Is Foreign Direct Investment in Japan Small?

By Dr. Ryuhei Wakasugi

The object of the Japan-U.S. Structural Impediments Initiative (SII) talks was mainly to open the Japanese market to foreign products and capital. The summary report shows a policy that both the government and the private sector should endeavor to make the Japanese market more transparent and open to foreign investors. I have no objection to the policy, but can we expect any effective results? If the market has been closed through government regulations, the government would have to bear greater responsibility for opening it. However, if this is not the case, the role of the government would be quite limited because investment activities are carried out by the private sector. The purpose of this paper is to reexamine if foreign direct investment truly is small and what are the possible impeding factors.

History of regulations and liberalization

In principle, foreign direct investment was banned until 1964 when Japan joined in the Organization for Economic Cooperation and Development. Since then, foreign investment has gradually been liberalized; since May 1973 foreigners have been allowed to invest up to 100% in principal when they set up a new company and, on condition that both sides agree, allowed to participate in existing companies by purchasing shares up to 100%. With the 1980 revision in the Foreign Exchange Control Law, with the exception of the agricultural, forestry, fishery, mining, oil refining and leather industries, foreign direct investment in Japan was fully liberalized. (Figure 1 shows the dramatic increase in foreign direct investment.) Now that more than 10 years have passed, it is difficult to argue that direct investment in Japan is still much affected by the old system.

It is interesting to compare the trends in Japan's foreign direct investment since 1980 with that of other industrialized countries. We've used the "Survey of Current Business," published by the U.S. Department of Commerce, currently the most comprehensive international statistics available. The following arguments are based on evidence obtained through a comparison of foreign direct investment by U.S. corporations in Japan, Canada, Britain, France and Germany.

Figure 2 shows the growth in U.S. direct investment abroad in the manufacturing sector in each country for the past 10 years. Investment in Japan grew to $10.4 billion in 1991 from $2.8 billion in 1979, showing the highest growth among the five countries. It should be noted that U.S. manufacturing firms began investing in the Japanese market more aggressively than in Canadian and European markets.

An expanding market brings about new business opportunities and absolves foreign capital. Has the expansion in the Japanese market been more attractive for foreign capital than the Canadian and European markets? To answer this, market attractiveness of the five countries are compared through estimating the elasticity of foreign direct investment to the growth of GNP in each country. The box below shows that the elasticity of U.S. corporations' investment position to Japan's GNP growth is the second highest next to Canada and followed by European counties. This would indicate that the Japanese market has been more attractive than European ones for U.S. corporations.

Market	Elasticity
Canada	1.4960
Japan	1.1277
France	1.0089
U.K.	0.8995
Germany	0.8054

note - estimating formula: $\ln(FDI) = C + a \cdot \ln(GNP)$

Photos: PRAP Japan, inc.

In Japan for less than two years, Toys "R" Us is an example of successful foreign direct investment.

Why direct investment is small

Admitting that the Japanese market has become more attractive and foreign direct investment has begun to increase after capital liberalization, Japan's position in foreign company investments is still low relative to its economic scale. Figure 3 shows each country's position in U.S. direct investment relative to the respective GNP. The relatively small figure for Japan is considered as symbolic for the closed nature of the Japanese market.

After the 1980 liberalization on direct investment, regulatory restrictions covering only foreign capital have disappeared, except for some industries. Moreover, the Japanese government has started adopting measures to encourage growth in foreign investment such as low interest loans exclusively extended to foreign capital, rather

than only eliminating restrictions. At least the government has no intention of limiting foreign capital. However, there are many regulations in the Japanese market. Although these regulations are equally applied to domestic and foreign investors, the rules are applied artificially, thus foreign investors tend to be more vulnerable relative to domestic investors who better understand local conditions.

Next we should compare direct investment in the regulated and non-regulated fields. Although manufacturing industries account for only one-third of Japan's GNP, they receive about two-thirds of the direct investment in Japan. But it was only after 1985 that foreign investment in financial and insurance industries became active and it is still small. The sectorial positions of U.S. corporate investment in Japan show that the less-regulated industries have relatively higher positions. This indicates that domestic regulations do negatively affect foreign investors.

Takeover bids have seldom been conducted in Japan, it is the managers and employees rather than the shareholders who actually run Japanese companies. It would be harmful to efficient management if the shareholders handed over their managerial rights or made mergers with other companies without a consensus among the employees and managers. Also, managers and employees tend to dislike direct interventions by the shareholders. Therefore, corporate take overs are quite rare in Japan, a situation very different from other markets.

For investors, however, a corporate take over is an effective method to get into a foreign market where they have little experience because it enables them to get through the market in a shorter time period as compared to setting up a new company. The fact that this effective method cannot be used in the Japanese market is another important factor limiting foreign investment.

Given the low position of the less regulated manufacturing sectors in foreign investment, it would be misleading to see the essential reason for small foreign investment in Japan as only regulatory factors. The most reasonable cause seems to be the difference in investment costs between the Japanese market and the Canadian and European market.

It has often been pointed out by many businessmen that operation costs in the Japanese market are higher than other foreign markets. Particularly, skyrocketing land prices and a stronger yen have caused higher expenses for foreign investors. If land prices and the yen exchange rate had not risen, investment costs would have been less and investment yields would have been higher. These are convincing arguments explaining why foreign investment has stagnated in Japan. (Additional arguments are available in my paper "Determinants of Foreign Direct Investment in Japan.")

Bearing all this in mind recent government measures to relax regulations in the Japanese market and to support foreign investors suffering from high land prices are meaningful toward increasing foreign investment.

Fig. 1
Direct Foreign Investment in Japan (flow)

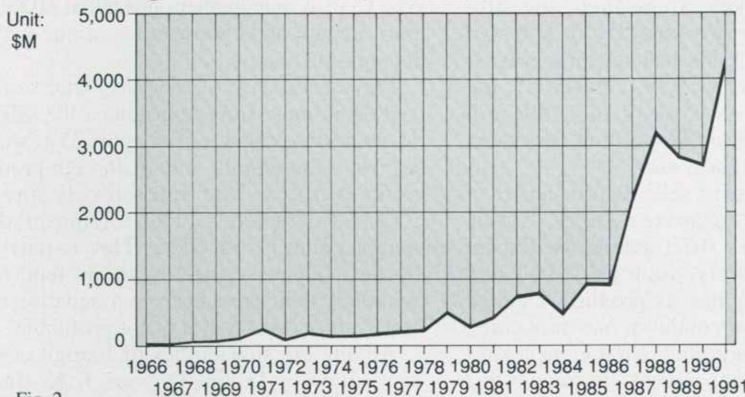


Fig. 2
U.S. Direct Investment Abroad

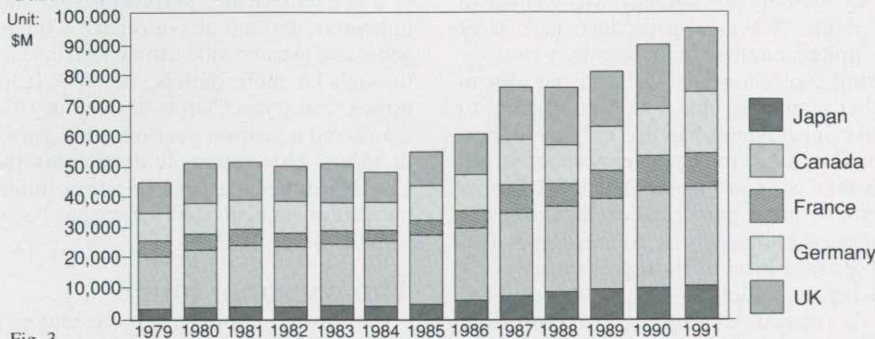
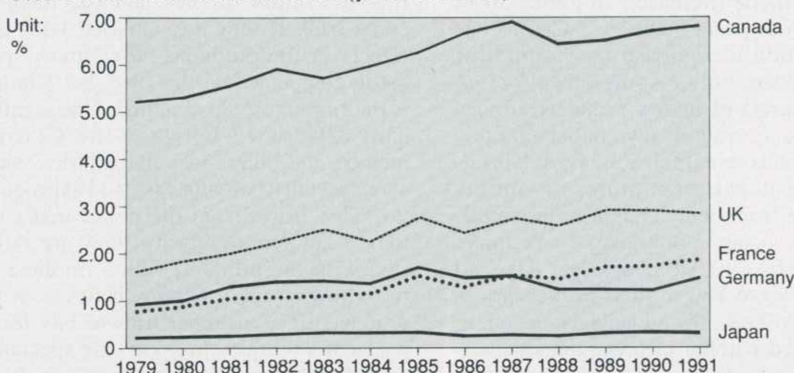


Fig. 3
U.S. Direct Investment Abroad (position/GNP)



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