japan-U.S. Structural Impediments Initiative (SII) talks, the United States took up alleged obstacles to foreign direct investment in Japan. Today Japan is under pressure to take prompt measures to facilitate inward direct investment and demonstrate its commitment to reciprocity in bilateral investment.

In fiscal 1989, foreign businesses invested \$2.9 billion in Japan, down 11.8% from a year before, according to the MOF statistics (Fig. 1). The number of investments actually increased 33.3% to 5,688, but in value terms the year saw a sharp slowdown from the 230% growth recorded in fiscal 1987 and 46.5% in 1988.

By sector, fiscal 1989 investment in manufacturing dropped 51.7% to \$1.2 billion (Fig. 2), while foreign investment in Japan's nonmanufacturing sector jumped 106% to \$1.7 billion. The share of nonmanufacturing investment expanded to 59% from 25.2% in fiscal 1988. Investment in real estate increased eight-fold over a year earlier, with its share of total investment soaring from 2.2% just a year before to 22.6%.

Investment from the United States, traditionally the largest investor in Japan, shrank 6.8%, falling to 57.4% of the total for the year. Investment by European companies fell an even sharper



23.5%, reducing their share to 21.9%.

The three main characteristics of foreign investment in Japan in recent years have been a keen interest in research and development, rising investment in distribution, and sharp growth in real estate investment. Foreign businesses have been moving to establish R&D centers in Japan in response to Japan's growing prowess in technological development. Similarly, the increased investment in distribution stems from the need to form marketing networks for entering Japan's huge market.

## How wide is the gap?

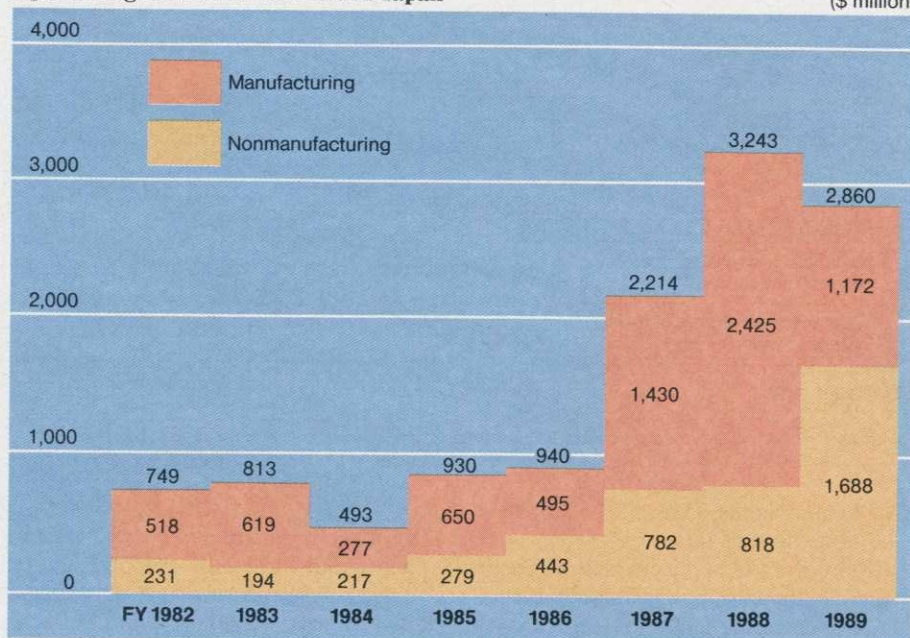
Judging from MOF statistics alone, the gap between outward and inward investment is indeed daunting. Yet in reality the gulf is not as wide as it seems. For one thing, heavy foreign investment in Japan's oil industry during the nation's postwar recovery period is greatly undervalued because the statistics are based on acquisition value rather than current value. Again, borrowings from Japanese banks account for a large proportion of foreign investments in Japan, but are not included in the MOF's statistics. Obviously, foreign businesses actually maintain a greater presence in Japan than the ministry statistics indicate.

Take, for example, the imbalance between Japan and the United States. Japanese investment in the U.S. had reached a cumulative total of \$104.4 billion by the end of fiscal 1989, while investment from the United States through fiscal 1988 totaled only \$7.9 billion. From these MOF statistics alone, U.S. investment was only one-thirteenth of Japanese investment. But 1989 U.S. Commerce Department statistics show a much smaller gap. According to the department, the balance outstanding of Japanese investment in the United States was \$69.7 billion and that of the U.S. in Japan \$19.3 billion. Thus the gap, while still formidable, is seen to be much smaller, even though it has widened recently as a result of extensive Japanese investment in U.S. real estate.

The above statistics are based on book values. In market value terms, the total

Fig. 1 Foreign Direct Investment in Japan

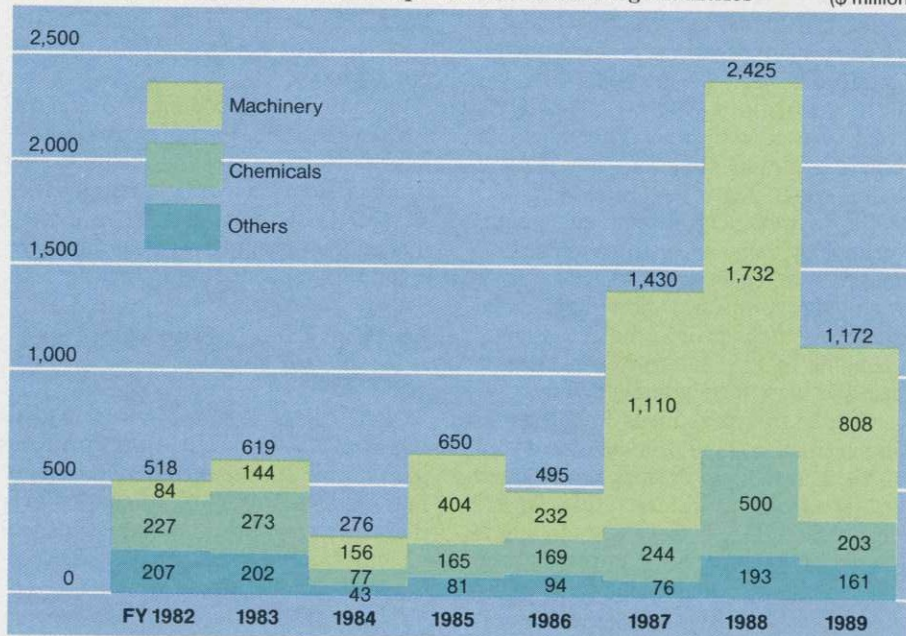
(\$ million)



Source: MOF statistics

Fig. 2 Foreign Direct Investment in Japanese Manufacturing Industries

(\$ million)



Source: MOF statistics

assets of Japanese corporations in the United States were worth \$195.8 billion and those of U.S. corporations in Japan \$106 billion, according to a Department of Commerce survey. That makes the figure for Japan only about 1.8 times that of the United States.

The same survey found that total sales of Japanese corporations in the United States are some 1.6 times those of U.S. corporations in Japan. The ratio is re-

versed in manufacturing investment, however. The balance outstanding of Japanese manufacturing investment in the United States stood at \$17.3 billion at the end of 1989, or nearly double the balance outstanding of U.S. manufacturing investment in Japan (\$10 billion). But the corresponding value of assets held by U.S. manufacturing corporations in Japan was \$52.2 billion compared with \$14.7 billion for Japanese manufacturing concerns in



Table 1 The Balance Outstanding of Foreign Direct Investments

	Japan (\$ billion)		U.S. (\$ billion)		Britain (£ billion)	W. Germany (billion marks)
	1974	1989	1974	1989	at the end of 1988	at the end of 1985
Balance outstanding of direct investment abroad (A)	6.6	154.4	110.1	357.9	101.5	85.1
Balance outstanding of foreign direct investment (B)	1.9	9.2	25.1	391.5	66.2	55.0
Ratio (A/B)	3.5	16.8	4.4	0.9	1.5	1.5

Sources: International Balance of Payments Statistics, Bank of Japan; *Survey of Current Business*, U.S. Commerce Department; Quarterly Bulletin, Bank of England; Monthly Report, Deutsche Bundesbank

the United States. Thus, the U.S. figure is 3.6 times that of Japan.

Moreover, U.S. businesses in Japan have a better earnings position than Japanese firms in the United States. According to a 1988 survey of business trends among foreign enterprises in Japan conducted by the Ministry of International Trade and Industry, the average current profit margin for all Japan-based foreign enterprises was 6.8% of sales, while that for manufacturing enterprises was 8.1%. The corresponding figures for Japanese enterprises operating in the United States were 2.8% and 4.5%, respectively.

Furthermore, U.S. investment in high-technology fields in Japan has increased markedly in recent years. As a result, U.S. high-tech companies now hold large shares of the Japanese market. Capital spending by U.S. enterprises in Japan is also the highest by a foreign country.

Clearly the investment imbalance is much smaller than it has been made out to be, and the gap in stock terms is not nearly as wide as in flow terms. Japan's share in the U.S. balance outstanding of direct investment abroad was 5.2% in 1988—ranking sixth in all industries, third in chemicals, fourth in electric machinery and third in commerce, underscoring the fact that Japan is a high-priority country for U.S. direct investment.

Japan is also host to numerous major corporations from other countries around the world. Of the 500 biggest companies listed in *Fortune* magazine, 207 either have joint ventures with Japanese companies or their own Japanese subsidiaries. If one includes companies with technical tie-up agreements the number jumps to 308.

Some large multinational companies,

such as IBM and NCR Japan, have long histories in Japan. Even smaller companies that have only recently entered the Japanese market, such as semiconductor device makers Applied Materials and Analog Devices, already hold the largest market shares in their respective fields. In the consumer goods market, Procter & Gamble of the United States ranks third in sanitary napkins and paper diapers.

Recently, some foreign companies have invested in Japan to establish laboratories. Some others do so to build their own marketing networks or develop their own R&D systems in order to directly market their products without relying on Japanese agents.

### Is the Japanese market "closed"?

Nonetheless, it remains true that inward direct investment is much smaller than outward investment in flow terms. Foreign criticism of and frustration over the gap is growing, and some Japanese systems and business practices are coming in for critical scrutiny.

There are a number of factors contributing to the imbalance of direct investments.

The first is the withdrawal of some foreign, and especially American, companies from Japan. The Japanese and U.S. balances of international payments for 1988 and 1989 show that net capital recovered by U.S. businesses in Japan reached \$600 million in 1988 and \$1.5 billion in 1989. Because of these withdrawals, the U.S. balance outstanding of investment in Japan has increased only marginally.

Some companies have pulled out of the Japanese market because they have lost their technological advantage and with it their competitive edge. Others have decided to withdraw to make capital gains, as in the case of Chrysler, which sold its holdings in a joint venture in Japan in 1989. The sale was designed to raise funds in order to overcome a financial crisis, and was part of the company's broader strategy in the United States. What made such a move possible, of course, was the sharp rise in stock and land prices in Japan and the steep appreciation of the yen, which enabled Chrysler to secure very large amounts of funds by selling its Japanese equity stakes and other assets. Merck, Nabisco, Honeywell and General Motors have done likewise.

Another notable trend has been the purchase of U.S. parent companies by their Japanese subsidiaries, including such high-profile buy-outs as CBS Records and Shaklee. Foreign subsidiaries in Japan have also been sold to Japanese companies, as was the case with Avon Products.

A second factor is a perception that Japan's policies are closed toward inward investment. How valid are these fears?

It was not until 1973 that Japan lifted some of its restrictions on such investment. In 1980 the investment market was almost completely liberalized. In this sense, investment decontrol came relatively late to Japan compared with other industrialized countries. This has led many foreign critics to attribute the wide gap between inward and outward investment to the continued existence of restrictions in Japan.

However, a survey by the American Chamber of Commerce in Japan and a poll of foreign business executives based in Japan by the *Nihon Keizai Shimbun*, a leading economic journal, found that many discount the policy-based restrictions theory. Another *Nihon Keizai Shimbun* poll of 433 executives of some of the world's leading corporations also found that a majority believe that Japan has fewer policy-based impediments than do the United States, Europe and the Asian NIEs.

The third contributing factor is the



growing view that traditional Japanese business practices and other structural impediments stand in the way of inward investment, even after institutional and regulatory restrictions have disappeared. High costs due to the strong yen, sky-high land prices and labor shortages, it is argued, impose de facto restrictions on investment.

The U.S. argument on Japanese land prices has four main points: (1) Japan's land use policy is inappropriate and inefficient, thus contributing to higher land prices. (2) High land prices restrict housing investment and consumption, thus applying downward pressure on domestic demand. As a result, Japan has generated large current account surpluses. (3) High land prices make it difficult for foreign enterprises to enter the Japanese market, thus limiting foreign direct investment. The high cost of land at home has prompted Japanese enterprises to invest in foreign countries where land is less expensive. (4) Lowering land prices would improve the housing situation, spur consumption, expand domestic demand and stimulate investment. The result would be a higher standard of living for all Japanese.

Land in Tokyo's business districts costs

100 times more than in New York, three to four times more than in London, 10 to 20 times more than in Paris and 40 to 100 times more than in Frankfurt, according to a recent survey. Yet other surveys have shown that high land prices are in fact not a major drag on business operations, because Japanese corporations maintain a high level of economic efficiency per unit area of land.

Nonetheless, there is little doubt that land price inflation has raised the cost of foreign investment in Japan. In that sense, the investment imbalance, like the trade imbalance, does indeed have to do with the harmonization of structures, systems and practices. The question for the future is how best to improve structural conditions for foreign investment in Japan.

### Promoting investment

There is no question that foreign direct investment must be reciprocal. Japan needs to work to redress the investment imbalance. It will not do to simply try to justify it as the result of differences in competitiveness, any more than the trade gap should be attributed solely to Japan's competitive edge. The necessary struc-

tural adjustments should be made to promote inward investment, including any policy measures that might be needed.

The Japanese government has introduced various measures to induce foreign investment in recent years. These include: (1) Expanding the financing facility of the Japan Development Bank to make more foreign firms eligible for funds. The credit line for foreign enterprises has also been raised. (2) Allowing foreign firms without research facilities of their own in Japan to participate in governmental R&D projects, beginning in fiscal 1989. (3) Encouraging local governments to take steps to invite foreign enterprises to help develop their local economies.

The Hokkaido-Tohoku Development Corporation, for instance, has created a financing facility aimed at promoting the internationalization of local enterprises. The facility provides special support for foreign investment in areas covered by MITI's "international model city plan" and "international industrial exchange model base plan." Local governments have also established councils to attract foreign enterprises and have sponsored investment seminars for interested firms.

Work is also under way to improve Japan's investment infrastructure. Transport and communications networks between Tokyo and outlying areas are being upgraded, and international airports are being built near smaller cities. So far more than 70% of foreign investment in Japan has been in Tokyo, but recent efforts to improve local infrastructure should contribute materially to promoting foreign investment in other parts of the country.

Meanwhile, the Japan External Trade Organization (JETRO) and the Japan Development Bank continue to hold seminars and send missions abroad to encourage foreign investment in Japan. In time, these many efforts should help dispel the perception that Japan is closed to inward investment, and prevent the spread of "investment friction."

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The president of Sony Corp., Norio Ohga, at the press conference in which the company sealed its purchase of CBS Records.

Photo: Nihon Keizai Shimbun