Promoting Japan for Foreign Direct Investment

By Alastair Morgan

In 1962, Japanese Prime Minister Ikeda Hayato visited Europe where he met Charles de Gaulle, President of the French Republic. General de Gaulle referred slightingly to Ikeda as an "electronics salesman," because of the latter's focus on trade issues rather than global politics. Forty years on, European perception of the role of political leaders in the overseas promotion of their country's commercial interests is very different. This is as true of the attraction of Foreign Direct Investment (FDI) as it is of exports. It should therefore be no surprise, with the United Kingdom as Europe's leading recipient of FDI, that successive British Prime Ministers have championed the country's attractions when overseas. Tony Blair, as part of his preparations for the May 1997 election that swept the British Labour Party to power, visited Japan to reassure business leaders that there would be no change to the welcome they had received for their investments under Margaret Thatcher and John Major. Rather more recently, the French government has pulled together its FDI promotion efforts into a single Agency for International Investment, headed by an Ambassador at Large and Special Representative of France for Inward Investment.

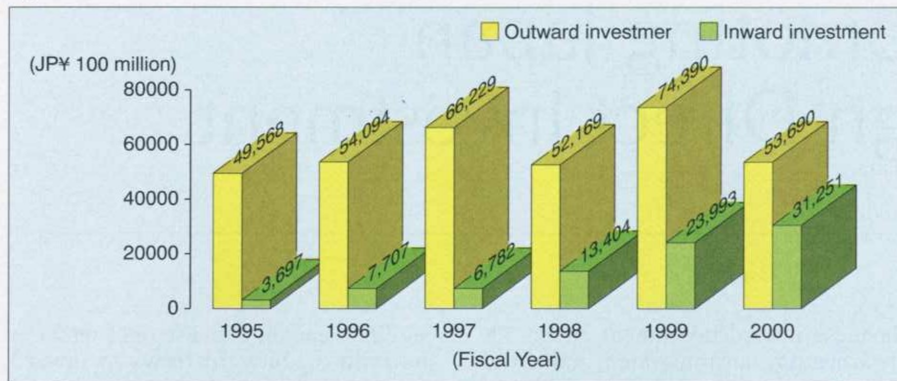
These approaches have not been lost on the Ministry of Economy, Trade and Industry (METI). Officials would welcome more "salesmanship" by Japanese political leaders on overseas visits and in receiving foreign investors at home. To date, however, the public profile in FDI promotion of Japanese politicians (local and regional as well as national) has been low. There are exceptions. Kitagawa Masayasu, governor of Mie Prefecture, has championed his prefecture for FDI. Kitagawa may not be known widely overseas other than to those who have met him on trade missions, but he has a strong reputation in Japanese inward investment circles for spearheading an integrated, industrial cluster-based, delivery-focused approach to FDI promotion. But such exceptions are rare.

In comparison with other developed countries, Japan's stock of FDI remains low in value and as a percentage of nominal gross domestic product (GDP). Figures compiled by METI show that at the close of the calendar year 2000, it stood at $50,300 million (based on a year-end exchange rate of 114.90 ¥/$), equivalent to 1.2% of GDP. Equivalent figures for the United Kingdom were $482,700 million, 34.1% of GDP. The equivalent percentage for the United States was 30.1% at the close of 1999, and 25.3% for Canada, 12.0% for Germany and 16.7% for France. A similar picture emerges when you consider FDI as a percentage of gross domestic capital formation. METI's *White Paper on International Trade 2001* stated that "Japan's inward FDI...comprises a mere 0.3% of gross domestic fixed capital formation, an extremely low level compared to the developed country average of 10.9% and the world average of 11.1%." Japan again stands out for the high ratio of outward to inward FDI stock. This was 5.5 at the end of 2000, against 1.9 for the United Kingdom and (at the end of 1999) 0.9 for the United States, 1.1 for Canada, 1.7 for Germany and 1.4 for France.

What these static figures fail to bring out is the evolution of FDI into Japan over the last decade. (Figure 1) Japan's inward flow in fiscal 2000 amounted to ¥3,125,100 million, some six times greater than the equivalent figure of ¥530,600 million for fiscal 1992. In fiscal 1992, the ratio of Japan's outward to inward flow was 8.4, whereas for fiscal 2000 it was 1.7. It is likely that the final figures for fiscal 2001 will, however, show a decline in the value of FDI flows into Japan over fiscal 2000, and an increase once again in the ratio of outward flows to inward flows. But this should be viewed against a global background of significantly reduced FDI flows into most major markets, reflecting in particular a sharp decrease in global merger and acquisition (M&A) activity. The United Nations Conference on Trade and Development (UNCTAD) has stated that the global decline is likely to be recouped once consumer confidence returns, though probably not in the current calendar year. UNCTAD has also noted that the decline for FDI into Japan in 2001 was proportionately smaller than the decline experienced by some other developed countries, as a result of large flows through M&A into Japan's telecommunications industry. Figures compiled by RECOF Corp. for their "Mergers and Acquisitions Research Report" suggest that the number of "out-in" M&A transactions (i.e. M&A by foreign companies into the Japanese market) in calendar 2001 was, at 158 cases, only slightly down from 175 for the previous year. The figure is well above 129 for 1999 and five times that of 31 for 1996. Ministry of Finance figures for the first half of fiscal 2001 put the value of FDI inflows at ¥1,535,800 million. While this is down from ¥1,890,100 million in the first half of fiscal 2000, it is greater than the 12 month figure for fiscal 1998 and the financial years before that.

Together with strong growth in M&A, a second feature reflected in the composition of Japan's FDI inflows has been a significant increase in the proportion of service sector projects. This is in line with trends in other developed economies. Of Japan's FDI inflows of ¥530,600 million in fiscal 1992, some two-fifths (¥208,100 million) was in manufacturing. In value terms, FDI inflows into manufacturing were considerably higher in fiscal 2000 at ¥790,700 million, but still constituted

Figure 1 Outward Investment vs. Inward Investment



Source: Ministry of Finance, Japan

only a quarter of the total inflows (¥3,125,100 million). This trend is borne out by analysis of the date of establishment of foreign-owned enterprises which shows a marked contrast between manufacturing and services. Ito Keiko and Fukao Kyoji of Hitotsubashi University have shown that the majority of Japan's manufacturing establishments with 10% or greater foreign ownership were set up or acquired before 1984. In the service sector, in contrast, establishment or acquisition after 1990 is common, with the majority of establishments in life and non-life insurance, telecommunications, and information services set up or acquired after this date. (Ito and Fukao, "Foreign Direct Investment in Japan, Empirical Analysis Based on Employment and Enterprise Census," Research Institute of Economy, Trade and Industry, September 2001)

The recent growth in services sector inflows is naturally reflected in the current composition of FDI in Japan. The value of accumulated inward investment into the top six industrial sectors accounts for more than 90% of total inward direct investment. These sectors in declining order by value are finance and insurance, machinery, trade, services, communications and chemicals. (*White Paper on International Trade 2001*) Of all workers employed by establishments with 33.4% or greater foreign ownership in the manufacturing sector in 1996, 51% were employed in four industries: motor vehicles and parts, electronic parts and devices, electronic equipment and computers, and drugs and medicines. Concentration was greater still in the service sector with 77% of employment in four industries: wholesale trade, eating and drinking places, retail trade, and computer programming and software. (These figures predate recent FDI into telecommunication carriers.) The same analysis (Ito and Fukao) shows that in 1996 Japanese establishments with 33.4% or greater foreign ownership employed 176,000 workers in manufacturing and 308,000 in services – significantly higher figures for services than estimated by METI on the basis of incomplete survey data.

Even though Japan's political leaders have been largely invisible in the overseas promotion of Japan for FDI, political measures over the last decade have had a significant impact on the composition and scale of inward investment flows. In June 1990, the Japanese government publicly committed itself, at the conclusion of the Japan-U.S. Structural Impediments Initiative talks, to pursuing "open policies" concerning international investment. This commitment has been followed by a stream of measures designed to simplify procedures for FDI into Japan, to put in place tax and other incentives at a national level, and to improve the provision of information and the delivery of investment promotion services – principally through the Japan External Trade Organization (JETRO), the Foreign Investment in Japan Development Corp. (FIND) and the Development Bank of Japan. (METI, "Measures for Promoting Foreign Investment in Japan," April 2001) At least as significant as measures aimed exclusively at facilitating FDI has been the effect of deregulation. Well-known measures have included the removal of restrictions on foreign ownership and foreign board members in Type 1 telecommunications carriers and the replacement of the Large Scale Retail Store Law with less restrictive regulation. In parallel with deregulation, changes in company law and the practice of corporate governance, including reduced intra-group cross shareholdings, have resulted in new opportunities for market entry through acquisition. In addition, Japan's asset deflation (while a major problem for Japanese businesses and financial institutions, and the single most pressing and intractable issue for Japan's economic policy makers) has resulted in a "'fire sale' situation" (Ito and Fukao) for foreign investors. High fixed costs in Japan have long been perceived as one of the prime deterrents of FDI. As of March 31, 2000, however, the price of urban industrial land was below 90% of the level in 1990. For urban commercial land, it was less than 60% of the 1990 equivalent: a level not seen since the start of the 1980s. (Japan Research Institute for Real Estate) One other factor benefiting foreign investors has been the progressive change in Japanese employment practices and attitudes. This has assisted recruitment by foreign firms of both experienced skilled staff and new graduates.

I would posit a further change since 1990. There was at that time, within the previous Ministry of International Trade and Industry (now METI) at least, an intellectual appreciation of the economic merits of attracting inward investment. But policy on the issue was driven largely by external factors, in particular the need to respond to pressure from the U.S. administration over "imbalances." In 2002, in contrast, the key policy drivers are internal. Attracting more inward investment has become an integral part of the industrial policy portfolio, driven by the perceived need to find remedies for rising unemployment, reduced competitiveness and "hollowing out." As one part of this policy process, METI's Trade and Investment Facilitation Division has set out an approach to future inward investment promotion resting on three pillars. These are further deregulation and reform of corporate governance; strengthening "one-stop shop" delivery of information and services to investors; and a more strategic

approach in identifying, developing and marketing Japan's regional and national "offer" for inward investors. The third pillar, in particular, directly connects the promotion of inward investment with cluster development, effective deployment of the science budget, and the fostering of linkages between academia and industry. It acknowledges the need for more professional standards in marketing Japan as an investment location, and in service delivery to potential investors. This requirement is also acknowledged by JETRO staff directly engaged in inward investment promotion, as is the scope (subject as ever to resources) for raising performance. In fiscal 2000, JETRO benchmarked Japan's inward investment promotion activities against the United Kingdom, France, Germany, the United States and Canada. The final report included recommendations for improved coordination at the national and regional level, better targeted activity overseas, and a step-change in the development and delivery of regional investment "propositions." (JETRO, "Steps for future inward investment promotion," March 2001)

One of the great challenges for Japan's inward investment promoters is more effective marketing by and of the regions. Survey data compiled by METI indicates that 87.7% of FDI in Japan is concentrated in just three of Japan's 47 prefectures: Tokyo 69.7%, Kanagawa (Yokohama and Kawasaki) 9.1% and Osaka 8.9%. Although FDI is more widely dispersed on an employment basis (Ito and Fukao), it is still highly concentrated. There are sound reasons for a degree of concentration in Japan's leading cities, but other locations offer under-exploited advantages for investors.

A negative factor sustaining this concentration in leading cities has been the difficulty for investors of securing accurate, timely, business-focused English language (or Japanese) information on other localities. JETRO took a major step towards overcoming this problem in November 2001 with the launch of its "Invest Japan!" website. (www.jetro.go.jp/investjapan) This contains, for the first time, data assembled in English on a consistent, investor-focused basis for each of Japan's 47 prefectures. This information, developed with the collaboration of the Japan Regional Development Corporation, includes in each case an industrial, research and labor market profile as well as summary outlines of financial assistance and tax breaks. The prefectures are grouped in regions, according to the coverage of METI's nine regional offices.

The quality of JETRO's "Invest Japan!" site is not yet matched by the prefectural and city government homepages with which it is linked. It is a truism that marketing will not secure investment if the regional "product" itself is ill-defined or unattractive. It is indisputable, on the other hand, that there are relatively attractive propositions in Japan's regions that remain under-sold. Okinawa offers an example. The prefectural government, seeking to develop information technology and telecommunications industries, has developed a compelling "offer" for call-centre operations. This is based on low labor and telecommunications costs. The average call-center salary in Okinawa is ¥130,000 for a 160-hour month, said to be some 40% lower than the lowest paying companies in Tokyo. Start-up salaries for employees under 30 are currently further subsidized by 50% by the prefectural government, under a program aimed at reducing Okinawa's high youth unemployment. Industry specialist Terrie Lloyd (President, LINC Media Inc. and publisher of *J@pan•Inc.*) assesses these call-center employee costs as competitive with most other countries in Asia. To offset the disincentive of high long distance telephone charges within Japan, the prefectural government currently also pays 100% of the cost on the 650 mbps (megabit per second) digital pipe to the mainland. A call to the capital therefore costs the same as from a central Tokyo location. (Levels of subsidy may change.)

Despite limited marketing, Okinawa has attracted over 20 customer and corporate service-centers, employing some 5,500 people. Investors include major foreign owned corporations, who testify that call-centers in Okinawa are able to serve the entire Japanese market as effectively as those in other more expensive locations. There is, however, no mention on the prefectural government's English language web-pages of these success stories, of broadband connections or the telecommunications subsidy. As Lloyd has commented "it is almost as if they didn't want people to know" (though in fact the prefectural government is currently developing new material for its homepage).

Okinawa is not alone in having an underdeveloped website (or indeed in seeking to attract call-center operations). Very few prefectures or regions of Japan have as yet developed English-language homepages for investors that are of the same overall standard as, for example, the Japanese-language investment site of the Industrial Development Board (IDB) of Northern Ireland. Yet in terms of population and GDP, Northern Ireland is no larger than a small Japanese prefecture. In some cases, this is being addressed and the web presence is beginning to build on material that has previously been available in paper-form. The international port cities of Yokohama and Kobe (Hyogo Prefecture), for example, both have succinct, well-focused material setting out convincing propositions for investors. These are sector and technology specific, and reasonably comprehensive in terms of actual and comparative operating costs, quality of life issues (such as accommodation, international schooling and medical care), infrastructure, research facilities, skills availability, existing investors and foreign residents, proximity to market, national and international transportation and communications. With an active program of support for investors, Yokohama hosts the German Centre for Industry and Trade, the British Industrial Centre, the Canadian Industry and Trade Centre and the U.S.-Japan Technology Village Partnership. Six of Kobe's 11 leading corporate tax-payers are foreign-owned corporations.

In other instances the issue is more fundamental. Even in some prefectures and regions committed to seeking FDI, there is still only limited evidence that investment promotion and case-han-

dling is approached in a business-like fashion, with the potential foreign investor treated as a client. English-language material, where it exists, is often translated directly from material aimed at residents or Japanese tourists. I have seen material which identifies the prefectural badge and flower, historical figures of local repute, local flora and fauna, and the contents of the local museum – with little or nothing on industrial strengths, the supply base, general and specialist skills availability, educational facilities, market access or investor support. In some cases this is because the prefecture is not yet ready or resourced to target foreign investors in the way that it would be for indigenous businesses. In other cases, it appears to be because basic analysis has yet to be carried on what – in current economic conditions – might constitute the prefecture's advantages as a location whether for Japanese or for foreign investors. This brings up a further issue. In cases where a prefecture or city has a strong "offer" or is geographically distinct (e.g. Hokkaido, Okinawa), proposition-marketing for investors can be handled satisfactorily at that level. In other cases, far stronger propositions could be developed on a regional basis, particularly with regard to academic institutions and clustering. Prefectural boundaries inevitably mean a lot more to prefectural governments than they do to potential investors. Although collaboration on a regional basis is growing, with the encouragement of JETRO and METI, it remains relatively weak. The Kansai region, for example, has established a single access point in the Kansai Council of Investment Promotion (K-CIP) with a reasonable website. But when, at a recent promotional event, a foreign business participant asked whether their site carried detailed information on financial support throughout the region, he was advised to contact Osaka and Kobe directly (leaving the remainder of the region uncovered) – though in this case METI followed up subsequently.

Promoting any developed market for inward investment presents challenges in the current economic climate, with strong competition in the field. Japan, especially, is seen as difficult to sell. It is self-evident that all FDI carries an opportunity cost for the investor. It is to be expected that some potential investors will be encouraged to look elsewhere than Japan by frequent reports of recession, non-performing loans and a deflationary spiral. Foreign investors, like other corporate citizens, have to look to Japan's authorities to grasp these nettles. They provide a poor setting for intensified promotional activity overseas by the Japanese government. It is the case, nevertheless, that lower asset prices and restructuring by Japanese corporations in difficulty will continue to provide market openings for foreign investors. (It is also the case that other countries, the United Kingdom included, have successfully stepped up inward investment promotion at times of economic difficulty.) New investors may also be deterred by reports of high profile downsizing by foreign firms in Japan's financial services or retailing sectors. Caution is justified, but there are successes as well as set-backs in these sectors. Across Japan's economy as a whole, foreign-owned companies have historically achieved higher levels of profitability than the Japanese average. (JETRO, "Invest Japan!")

It has been demonstrated that eliminating restrictions can increase FDI in Japan's services sector. Recent investment patterns show that foreign companies continue to be attracted by investment opportunities both for business-to-business and business-to-consumer services, including Japanese-language software development. Deregulation of remaining "sanctuary" sectors would initiate new prospects for service sector investment, while out-in M&A would be facilitated by the removal of restrictions on partnerships between foreign and Japanese law firms looking to provide a seamless service (as would expanding the availability of high quality professional advice more generally). Promoting Japan for "green-field" FDI in manufacturing is more difficult. At a time when major Japanese corporations are increasing the transfer of assembly to other Asian locations, it would be unrealistic to expect foreign companies to invest en masse in comparable activities in Japan.

The challenge (easy to state, harder to meet) is to identify the high value-added, capital and research intensive sectors, sub-sectors and technologies where Japan continues to enjoy comparative advantage as a location for investment. At a national level, positive factors are not so difficult to identify. They include high GDP and GDP per capita (a large, affluent market); major industrial customers both manufacturing in Japan and conducting research and product development for their global operations; high quality component supply; a massive science budget now producing ground-breaking research in areas such as nano, bio and environmental technology; a highly educated workforce; well developed infrastructure; excellent transport and communications; low cost broadband access; and crime levels which, though rising, remain very low by international standards. Foreign investors already manufacturing in Japan in sectors such as pharmaceuticals and automotive components will readily identify the key drivers behind their investments, and in some cases also reasons why they could not afford not to have a Japanese operation.

The requirement, however, is not for generalities such as these, but for specific propositions linking technology and location, people and finance. These are best developed at the regional level, and there is a way to go before they are widely in place. This observation is not intended to discourage (either Japan's regions or potential investors). If each of Japan's regions had already done its utmost to market its attractions for inward investment, then the results would be discouraging. As it is, some among them have hardly begun. JJTI

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