FIELD SURVEY

Changing Climate for Inward Investment in Japan

By Rupert Naylor

During 1997, the Industrial Machinery Division of MITI has been looking at the inward investment climate for their sector, through a series of interviews with inward investors in the field and support organizations. In the first of three articles on the inward investment climate in Japan in the industrial machinery sector, Rupert Naylor looks at some of the reasons behind Japan's low levels of inward investment. In later articles he will look at problems commonly cited by inward investors and some of the policy solutions that are currently being used to tackle them.

Japan's significant investment imbalance is not news. While most of the G-7 economies have higher levels of inward than outward investment, the imbalance in Japan, at 7:1 in 1996 and 13.2 the year before, is by far the highest. Actual levels of inward investment remain low; per capita investment in the United Kingdom in 1993 was almost 22 times the 1994 level of $154 in Japan. Yet inward investment is now more important than ever for Japan, because of both the increase in hollowing-out and its stimulative effect on imports, which would help to reduce the trade surplus which preoccupies Japan's trading partners.

There have been numerous studies of this, and during 1996, the International Business Directorate of MITI carried out a survey of inward investors to consider the changes that might be made to reverse the situation. Following on from this, the Industrial Machinery Division of MITI has looked in more detail at the situation in the machinery and related sectors.

Most causes of low investment levels, such as past economic policy and the high-cost, low-return economy, are common to all industries. Post-war Japanese economic policy, aimed at building up domestic industry and protecting the domestic market from overseas competition, has left a legacy of under-investment in Japan. The Foreign Investment Law of 1950 and the 1949 Foreign Exchange and Foreign Trade Law regulated all external transactions and allowed capital investments only when they contributed to Japan's economic independence and development.

Japan began to liberalize upon joining the OECD in 1964 and by the fifth phase liberalization in May 1973, restrictions remained in only the five sectors excluded from the OECD Capital Liberalization Code (agriculture, forestry and fisheries; mining; petroleum; leather goods and small retailers). There was some investment before this—printing machine maker Heidelberg has been in Japan for over half a century and Rank Xerox's Joint Venture with Fuji Film to produce photo-copiers took place in the 1960s—but several companies entered the market during the early 1970s to take advantage of a rapidly developing and advancing economy, growth in Japanese exports and a more liberal investment regime. Reform of the regulations on inward investment has continued and, with the revised Foreign Investment Law of 1980, brought a change in approach from authorization of investments by the government to notification of investments by the investor.

A major concern for many potential investors is the apparent difficulty of making money in the Japanese market. According to Daiwa Institute of Research, over the past decade, Japanese manufacturers have managed just 5.2% return on equity, compared with 17.4% in the United States. Concern for market share and employee welfare over profitability, and high service requirements that eat into profitability in a high-price, high-margin economy, have contributed. As more than half of Japan's publicly held shares are effectively untraded because of cross-ownership, concerns of shareholders have never been a major issue. In fact, as Sam Nakamura of Dana says, "Financial reasons are the most important in making investment decisions but for a long time it was almost rude to talk about money in Japan. There have to be winners and losers in a capitalist system, but the Japanese government wanted a win/win situation."

Things are already changing. *Keiretsu* no longer dictate purchasing decisions, increasing openings for foreign firms. And the sense of change is apparent in the companies themselves—Mitsubishi Corporation's annual report talks of "leaving stereotypes behind," for example. But the most important changes in this area will come from "Big Bang" financial reforms. Current inward investors hope these reforms will bring shareholders and management into a closer partnership. Some Japanese firms have even begun to list ROEs as business goals. NEC, for example, aims to achieve a 15% return.

In some ways, industrial machinery is a particularly hard market to crack. It is mature and highly competitive, and in most fields there are Japanese companies which are world leaders, with suppliers involved at the development stage of every new product. If the electrical machinery industry is included, the machinery industry is the largest in Japan's manufacturing sector, accounting for 37.3% of national employment and 43.4% of total shipments, but in 1995 this sector accounted for only 4.9% of the total inward investment by value (though this improved to 20.2% in the following year).

Moreover, though hollowing-out is often overstated in the media, and while overall levels are still low when compared to most other G-7 countries, it is more advanced in the machinery sector. While less than 8% of Japan's total manufacturing output took place offshore in 1994, some estimates indicate that for FY1995, 28% of machinery production took place offshore.

Before taking Japan's low level of inward investment for granted, it is worth considering the many factors in its favor. It has a high-quality labor force with increasing capacity in the labor market. It is located in the fast-growing Asia-Pacific region, with high-quality infrastructure and a large domestic market willing to pay for quality, as well as a manufacturing sector committed to high levels of plant investment. And given Japan's high level of overseas investment, relations built up in Japan often have significant implications elsewhere. Japan's dominance in this sector also means that it is a market that cannot be missed. "How can you ignore a market that produces one third of the world's cars?" asks Brent Dorman of roller-bearings maker Timken. For makers in the components industry, Japan is an essential market, as it is for many other fields—photocopier makers, printer makers, production machines and so on, dominated by Japanese firms. The products that accompany these machines will find a difficult domestic market that, once cracked, can bring substantial rewards. Moreover, the high level of research and technology in Japan has created a technology hub from which many developments spring. Suppliers to these markets have to have a presence in Japan to keep in touch with these developments and build up relations with Japanese makers. Japanese levels of outward investment also make inward investment important. With Japanese firms dominating many manufacturing sectors in Southeast Asia, it is important to build relations in Japan if a company wishes to supply a plant in, say, Thailand. Many companies are using this in reverse, using the relations that they have built up with Japanese companies overseas as the basis for establishing relations with makers in Japan. There are also still fields in which Western companies have a potential advantage. Several medical fields are still dominated by overseas firms, which account for about half of the market in MRI systems. Companies that do invest here, if patient, can make considerable returns. Many companies spoke of building up considerable losses in the first few years of operation in Japan. They soon realized that they had to compete not only on quality but on levels of service, for which further investment was necessary. Companies that have survived these difficult times, thanks in large part to the considerable patience of their head offices, (contrasting with the prevalent image of short-termism) have found considerable rewards. As Stephen Williamson of Rover Japan said, "If there's one secret to success in Japan, it's long-term commitment." MITI figures suggest that less than one quarter of firms which established in Japan before 1978 are currently unprofitable, compared to nearly 45% of those which were established during the 1990s and many long-term investors are very positive about their situation. The American Chamber of Commerce of Japan has estimated that it takes eight years on average to establish a positive cash flow. Foreign companies, though, tend to be more profitable than Japanese ones—they account for just 1.2% of turnover domestically, but 7.2% of post-tax profit, so there is money to be made here. Japan could certainly become a more attractive market (I will look at this in more detail in the next article). However, any company with long-term aims for the Japanese market can only reach a certain level of sales through an agent, and there are still many companies that are seeking to set up in the Japanese market but are hampered by lack of information and the difficulty in finding a suitable Japanese partner.

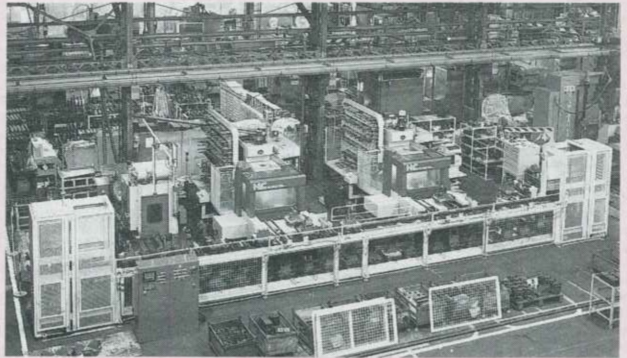

Photo: Hitachi Seiki Co. Ltd.

Imposing fortress: Foreign investors are facing challenges entering the industrial machinery sector in Japan

Companies will therefore continue to invest. The point, though, is not whether a company hoping to expand its business in Japan should set up in Japan. It is rather whether in the current climate it is really viable to have anything more than a liaison or sales office. Many foreign companies have offices in Japan—Ed Phillips, Director of the Motor and Equipment Manufacturers Association (MEMA) estimates that 129 of his members are established in Japan (out of about 500 involved in the Japanese market), but that 70% of these simply have liaison offices. About 20% have R&D facilities, though these range from a workbench to Ford's $4 million component research center in Yokohama. Of the total, 32% of companies have warehousing facilities, which helps them to meet just-in-time requirements for Japanese manufacturers, but "the proportion of companies manufacturing here is very small. A far higher proportion of companies located in Southeast Asia are involved in manufacturing—about 80% of MEMA member companies located in Thailand are involved in manufacturing."

To meet most of the common investment goals, companies do not necessarily need to establish a production facility here until the cost of the market can be brought down, so the actual level of investment will remain low. Until this time, Japan should focus its efforts on bringing foreign R&D facilities and technology or engineering centers to Japan as the most likely source of sizable investments. JJTI

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