



Title	The Determinants of and Prospects for Foreign Direct Investment in Japan
Author(s)	Paprzycki, Ralph
Citation	
Issue Date	2007-05
Type	Technical Report
Text Version	publisher
URL	<a href="http://hdl.handle.net/10086/13604">http://hdl.handle.net/10086/13604</a>
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**Discussion Paper Series**

No.211

**The Determinants of and Prospects for  
Foreign Direct Investment in Japan**

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May 2007

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# **The Determinants of and Prospects for Foreign Direct Investment in Japan**

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May 2007

## **ABSTRACT**

Although Japan experienced a significant jump in inward foreign direct investment (FDI) around the turn of the millennium, the level of inward FDI penetration remains much lower than in many other countries. Looking at the factors that determine Japan's attractiveness as an investment destination for foreign multinationals, this paper examines the prospects for future FDI inflows. Topics addressed include the macroeconomic outlook for Japan (an important factor for market-seeking FDI), political, social and cultural factors reflecting Japan's willingness to embrace globalization, and policies the government could pursue to attract more FDI. It is argued that although Japan has clearly "opened up," lingering unease over a more laissez-faire market economy and inward foreign inward remains widespread and certain patterns from the past are beginning to reappear. A key issue in this context are merger and acquisition (M&A) rules and their implications are discussed in detail. The paper concludes by suggesting that unless Japan embarks on further substantial deregulation, increases in FDI inflows are likely to remain moderate and inward FDI penetration will continue to significantly trail behind that in other major advanced economies.

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## 1. Introduction

The past decade or so has been an important transitional period for the Japanese economy, and foreign direct investment (FDI) is one area in which changes are readily visible. Until the mid-1990s, the amount of FDI that Japan used to receive was miniscule and the role of foreign firms in the Japanese economy remained accordingly small. Since then, however, Japan has experienced what by the country's own standards amounts to a veritable boom in inward FDI. In the five years from 1998 to 2002 alone, Japan received more such inflows than in the entire post-war period. And although inflows have receded somewhat (on a balance-of-payments basis), they still continue to be much larger than before.<sup>1</sup>

At the same time, however, the recent wave of inward FDI appears momentous only because inflows in the past have been so small. In fact, inflows and the stock of inward FDI in Japan remain at levels much lower than those in comparable advanced economies.<sup>2</sup> This means that Japan risks losing out on the contribution that FDI can make to economic growth through, for example, the know-how and managerial techniques foreign firms introduce, technological spillovers, and the greater degree of competition to which the presence of foreign firms contributes.<sup>3</sup> The Japanese government, in principle, recognizes the potential benefits and has begun to actively promote foreign investment. This attitude in itself represents a significant break with the past, and it seems clear that foreign direct investment in Japan is bound to continue increasing in the future. However, the role Japan will play as an FDI destination in the global context, and the role foreign firms will come to play in the Japanese economy, are less clear. The purpose of this paper is to consider the prospects for FDI in Japan and the factors shaping these prospects.

This is obviously a proposition fraught with danger: for example, in the mid-1990s, few would have anticipated the surge in FDI witnessed over the past decade. Moreover, even today, it is difficult to decide to what extent Japan has really transformed itself: on the one hand, a number of important economic reforms have been implemented, cross-shareholdings (a key element of the *keiretsu*) have declined significantly, there has been substantial consolidation in the banking sector, labor markets have become more flexible, etc. On the other hand, many areas of the economy continue to be highly regulated, resistance to a more *laissez-faire* market system remains strong, and the political system continues to be dominated by the Liberal Democratic Party, which (with only a brief interruption from 1993 to 1996) has governed Japan since 1955. This mixture of continuity and change, however, also means that future trends will be largely shaped by circumstances discernable today.

In order to assess these circumstances and the outlook for FDI in Japan over the coming decade or so, the analysis in this paper is divided into four major sections. The next section

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<sup>1</sup> For a description and analysis of recent inward FDI trends in Japan, see Paprzycki (2004) and Paprzycki and Fukao (2005).

<sup>2</sup> Average FDI inflows as a percentage of gross fixed capital formation for the period 2000-2005 were 0.7 percent for Japan, compared with 6.7 percent for the United States, 13.4 percent for Germany, 15.0 percent for France and 24.5 percent for the UK. The stock of inward FDI as a percentage of GDP in 2005 was only 2.2 percent in Japan, but 13.0 percent in the United States, 18.0 percent in Germany, 28.5 percent in France, and 37.1 percent in Britain. Even in India and South Korea, both countries which until recently were similarly unwelcoming to foreign direct investment, the share is substantially higher at 5.8 percent (India) and 8.0 percent (South Korea).

<sup>3</sup> On the (potential) contribution of FDI to economic growth and structural change, see Paprzycki and Fukao (2004), Fukao and Amano (2004), and Paprzycki (2006).

looks at what factors determine Japan's attractiveness as a host for FDI and examines the strategic objectives of multinationals investing in the country, the profitability and success of foreign firms operating in Japan, and perceptions of the country as an FDI destination. It will be suggested that the market-seeking objective plays a dominant role and growth prospects are therefore likely to be a key factor determining future FDI flows. The outlook for Japan's economic growth, and regional growth prospects more generally, will be discussed in Section 3. But the environment for FDI in Japan will also depend on political and social attitudes toward foreign companies and internationalization, which in turn will shape policies and determine the availability of human resources. Another factor is Japan's relations with its neighbors, which affect the likelihood of bilateral or regional agreements to enhance economic integration and hence FDI. These aspects will be addressed in Section 4 and to a large extent provide the agenda for Section 5, which discusses steps the Japanese government could take to raise the level of inward FDI.

## **2. Japan as an FDI destination**

The attractiveness of Japan, as of any other country, as a host for FDI depends on a range of factors that can be divided into three major categories: economic determinants, the general policy framework for FDI, and business facilitation measures.<sup>4</sup> Economic determinants include fundamental characteristics such as market size, per capita income, market growth, access to regional and global markets, etc. These determinants are particularly relevant for FDI of the market-seeking variety. In addition, economic determinants include natural and human resources, physical infrastructure, technological and other created assets, etc., that are of interest in the case of resource- or asset-seeking FDI. Finally, they include the cost of these resources and assets, other input costs, and membership of regional integration agreements that are conducive to the establishment of regional corporate networks – factors relevant in the case of efficiency-seeking FDI. The attractiveness of a country for foreign direct investment depends on the particular configuration of these economic characteristics and the extent to which that configuration coincides with the specific market-, resource-, asset- or efficiency-seeking objectives multinationals pursue.

But in addition to the economic determinants, the policy framework for FDI also plays an important role. This framework includes basic economic, political and social stability, rules regarding the entry and operations of foreign firms, the standards of treatment of foreign affiliates, policies regarding the functioning and structure of markets (in particular those pertaining to competition and M&As), international agreements on FDI, trade policies, tax policies, etc. Lastly, the third category of host-country factors are business facilitation measures for foreign companies. Examples of such measures are investment promotion and incentives, measures to minimize hassle costs (that is, costs related to corruption and administrative efficiency, for example), social amenities (bilingual schools, quality of life, etc.), and after-investment services. The policy framework for FDI and business facilitation measures can be considered as enabling factors that make it possible and/or more attractive for multinationals to invest in a particular country.

Applying these concepts to Japan helps to understand both past inward FDI trends and the outlook for future FDI inflows. For instance, the surge in FDI in Japan witnessed during the late 1990s and early 2000s can be viewed to a large extent as the result of a combination of

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<sup>4</sup> See UNCTAD (1998: Chapter IV).

changes in the economic structure (the unwinding of cross-shareholdings, labor market changes, etc.) and improvements in the policy framework for FDI.<sup>5</sup> These developments removed many, though by no means all, of the implicit and explicit barriers that had obstructed FDI in Japan in the past. Similarly, looking ahead, the concepts help to focus on factors that are likely to be relevant in determining future FDI inflows. For example, although the policy framework for FDI in Japan has improved considerably over the past decade, certain obstacles remain. Subsequent sections therefore look at the politics surrounding FDI-related policies and consider measures the government could pursue to further improve the environment for FDI.

Yet, although the policy framework is crucial, it is only an enabling factor. Multinationals' decision to invest – or not invest – in Japan first and foremost depends on economic determinants and the extent to which conditions in the country provide the basis for opportunities to expand profits. To begin the assessment of the prospects for FDI in Japan it is therefore useful to first look at the motives multinationals pursue when investing in the country and then to consider the extent to which Japan is viewed as providing the right conditions.

Examining recent FDI patterns in Japan suggests that the overriding objective in the majority of cases has been to gain access to the country's market. One indication of this is that the service sector accounted for almost four-fifths of FDI inflows during the period 1998–2004.<sup>6</sup> In the case of services, not only is establishing a local presence often the only way in which a market can be served. Japan's productivity and international competitiveness in this area are generally low, so that resource-, strategic asset-, or efficiency-seeking motives in most cases were probably of secondary importance. A case in point is finance and insurance, which alone made up half of the service sector FDI during that period. In this industry, foreigners acquired a number of insurance companies that either had failed or were at the brink of collapse. Although these transactions involved the acquisition of local assets, it was not the quality of these assets, or the contribution they could make to regional or global operations, that motivated the purchase, but rather the instant access to the local market they provided.<sup>7</sup>

Other major service sectors that attracted FDI during this period were wholesale & retail trade – where the market-orientation is quite clear – and telecommunication. With regard to the latter, the dominant case, the acquisition of J-Phone by Vodafone, again primarily served to provide the British company with a presence in the Japanese market, although the strategic asset-seeking motive is likely to have played a role as well as Vodafone was interested in the firm's mobile technology.<sup>8</sup>

The order of priorities is less clear in the manufacturing sector. The acquisition of Nissan by Renault, for example, is likely to have been based on a combination of efficiency-, strategic asset- and market-seeking motives, given that, despite its problems, Nissan possessed considerable technological capabilities, and common management of the two companies provided ample opportunity for specialization, economies of scale and scope, and the rationalization of global activities.<sup>9</sup> On the other hand, in the automotive supply industry,

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<sup>5</sup> See Paprzycki (2004) for details.

<sup>6</sup> Based on Ministry of Finance data on a notification basis. The exact share was 78.0 percent.

<sup>7</sup> See Paprzycki (2006) for details. It should be noted that there were also a number of failed financial institutions in the banking sector. Conducted by foreign investment funds for the purpose of turning these banks around and selling them again at a profit, these cases do not neatly fit into the typology of FDI presented above.

<sup>8</sup> See Paprzycki (2006).

<sup>9</sup> Again, see Paprzycki (2006) for details.

access to local customers, the smooth function of relationships with them, and the reduction of transaction costs – i.e. market-seeking objectives – are likely to play an important role. As a final example, take the pharmaceutical and medical devices industries. The capabilities of Japanese firms lag considerably behind those of their Western counterparts that have invested in the country and again access to the lucrative local market has been the central motive for multinationals to establish or expand their presence.<sup>10</sup>

Another way to look at FDI patterns and motives is in terms of the relative productivity levels of foreign and Japanese firms. Asset-seeking FDI is likely to be concentrated in sectors in which domestic firms display a high level of productivity, such as in the transportation machinery sector. On the other hand, market-seeking FDI is likely to be found in sectors where the productivity of domestic firms lags behind international levels (provided that the productivity gap is not the result of regulations, such as explicit or implicit restrictions on market entry, which would also constrain FDI). Such sectors, which are largely concentrated in the service sector, provide foreign multinationals with opportunities to exploit their superior productivity and allow them to prosper even if overall economic growth is subdued.

With market-seeking objectives as the main driver of foreign direct investment, profit opportunities within the country and the likelihood of success become key determinants of multinational firms' decision to establish themselves in Japan. One way to examine profit opportunities in Japan vis-à-vis other potential host countries is to compare the profitability of all firms in each economy. Measuring profitability in terms of returns on assets, such a comparison shows that firms in Japan tend to be much less profitable than in Western countries (Figure 1). Although this suggests that profits are hard to come by in Japan, it also reflects the fact that Japanese firms historically have paid little attention to profitability and have instead tended to focus on growth and market share.

Insert Figure 1

Comparing the profitability of foreign companies active in Japan with their domestic counterparts shows that the former tend to be considerably more profitable. According to data from the “Financial Statements Statistics of Corporation by Industry” published by the Ministry of Finance, the ratio of ordinary profits to sales of the affiliates of foreign firms in Japan has consistently been about twice as high as that of all incorporated enterprises in the country (see Figure 2a). Moreover, profitability has been increasing in recent years. Employing a different measure, return on equity (ROE), foreign affiliates again show a much better performance than the average of all incorporated enterprises, although the gap has shrunk in recent years and foreign affiliates as a group in fact registered significant losses in 1999 (Figure 2b).

Insert Figures 2a, 2b

Finally, it is instructive to compare the profitability of US subsidiaries by host country (measured in terms of the net income/sales ratio). Although such a comparison is not without problems because of practices such as transfer pricing, the overall pattern seems to be

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<sup>10</sup> For further details on these two industries, refer to Paprzycki (2006).

consistent with the findings so far, suggesting that the profitability of US subsidiaries in Japan was relatively low in 1995 and 2000 but has increased in recent years (Figure 3). Moreover, although lower than in newly industrializing and developing countries such as Singapore, Taiwan, Thailand and China, the profitability of US subsidiaries in Japan in 2003 was more or less on par with that of US subsidiaries in Germany, France and the UK and is likely to have increased further along with the continued recovery of the economy.

Insert Figure 3

But average profit rates say little about the likelihood that a particular company investing in Japan will indeed do well and there is some evidence that the country may still be a difficult place in which to do business. For example, recent years have seen a number of prominent failures of foreign firms in Japan, including Carrefour, Boots, Cable & Wireless, and Vodafone. Arguably, strategic management errors (in particular a failure to properly understand the Japanese market) have played a role in each of these cases.<sup>11</sup> But they are no exception: recent research suggests that between 1999 and the first quarter of 2005, on average 170 foreign firms a year exited the Japanese market, and it is particularly young foreign involvements that are affected.<sup>12</sup> And data published by the Ministry of Economy, Trade and Industry (METI) suggest that the number of firms withdrawing from Japan may be about as high as the number of foreign firms being newly established (Figure 4), although the METI figures should be viewed with caution because of the way they are compiled.<sup>13</sup>

Insert Figure 4

That along with the increase in inward FDI disinvestments have also been on the rise is confirmed by the balance-of-payments statistics (Figure 5). In fact, in 2006, net FDI in Japan even turned negative as outflows jumped and exceeded inflows. To some extent, the outflows reflect the nature of some of the investments in recent years, i.e., purchases of ailing Japanese firms by foreign funds which, having successfully restructured their acquisition targets, recoup their investment by selling them again. Examples include KS Bank, which was sold to the Bank of Kansai in 2003, and Shinsei Bank and Tokyo Star Bank, which listed on the stock market again in 2004 and 2005, respectively.<sup>14</sup> Outflows have also been inflated by GM's dissolution of long-standing capital ties with Fuji Heavy Industries (Subaru) and Isuzu and

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<sup>11</sup> Added to this list may be the dissolution of DaimlerChrysler's ties with Mitsubishi Motors, although the German-American firm did retain its majority stake in Mitsubishi Fuso and it has been speculated that it was the truckmaker that DaimlerChrysler was interested in in the first place.

<sup>12</sup> David (2006). According to this research, which is based on a careful evaluation of the *Gaishikei Kigyō Soran* published by Toyo Keizai Shinposha, there were 1,056 withdrawals in the period from 1996 to the first quarter of 2005. By age, the highest frequency of withdrawals was observed for foreign investments that were only four years old, indicating a high infant mortality.

<sup>13</sup> The survey (METI, 2006a) reporting these numbers indicates that withdrawals "include[...] 'liquidation' and 'reduction in controlling share (controlling share possessed by foreign enterprise drops to one-third or less of the total)'" (ibid.: Note 3), but it is not quite clear whether they are based on all foreign firms in Japan or only those that were subject of the survey. In addition, the survey on which the figures are based suffers from a relatively low response ratio (59.5 percent in the survey published in 2006) and there appear to be other inconsistencies in the data (including differences between the Japanese and the English version of the report). If withdrawals are calculated on the basis of firms included in the survey, which appears to be the case, the number of actual withdrawals is probably higher still.

<sup>14</sup> See Paprzycki (2006) for details.



the reduction of its stake in Suzuki (from 20 percent to 3 percent), which appears to be more a reflection of the American carmaker's troubles at home than any problems with its Japanese investments. Given that the jump in disinvestments in 2006 seems to be largely due to two major cases – GM and Vodafone – it may be premature to suggest that it indicates the beginning of a mass exodus from Japan. Nevertheless, combined with the high number of withdrawals it certainly is a development that should give policy-makers cause for concern.

#### Insert Figure 5

This is especially the case since perceptions of Japan's attractiveness as an FDI destination also appear to be deteriorating. According to the *FDI Confidence Index* published by a global consulting firm and based on a survey among executives of the world's 1,000 largest corporations, Japan gradually moved up in ranking from 23<sup>rd</sup> place in 1998 (the first year of the survey) to 10<sup>th</sup> place in 2004.<sup>15</sup> However, in 2005, Japan dropped by five places to 15<sup>th</sup>, suggesting that the country was gradually falling out of favor again, ranking behind China, India, United States, the major Western European economies (the UK, Germany and France, in that order) and a number of Eastern European countries (Poland, Russia, Hungary, Czech Republic).<sup>16</sup> Japan also did not make it into the global top ten FDI destinations listed by multinational corporations in UNCTAD's *Prospects for Foreign Direct Investment*, although among developed economies, Japan was ranked sixth (behind the United States, the United Kingdom, Canada, Germany and France) by a panel of experts and eighth (behind the countries just listed as well as Spain and Ireland) by multinational corporations.<sup>17</sup>

But Japan does rather well in the more broadly based *Global Competitiveness Report* published by the World Economic Forum. Although the report does not explicitly address countries' attractiveness as an FDI destination, it does offer useful indicators of how a country's economic and business environment is perceived more generally.<sup>18</sup> In the 2006-2007 report, Japan is ranked seventh in terms of global competitiveness overall, which itself is composed of nine "pillars." The country does extremely well, coming first or second, in three of them: health and primary education, business sophistication, and innovation. It is also among the top ten in terms of infrastructure (7<sup>th</sup>) and market efficiency (10<sup>th</sup>), but for an advanced country only scores a middling place in terms of higher education and training (15<sup>th</sup>), technological readiness (19<sup>th</sup>), and institutions (22<sup>nd</sup>), while its macroeconomy earns it only 91<sup>st</sup> place. These indicators suggest that apart from the macroeconomic situation, Japan offers a business environment that allows its firms to be among the most competitive in the world.

Overall, the picture of Japan as an investment destination that emerges is that the country is of interest primarily for market-seeking FDI, although the efficiency-seeking and the strategic asset-seeking motive have also played a role in some cases. Foreign firms operating in Japan tend to be profitable – and, as a group, in fact more profitable than domestic firms – but the number of withdrawals also appears to be relatively high. Moreover, the country's attractiveness as an FDI destination, which had been improving, seems to have suffered a

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<sup>15</sup> A.T. Kearney (2004).

<sup>16</sup> A.T. Kearney (2005).

<sup>17</sup> UNCTAD (2005b).

<sup>18</sup> World Economic Forum (2006). The executive summary of the report with these rankings can be found online at: < [http://www.weforum.org/pdf/Global\\_Competitiveness\\_Reports/Reports/gcr\\_2006/gcr2006\\_summary.pdf](http://www.weforum.org/pdf/Global_Competitiveness_Reports/Reports/gcr_2006/gcr2006_summary.pdf) > (accessed March 12, 2007). Despite their sophistication, such rankings obviously contain a considerable degree of subjectivity, both in terms of how individual measures are evaluated and how they are weighted. The IMD in its *World Competitiveness Yearbook*, for example, arrives at a very different ranking.

setback and continues to lag behind the major Western economies. Finally, Japan does reasonably well in an international comparison of national business environments, but has been hampered by its macroeconomic performance. The outlook for the latter is likely to be one important determinant of future FDI flows into the country and will be discussed in detail in the following section.

### **3. Macroeconomic prospects**

The increase in FDI in Japan witnessed in recent years can be largely seen as a catch-up process triggered by the removal of barriers that had hitherto hindered market penetration by foreign multinationals. Given the substantial size of this untapped market potential, it mattered little that the Japanese economy was stagnating during this period. (In fact, the economic malaise helped to create the conditions that made many of the investments possible.) What is more, this catch-up process can be expected to continue in the next few years, since even today, the level of inward FDI penetration in Japan remains very low by international standards.

However, in the longer term, given that the large majority of FDI in Japan is of the market-seeking type, the country's macroeconomic performance is likely to be an important determinant of future investment inflows. After all, a vibrant and expanding economy provides far greater profit opportunities than a stagnating one. In this context, it is also useful to consider Japan's economic prospects in a regional perspective. Japan's prolonged economic stagnation and China's stellar economic performance over the past decade-and-a-half or so have gradually shifted attention away from the former and toward the latter. Of course, Japan and China or India (another country that has seen a significant rise in FDI in recent years) are unlikely to be competing for the same kind of investment (as, say, Western European nations often are). Furthermore, especially in the case of market-seeking investment and/or in the service sector, FDI is not a zero-sum game where investments in one country come at the expense of another. Yet, as reflected in the studies mentioned above, it is also clear that it is China (closely followed by India) which is uppermost in business leaders' minds when it comes to foreign investment destinations.<sup>19</sup> On the other hand, taking a long-term view, it is also conceivable that FDI in Japan may benefit from rapid economic development in China, India, and the rest of the Asia-Pacific region, although whether the potential benefits will materialize also depends on Japan's political relations with its neighbors. The following sections take up these various issues in detail.

#### *Japan's growth prospects*

Japan's economy is finally on the mend. Following two aborted recoveries in 1996 and 2000, annual GDP growth has gradually accelerated from only 0.3 percent in 2002 to 2.2 percent in 2006 and by the end of that year had posted 18 successive quarters of year-on-year expansion.<sup>20</sup> Moreover, unless the policy mistakes following earlier recoveries (premature fiscal and monetary tightening, respectively) are repeated, growth at similarly respectable rates is likely to continue for a while as the economy "catches up" to close the large output gap that has opened up during the recession.

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<sup>19</sup> China tops both A.T. Kearney's *FDI Confidence Index* and the list of most attractive global business locations named by TNCs in UNCTAD's *Prospects for Foreign Direct Investment*.

<sup>20</sup> The growth figure for 2006 is the second preliminary estimate made public in March 2007.

Yet, while the short-term outlook for the economy has brightened, Japan continues to face serious long-run challenges. Central among these are demographic trends, i.e., the shrinking and aging of the population. Japan's working age population (those aged 15–64) has been declining since 1996, while the population overall was expected to start shrinking in 2007.<sup>21</sup> Although there is some room for increased labor force participation by women and older workers,<sup>22</sup> labor input in the economy is expected to shrink in the decades to come and depress output growth. Future economic growth therefore will largely have to come from improvements in productivity.

Estimates of Japan's potential growth rate generally put this at around 2 percent. The Bank of Japan (BOJ), for example, estimates that the potential growth rate, after having fallen to around 1 percent in the 1990s, has recovered to around 1.5 to 2 percent.<sup>23</sup> Similarly, the Council on Economic and Fiscal Policy has raised its estimate of the growth potential from about 1.5 percent to 2 percent.<sup>24</sup> Other observers are even more optimistic, arguing that Japan's potential has risen in the past few years as a result of greater efficiency in the allocation of capital thanks to financial sector reforms, increasing competition such as in the retail and telecommunication sectors, better corporate governance, and deregulation facilitating the establishment of new companies.<sup>25</sup> In addition, there has been a rise in productivity-enhancing investment in information and communications technology; yet, there also remains ample room for a further increase in the deployment of information technology in Japan when compared with current levels in the United States.<sup>26</sup> Consequently, the optimists estimate that Japan's growth potential is in the range of 2.0 to 2.5 percent rather than the 1.5 to 2.0 percent suggested by BOJ and government estimates.<sup>27</sup>

Despite their diverging results, which reflect the inherent difficulties in assessing a country's growth potential, these estimates provide a useful indication of Japan's future growth prospects. While it is clear that there will be no return to the heady growth rates of the period before the "lost decade" of the 1990s, the coming decades also do not have to be a period of long-term relative decline. Being cautiously optimistic and assuming that GDP growth will indeed be around 2 percent, Japan's economic performance in the coming years will probably not lag much behind that of the member countries of the Eurozone, which grew by an average 2.1 percent in the period from 1995-2005 and face similar, although not quite as severe, demographic challenges.<sup>28</sup> Moreover, given that Japan's population is going to shrink in the coming decades, per capita incomes are going to rise faster than overall GDP, meaning that the Japanese will continue to be among the richest consumers in the world.

In terms of the outlook for FDI, these prospects imply that although the Japanese market is unlikely to show rapid rates of growth, it will continue to expand, providing opportunities for foreign multinationals particularly in the area of high-end consumer goods and sophisticated services. In fact, much of Japan's future economic growth will occur in the service sector, whose share in gross value added has gradually expanded from 58.0 percent in 1990 to 69.4 percent in 2004,<sup>29</sup> and in which Japanese productivity lags farthest behind other advanced

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<sup>21</sup> National Institute of Population and Social Security Research (2002; 2006).

<sup>22</sup> See, e.g., Council on Economic and Fiscal Policy (2005) for details.

<sup>23</sup> Bank of Japan (2006).

<sup>24</sup> Council on Economic and Fiscal Policy (2005, 2007).

<sup>25</sup> Posen (2001, 2004).

<sup>26</sup> Posen (2001, 2004), Jorgensen and Motohashi (2004), Fukao and Miyagawa (2007).

<sup>27</sup> Posen (2001, 2004), Jorgensen and Motohashi (2004).

<sup>28</sup> Growth figure from OECD online database.

<sup>29</sup> Figures from OECD, *OECD in Figures* (2002 Edition and 2006–2007 Edition).

economies. The service sector thus is the area in which foreign investment can make the greatest contribution to growth and has already been concentrated in recent years.

### *Regional growth dynamics and their implications*

Japan's growth prospects of course pale in comparison to those of many other countries in East, Southeast, and South Asia, notably China and India. A recent study by an investment bank projects that unless growth in the two largest developing countries is derailed, China's GDP may overtake Japan's as early as 2015, while India's might surpass it around 2030.<sup>30</sup> Such projections are naturally fraught with a high degree of uncertainty.<sup>31</sup> Yet, they nevertheless provide a useful scenario to consider the region's growth dynamics and their potential implications for FDI in Japan.

The first thing to note is that the Chinese and Indian economies are likely to expand at rates above or close to 5 percent for another decade-and-a-half or more, even as their potential for catch-up growth diminishes. As well as the large pool of low-cost labor, it is these growth prospects and the associated market potential that draw so many multinationals to these countries. Yet, it is also important to note that even if the Chinese and Indian economies achieve the rates of GDP growth projected in the study, their level of development will continue to significantly lag behind that of Japan. One indicator of this are per capita GDP projections in U.S. dollar terms: even under the relatively pessimistic growth assumptions for Japan made in the study, the country's per capita GDP in 2030 would still be about five times that of China and more than ten times that of India. Of course, these figures are only averages and already there is a large and growing middle class in China and India whose consumption patterns more and more resemble those of consumers in the advanced countries. Nevertheless, Japan will continue to offer the largest market for sophisticated products and services in the region for years to come, with obvious implications for foreign direct investment of the market-seeking type.

In addition, the economic advance of China, India and other countries in the region gives rise not only to potential rivalry but also great opportunity. At present, Japan finds itself as the only advanced economy in an area of developing countries and therefore does not enjoy any of the benefits that proximity to similarly developed nations provides for cross-border trade and investment. This situation is quite different from that of European countries, for example, and is one of the reasons (although there are many others), why FDI has been so low in Japan.<sup>32</sup>

However, as rapid economic development progresses, not only will the gap between Japan and the rest of Asia shrink, but the global economic balance will continue its gradual shift to the region, which is reflected in recent FDI trends: since 1990, East and Southeast Asia's inward FDI stock has grown almost eightfold, from US\$157 billion to US\$1,439 billion (2005), more than doubling the region's global share from around 9 percent at the beginning of the 1990s to 19 percent at the end of the decade, although this has since dropped again to around 14 percent. The region's outward FDI stock (excluding Japan) has risen even more dramatically, increasing 14-fold from US\$68 billion in 1990 to US\$827 billion in 2005, and its share in the global total jumped from only 3 percent during the 1980s to approximately 10

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<sup>30</sup> Goldman Sachs (2003).

<sup>31</sup> The study, for example, projects annual real GDP growth rates for Japan that are well below the 2 percent growth potential that most observers now project.

<sup>32</sup> See Paprzycki and Fukao (2005).

percent at the end of the 1990s, although this figure, too, has recently declined again, to around 8 percent.<sup>33</sup>

The regional growth and FDI dynamics may help to boost investment in Japan in two ways. The first is that multinationals from outside the region may decide to serve Asian markets from Japan and/or locate in Japan functions supporting activities elsewhere in the region. Such functions may range from regional headquarters to R&D centers to logistics and financial operations. In the taxonomy of strategic objectives pursued by MNEs, investments in these types of activities would combine market-seeking motives (the lowering of transaction costs as a result of greater proximity) with efficiency-seeking motives (the rationalization of global activities, international specialization) and thus help to broaden the scope of foreign direct investment in Japan.

However, in attracting these support functions, Japan is directly competing with a number of other economies vying to establish themselves, or expand their role, as regional operations centers for multinational companies such as Singapore, Hong Kong, Korea and Taiwan. Singapore, for example, started its Headquarters (HQ) Programme as early as 1986 and further enhanced it in 2003, offering companies that use Singapore as their base for the Asia-Pacific region a preferential tax rate for three years.<sup>34</sup> Similarly, South Korea provides support and various incentives in three free economic zones in an attempt to establish itself as a regional logistics center and business hub for high-value-added services,<sup>35</sup> while Taiwan has spelt out its ambitions in the Asia-Pacific Regional Operations Center (APROC) plan introduced in 1995, which aims to establish the island as a center for manufacturing, sea and air transportation, finance, and telecommunications.<sup>36</sup>

Companies from other parts of the world looking to set up regional head offices or other support functions in Asia thus have a wide range of potential locations to choose from. Compared with these and other alternative investment locations, Japan's attractiveness as a destination for this kind of FDI seems rather limited. Although the country offers certain advantages, such as excellent infrastructure and political stability, its geographic location at the periphery of the continent, the high costs of doing business, relatively heavy regulation in areas such as finance, and other political, cultural, and social factors discussed below put it at a disadvantage.

But there is a second way in which regional growth dynamics may help to boost FDI in Japan: the potential for greater inflows from other Asian countries. Although at present, FDI from the rest of Asia is still relatively small when compared with inflows from the United States and Europe, it is no longer negligible. The number of out-in M&As by Asian firms jumped from less than 10 annually during the 1990s to around 20 per year during 2000-2002, accounting for about 10 to 15 percent of all out-in M&As in Japan.<sup>37</sup> Moreover, by 2005, Asia accounted for 6.6 percent of the total inward FDI stock, led by Hong Kong, Singapore, Taiwan, and South Korea (in that order).<sup>38</sup> This trend reflects the fact that the more advanced economies of the region are gradually emerging as source countries of foreign direct

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<sup>33</sup> All figures are authors' calculations based on the UNCTAD online database.

<sup>34</sup> UNCTAD (2004: 198).

<sup>35</sup> UNCTAD (2004: 199).

<sup>36</sup> Japan now also appears to be keen to establish itself as a regional hub, as indicated by Prime Minister Abe's "Asia Gateway Vision," which, however, is short on detail and does not include any of the tangible benefits for multinationals that Singapore, Taiwan, or South Korea offer. See below for more on the "Asia Gateway Vision."

<sup>37</sup> RECOF (2003).

<sup>38</sup> Authors' calculations based on International Investment Position statistics retrieved from the Bank of Japan website: <[http://www.boj.or.jp/en/type/stat/boj\\_stat/bop/diri/index.htm](http://www.boj.or.jp/en/type/stat/boj_stat/bop/diri/index.htm)> (accessed April 2, 2007).

investment and the combined outward FDI stock of these four countries has risen more than fourteen-fold from US\$52 billion in 1990 to US\$715 billion in 2005.<sup>39</sup> Moreover, even India and China, although still at much lower levels of economic development, have seen substantial increases in outward FDI over the past decade-and-a-half: India's outward stock has risen from only US\$124 million in 1990 to US\$9.6 billion in 2005, while China's has grown from US\$4.5 billion to US\$46.3 billion over the same period.<sup>40</sup> Of course, in a global comparison, these figures are still very small, but if the two countries fulfill their economic growth potential, FDI outflows can be expected to rise rapidly. Already, both countries have spawned a number of multinationals. Examples include Infosys, an Indian IT and business consulting firm with offices around the world (including Japan) and a listing on the NASDAQ stock exchange, Ranbaxy (also from India), which is among the global top ten generic drug makers and has manufacturing operations in nine countries and offices in 49,<sup>41</sup> and Tata Steel, which in October 2006 took over the Anglo-Dutch steel maker Corus. Chinese companies are not far behind. In December 2004, Lenovo Group, the country's largest personal computer maker, attracted worldwide attention when it acquired a major interest in IBM's PC making business. Other firms, many of them state-owned, are also becoming global players, including China National Petroleum Company, Sinopec, and Baosteel.

As Asian countries continue their rapid economic development, regional FDI dynamics will continue to gather pace. Yet, how much of this investment will find its way to Japan depends not only on economic factors, but also on political ones – in particular the extent to which Japan is able to overcome frictions with neighboring countries, especially China and Korea, and work toward a framework conducive to regional trade and investment. These questions are among the topics addressed in the following sections.

#### **4. Political, social and cultural factors**

At the outset of this paper, it was suggested that a country's attractiveness for FDI is determined by a combination of economic and policy factors. The latter include policies explicitly aimed at facilitating FDI as well as policies that affect firms and markets more generally. For example, the surge in FDI in banking and insurance, telecommunications, and pharmaceuticals followed hot on the heels of regulatory changes in these sectors during the latter half of the 1990s. More broadly based measures, such as changes in accounting rules and legislation to facilitate mergers and corporate restructuring also played a role. Yet, although these measures represent important steps toward making Japan more attractive for foreign direct investment, more could be done. Looking at recent political developments, this section considers the likelihood that further FDI-friendly policies will be forthcoming, while the next section considers what measures the government could pursue in order to improve Japan's attractiveness for FDI in the medium- to long-term.

In addition to the political dimension, there is also a social and cultural dimension shaping the policy framework as well as economic determinants relevant for FDI. For instance, the past decade-and-a-half or so has seen an important transformation in social attitudes toward foreign companies and there is now a greater willingness among Japanese employees – and especially the young – to change jobs and/or work for a foreign company. This means that the supply of labor that foreign multinationals can tap into in Japan – and the cost at which they

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<sup>39</sup> Figures from UNCTAD online database.

<sup>40</sup> Figures from UNCTAD online database.

<sup>41</sup> Based on information from the companies' websites.

can do so – has significantly shifted in their favor. Similarly, hard-nosed employment practices and a clear profit orientation have become more common among Japanese companies as they struggled to return to health, making foreign ways of doing business no longer appear as cold and ruthless as in the past, while mergers and acquisitions have become a regular feature of the Japanese business landscape as well. Yet, although these developments play into the hands of foreign multinationals, unease remains strong in some political circles, a substantial part of the public, and the business community, so that further change will not come without resistance.

Questions also remain over the extent to which Japan is prepared to fully embrace and exploit globalization more generally. Japanese society continues to be highly homogenous, a fact that shapes both its willingness to accept foreigners and foreign ideas and its ability to adapt to the needs of a global economy. This means that even today, foreign companies operating in Japan still often find it difficult to hire personnel with the necessary language skills and international outlook. Finally, political, social and cultural attitudes shape Japan's relations with its neighbors and the wider region, affecting progress in attaining deeper economic integration, with potentially adverse effects on future FDI in Japan. These political, social, cultural and international issues are taken up in the following subsections.

#### *Government policies and business attitudes toward FDI*

In contrast with earlier decades, the Japanese government today, in principle, recognizes the benefits of inward foreign investment. One of the strongest indications of this are the goals for inward FDI set by Prime Minister Koizumi and his successor Abe.<sup>42</sup> Similarly, the business community has spoken out in favor of FDI: during the 1990s, the powerful business federation Keidanren, for example, repeatedly called on the government to deregulate the economy and encourage foreign investment.<sup>43</sup> Yet, along with the recovery of the economy more generally and of corporate profits in particular, old patterns are beginning to reappear, indicating that lingering suspicions of foreign investment, combined with unease over the economic forces unleashed by recent reforms, remain strong.

Nowhere does this become clearer than with regard to mergers and acquisitions and, in particular, “triangular mergers.” M&A activity in Japan has grown substantially in recent years, reflecting wider changes in the country's economy as well as measures introduced by the government to facilitate corporate restructuring.<sup>44</sup> The number of cases involving a Japanese firm as the acquisition target rose from less than 300 during the mid-1990s to over a thousand in 2000 and reached more than 2,300 in 2006 (see Figure 6). In-in M&As make up the bulk of these cases, indicating that Japanese firms have been actively making use of this tool. In addition, the number of out-in M&A cases has also increased, climbing from around thirty a year during the mid-1990s to an annual average of around 170 during the 2000s. As

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<sup>42</sup> In January 2003, then-Prime Minister Koizumi announced that the government was seeking to double the amount of inward FDI stock in the space of five years, from ¥6.6 trillion in 2001 to ¥13.2 trillion by the end of 2006. And even before that goal was achieved, Koizumi in March 2006 set the new target of reaching an inward FDI stock equivalent to 5 percent of GDP by the end of 2011. Subsequently, Abe, his successor, in one of his first policy speeches in September 2006 promised to aim for the early achievement of the goal by 2010, although it seems that Koizumi's first goal will have been missed because of substantial disinvestments in 2005 and 2006.

<sup>43</sup> See, e.g., the address of Keidanren Chairman Toyoda to the Keidanren general assembly in 1995 (online: <<http://www.keidanren.or.jp/english/speech/spe005.html>>; accessed February 16, 2007) and Keidanren proposals for an improvement of the Japanese investment environment (online: <<http://www.keidanren.or.jp/english/policy/2002/042/proposal.html>>; accessed February 16, 2007).

<sup>44</sup> See Paprzycki (2004) for details.

these trends indicate, M&As are becoming an established feature of the Japanese business landscape.

Insert Figure 6

However, despite – or because of – this trend, concerns about M&As, and especially hostile takeovers, have also been growing. A key episode in this context are the events surrounding the internet and finance firm Livedoor and its owner, Takafumie Horie. Already having gained media fame with a bid for a baseball team, Horie in 2005 launched a hostile takeover bid for Nippon Broadcasting System (NBS), a radio station, which represented an indirect attempt to gain control of one of the country's private TV stations, Fuji Television. Resulting in a bitter battle that dominated the news for weeks, the spat eventually ended in a compromise deal between the two sides. However, Livedoor continued to make headlines when it emerged in early 2006 that an affiliate, Livedoor Marketing, had broken disclosure rules and falsified statements and Horie and other board members were arrested.

The Livedoor episode is important because it brought to the surface continuing resistance to the changes sweeping Japan and, at least indirectly, played a role in shaping the environment for M&As and FDI in Japan. While to some, Horie, until his arrest, was a model of the new kind of entrepreneur the country desperately needed, to others he and his business practices exemplified the “market fundamentalism” and “excesses” unleashed by economic reforms. In particular, Horie’s bid for NBS fanned latent fears over hostile takeovers, which featured prominently in the debate leading up to the revision of the commercial code implemented in May 2006. Reflecting such fears, the revision not only established clearer rules for mergers and acquisitions, but also introduced provisions allowing firms to adopt a variety of anti-takeover measures such as “poison pills.” Moreover, citing concern over an imminent wave of foreign hostile takeovers, parliament postponed the lifting of the ban on triangular mergers for a year.

Following this, albeit temporary, setback for foreign firms wishing to invest in Japan, efforts by Japan’s business community to protect themselves against unwanted takeovers, if anything, intensified in the run up to the lifting of the triangular merger ban at the new date in May 2007. In order to understand the significance of triangular mergers, one needs to be aware that most large-scale M&A deals in Western countries are at least partially financed by equity swaps. In Japan, however, foreign firms have been effectively barred from using this method because firms wishing to pay for the acquisition of another firm with their own shares could only do so if they were listed in Japan. Yet, as of December 2006, only 25 foreign firms were listed on the Tokyo Stock Exchange, and their number in fact has been shrinking in recent years (the current figure compares with 127 in 1991), with IBM and Pepsi among the latest firms to exit.<sup>45</sup> Hence the importance of the triangular merger scheme, which allows a foreign firm to issue its shares to a special purpose company it owns in Japan, which then merges with the Japanese company for legal purposes. Shareholders of the Japanese company receive the newly issued shares in an effective swap.

Although triangular mergers cannot be used for hostile takeovers,<sup>46</sup> the two are often mentioned in the same breath and – intentionally or unintentionally – confused, reflecting the

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<sup>45</sup> Source: Tokyo Stock Exchange website. The delisting of foreign firms itself of course should be cause for concern given the government’s stated ambition of making Tokyo a global financial center on par with New York and London.

<sup>46</sup> By law, the board of the company to be acquired must approve the transaction before it goes to shareholders for their final approval, thus precluding any takeover against the will of the board.



apprehension with which Japan's business community has viewed the lifting of the ban. In a last-minute attempt, the Keidanren, for example, called for more stringent takeover rules, arguing that the country's "overall legal provisional framework [was] inadequate for the blocking of corporate merger and acquisition attempts that are detrimental to corporate value or that harm the national interest through the outflow of technology."<sup>47</sup> In an encouraging sign, however, the ruling LDP dropped a proposal that would have imposed tougher shareholder approval requirements for triangular mergers on the grounds that such requirements would make it virtually impossible to conduct such mergers.<sup>48</sup>

At the same time, though, firms are coming up with other ways to protect themselves against hostile takeovers. By February 2007, nearly 200 firms had adopted anti-takeover measures such as issuing share warrants to trust banks or other "friendly" outside parties.<sup>49</sup> In addition, firms have started resorting to cross-shareholdings again. Since bottoming out in 2004, shareholdings by nonfinancial firms have increased by about 30 percent.<sup>50</sup> Nippon Steel, for example, has strengthening its alliance with Sumitomo Metal Industries and Kobe Steel by increasing cross-shareholdings with the explicit aim of fending off any takeover attempt.<sup>51</sup> Likewise, following a failed hostile takeover attempt by Oji Paper, Hokuetsu Paper Mills entered cross-shareholdings with Daio Paper, while Nippon Paper Group and Rengo announced a similar move.<sup>52</sup>

Overall, therefore, it appears that at the same time that the triangular merger scheme, long-awaited by the foreign business community in Japan, is going ahead, the Japanese business community – having regained some confidence on the back of the country's economic recovery – is reverting to traditional patterns. As much as fending off potential foreign suitors, anti-takeover measures seem to be designed to protect the interests of incumbent managers, as is illustrated, for example, by the vigorous fight put up by Hokuetsu Paper Mills to ward off Oji Paper in an entirely domestic hostile takeover attempt. Although it is unlikely that the developments described here will result in a return to the economic structures of earlier decades, they clearly indicate that resistance in the Japanese business community to "Western" business practices and acquisitions by foreign firms remains widespread. Combined with anecdotal evidence suggesting that it remains difficult for foreign firms to find suitable and willing acquisition targets,<sup>53</sup> this may explain why the number of out-in M&As has been stagnating in recent years and has actually been falling as a share of all M&As involving Japanese target firms (see Figure 6).

It is important to note that there are also voices in Japan criticizing this continuing resistance and urging the country to welcome globalization in general and foreign investment in particular. The *Nikkei Shimbun*, Japan's leading economic daily, for instance, has become a

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<sup>47</sup> Nippon Keidanren, "Further Revision of M&A Legislation is Needed," December 12, 2006. Online: <<http://www.keidanren.or.jp/english/policy/2006/085.html>> (accessed April 11, 2007).

<sup>48</sup> Nikkei, "LDP nixes stricter triangle merger rules," March 12, 2007.

<sup>49</sup> Nikkei, "Nearly 200 firms introduce measures to foil hostile takeover bids," February 23, 2007; Nikkei, "Firms erecting anti-takeover defenses also raising transparency," March 29, 2007.

<sup>50</sup> Nikkei, "Cross-holding revives as takeover shield," January 29, 2007.

<sup>51</sup> Reuters, "Nippon Steel, two others eye anti-takeover defence," March 29, 2006.

<sup>52</sup> Nikkei, "Cross-holding revives as takeover shield," January 29, 2007.

<sup>53</sup> According to a survey by the Economist Intelligence Unit, for example, 60 percent of M&A deals since 1998 involving foreign firms have related to unlisted Japanese companies, and often these were small deals with firms or subsidiaries where relationships already existed (Economist Intelligence Unit press release, "Threat of hostile takeovers hangs over Japanese companies," July 14, 2005. Online: <<http://www.eiuresources.com/mediadir/default.asp?PR=360001836>>; accessed April 12, 2007).

staunch supporter of inward FDI.<sup>54</sup> At the same time, however, politicians' enthusiasm for inward FDI has been waning since Koizumi's departure. The Expert Committee of the Japan Investment Council, for example, which under Koizumi used to hold four or five meetings a year, (as of April 2007) has not met once since Abe took over, and although he has promised to strive for the early fulfillment of Koizumi's FDI goal, no new initiatives that could help to achieve this have been launched.

This apparent lack of interest in inward FDI appears to reflect a different set of priorities more generally. Koizumi explicitly ran on a platform of economic reform, making an economics professor, Heizo Takenaka, his right-hand man who held important posts in all five Koizumi cabinets, and calling a snap election to gain popular backing for his plan to privatize the postal-savings system. Although Abe at the beginning of his premiership indicated that he wanted to bring about more far-ranging structural change, he appears to be more concerned with foreign policy, while the domestic policy debate has been largely dominated by the issue of income equality (*kakusa shakai*), a topic forced onto the government's agenda by the opposition.

Looking at business and political trends taken together, it seems that as Japan's economy is regaining strength, the enthusiasm for reform, structural change, and inward FDI is dampening. In large parts of the business community, foreign investment continues to be viewed as a threat rather than an opportunity, prompting the adoption of anti-takeover measures that are likely to put a brake on future FDI inflows. As for the government, recent signals have been mixed, with the LDP nixing proposals to impose more stringent requirements for triangular mergers, but also no new measures on the table. Against this background, the way the triangular merger scheme works in practice – which only time can tell – will provide a crucial test of the government's stance on FDI. Measures to ensure that triangular mergers indeed become a useful tool for FDI in Japan, as well as other steps the government could take to promote foreign investment, are discussed further below.

### *Social and cultural aspects*

Japan's "closedness" to foreign direct investment in the past to a large extent is a reflection of the "closedness" of the country more generally. Unlike the United States and Australia, or, more recently, Britain and other Western European countries, Japan has no history of large-scale immigration. Foreign nationals account for only 1.5 percent of the population, compared with 4.5 percent in the U.K. (which, in addition, has a large number of naturalized immigrants) and 8.9 percent in Germany, while foreign-born nationals make up 11.8 percent of the U.S. population.<sup>55</sup> Ethnically, culturally, and linguistically, the Japanese remain one of the most homogenous people in the world, and for this reason, foreign direct investment poses as much a social and cultural challenge as it is an economic and political one.

In fact, many of the implicit barriers to FDI in the past, such as closed labor market institutions (in particular the life-time employment system) or constraints on M&A, contain a social and cultural dimension. Similarly, adapting to the needs of a global economy require skills and attitudes that are shaped by social and cultural factors. Thus, although economic prospects and policies toward foreign firms are likely to be the key determinants of future FDI

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<sup>54</sup> Examples of representative editorials include "Foreign capital must be welcomed amid rapid globalization" (March 5, 2007) and "Make Japan a global nation of lofty aspirations" (January 7, 2007).

<sup>55</sup> Figures from the OECD online database.

inflows into the country, the extent to which Japan as a society is willing and equipped to provide a home to foreign multinationals will also play a role.

In this regard, Japan certainly has come a long way. Despite lingering unease, most Japanese appear to accept the need for a more market-driven economy and see foreign companies in a positive light. For example, according to a survey conducted in 1995, 97 percent of managers thought that it is *stakeholders* who own companies. But by 2005, this had completely changed, with 90 percent of managers replying that it is the *shareholders* who own companies.<sup>56</sup> Similarly, foreign companies are increasingly seen in a positive light. A recent survey involving 3,000 ordinary Japanese suggests that roughly a third of respondents had a positive or somewhat positive image of foreign firms in Japan, while only 6.6 percent held a negative or somewhat negative opinion.<sup>57</sup> In addition, 30.2 percent of respondents answered that their image of foreign firms had improved, while only 8.9 percent indicated that it had become worse.<sup>58</sup> This pattern is more or less confirmed by foreign companies themselves, who believe that their image has improved in recent years and that they are generally perceived in a positive light.<sup>59</sup>

The majority of respondents who expressed an opinion also thought that foreign companies had a positive effect on the Japanese economy (47.3 percent), while only a small minority thought the effect was negative (7.7 percent).<sup>60</sup> Among those who held a negative opinion of foreign firms, about half thought that foreign companies were only after a quick profit, aiming to buy Japanese firms cheaply only to sell them again after a brief period.<sup>61</sup> Yet, overall the number of such respondents was less than 4 percent, indicating that the identification of foreign firms with “vulture funds” that can sometimes be found in the press is not widely shared.

One problem faced by foreign firms setting up in Japan in the past was the difficulty to recruit employees. Yet, the survey indicates that around 20 percent of respondent either are already working for a foreign company or would like to do so, roughly the same share as those who say they do not want to work for a foreign company, while a further 45.5 percent replied that they could not say.<sup>62</sup> Interestingly, a larger share of women than men indicated they would like to work for a foreign firms (21.5 percent versus 17.2 percent). Moreover, unsurprisingly, it is particularly the young that would like to work for a foreign firm, and the most important motivation is to develop a global outlook (cited by 52.1 percent of those wanting to work for a foreign firm), followed by the high pay and the opportunity to test one’s ability. These survey results suggest that, on the whole, the Japanese today are well disposed toward foreign firms, and especially many of the young are willing to embrace the opportunities they provide.

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<sup>56</sup> Survey cited in METI presentation “M&A Rules in Japan” dated May 2005 and available online at: <[http://www.meti.go.jp/policy/economic\\_organization/pdf/rontenkoukai\\_gaiyou\\_eng.pdf](http://www.meti.go.jp/policy/economic_organization/pdf/rontenkoukai_gaiyou_eng.pdf)> (accessed April 3, 2007).

<sup>57</sup> Nomura Soken Kenkyujo (2005: 2). The rest either had no particular impression or no particularly positive or negative image of foreign firms.

<sup>58</sup> Nomura Soken Kenkyujo (2005: 2). 47.7 percent reported no change in their opinion, while 13.2 percent did not know.

<sup>59</sup> Nomura Soken Kenkyujo (2005: 46-47).

<sup>60</sup> Nomura Soken Kenkyujo (2005: 3). The rest did not know (12.0 percent) or said that it was impossible to say (33.0 percent).

<sup>61</sup> Nomura Soken Kenkyujo (2005: 16).

<sup>62</sup> Nomura Soken Kenkyujo (2005: 20). The remaining 12.2 percent either did not want to work for a company (11.7 percent) or provided no answer (0.5 percent).

Yet, although the acceptance of foreign companies is increasing, Japan's potential as a foreign investment destination is likely to also depend on the extent to which society is equipped and willing to accept and respond to internationalization and all that implies. As in most countries, there is little enthusiasm for allowing more immigration (despite the fact that this would help to ease population trends). Similarly, many Japanese remain uneasy about what an influx of foreigners would mean for their community. For example, in the same survey referred to above, while 48.1 percent of respondents thought that having foreign residents live in the same area helps to give it an international character, an almost equal share (47.8 percent) was worried that it might lead to problems, and a third feared that communication might be difficult.

Nevertheless, the government has recognized that Japan needs to attract not only foreign business, but also foreign talent. For this reason, the country's strict visa regulations have been gradually relaxed: the duration of a standard work visa, for example, was extended from one to three years and foreign students, who previously would have lost their residence status upon graduation are now granted visa extensions to allow them time to find a job.<sup>63</sup> In addition, the government has been actively seeking to expand the number of foreign students studying in Japan. In fact, a "Plan to Accept 100,000 Foreign Students" was formulated as early as 1983 and this goal was reached in 2003 following an increase in the number of foreign students between 1998 and 2003 by 54 percent.<sup>64</sup> As a result, Japan today is the sixth most important destination for students studying abroad (behind the United States, the United Kingdom, Germany, France, and Australia, which together account for 70 percent of the global intake of foreign students).<sup>65</sup>

At the same time, however, at 2.2 percent, the share of foreign students in tertiary enrolments remains much lower than the OECD average of 6.4 percent. And although the number of foreign students who stay on in Japan to work after graduating has increased in recent years, their number, at 5,264, is still very small.<sup>66</sup> What is more, almost two-thirds of those obtained visas to work as interpreters or language teachers,<sup>67</sup> i.e., probably not in their field of study. One reason why the number of foreign students remaining in Japan to work is so small appears to be "the negative mindset of Japanese firms toward employment of international students."<sup>68</sup> Another possible reason is that many suffer unpleasant experiences while in Japan. In a comprehensive survey involving almost 5,000 foreign students in Japan, roughly half complained about "Japanese peoples' prejudice and closed-mindedness toward non-Japanese people."<sup>69</sup> And 53.0 percent felt that when it comes to the type of non-Japanese person Japanese people like, it was typically "Americans, Europeans, blonds, people with blue eyes, people who speak English, people from advanced countries, rich people, etc." Yet, more than 90 percent of foreign students in Japan are from the rest of Asia (with Chinese students accounting for 59.7 percent and South Korean students for 22.0 percent of the total).<sup>70</sup> On the other hand, the survey among foreign students is somewhat dated – it is from 1995 – and anecdotal evidence suggests that Japanese attitudes are changing. For example, there has been

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<sup>63</sup> JETRO (2005a).

<sup>64</sup> JETRO (2005a: 32) and OECD (2005: 267)

<sup>65</sup> OECD (2005: 254).

<sup>66</sup> JETRO (2005b).

<sup>67</sup> JETRO (2005b). Of the remainder, 23.4 percent received visas for work in mechanical engineering, 7.4 percent obtained visas to teach at university, 2.4 percent received visas to work as researchers at government institutions or private corporations, and 1.0 percent obtained visas to serve as business/investment managers. 94.9 percent of the students who remained in Japan to work were from Asia.

<sup>68</sup> JETRO (2005a: 8).

<sup>69</sup> Cited in Keizai Doyukai (2002: 24). The survey was conducted by Sumiko Iwao.

<sup>70</sup> OECD (2005: Table C3.2). Figures for 2003.

a visible increase in TV programs featuring foreigners, and pop culture from other Asian countries, particularly from South Korea, has gained great popularity in Japan – trends which, it may be assumed, reflect and contribute to an environment in which foreign students, especially those from other Asian countries, can feel more comfortable.

The relatively low degree of internationalization of Japanese society – in terms of the overall number of foreigners living in the country, the number of foreign students studying and staying on to work in Japan, and the extent to which this provides the Japanese with experience in interacting with foreigners – is relevant for inward FDI because it plays a role in determining the ease with which foreign multinationals can find employees with the right skills, attitudes, and experience. For example, although more and more Japanese are willing to work for a foreign company, in a survey of foreign firms, 35.5 percent of firms indicated that they still had difficulties in finding qualified personnel, with language being by far the most important reason.<sup>71</sup> The shortage of qualified personnel is also the most frequently cited issue when it comes to setting up outside the main business regions of the Kanto and Kansai areas.<sup>72</sup> And the European Business Council in Japan observes:

One of the greatest difficulties European firms continue to face doing business in Japan is securing internationally qualified Japanese employees for their Japanese operations. Unfortunately, Japan's education and certification system does not effectively address the widening gap between competency levels and the needs of employers in today's increasingly global economy, especially for skills in areas such as legal services, engineering, biotechnology, financial accounting, and IT.<sup>73</sup>

These observations are confirmed by anecdotal evidence that especially in highly specialized fields, the pool of candidates is very small. For instance, according to the educated guess of the Japanese CEO of a foreign-affiliated insurance firm, there may be only about 1,000 actuaries in Japan, and of these, only ten possess sufficient language skills to be able to communicate with a foreign head office over the phone.<sup>74</sup>

Yet another survey, this time among foreign financial institutions operating in Japan, provides further instructive results.<sup>75</sup> Asked to compare Tokyo as an international financial center with London and New York and with Hong Kong and Singapore, foreign financial institutions overwhelmingly indicated that employing and securing personnel competent in international finance was more difficult in Tokyo than in both the two Western and the two Asian financial centers. Individual comments cited in the survey highlighted the difficulty of “securing personnel that have a good command of English and can give advice from a global viewpoint” and that “not only internationalization of the financing business but also internationalization of the entire Japanese society, and thus fundamental educational system reforms are needed.”<sup>76</sup>

These social factors, coupled with high operating expenses (such as office rents, labor costs, and property costs), high taxes and heavy regulation put Tokyo at a clear disadvantage vis-à-vis the other international financial centers and 18 out of the 29 institutions subject of the survey indicate that the Tokyo unit is and has been only handling transactions in Japan. What is more, another three replied that they had transferred or were planning to transfer part of the

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<sup>71</sup> Nomura Sogo Kenkyujo (2005: 52 and 55).

<sup>72</sup> JETRO (2004a).

<sup>73</sup> European Business Council (2005).

<sup>74</sup> Hitoshi Morita, President and CEO, PCA Life, interview on 17 May, 2005.

<sup>75</sup> Japan Center for International Finance (2004).

<sup>76</sup> Japan Center for International Finance (2004: 9).

major operations of their unit in Tokyo to some other unit(s) in Asia, which in all three cases was Singapore.

Although this survey covers less than three dozen firms from one particular sector, the results highlight the difficulties Japan faces not only in turning Tokyo into an international financial center on par with London and New York, or even Hong Kong and Singapore, but also in attracting the regional support functions of foreign multinationals more generally. Unless firms have a strong market-seeking motive for investing in Japan, they are unlikely to base themselves in the country as a result of the high costs, the heavy regulation, and the low degree of internationalization of Japanese society when compared with many other countries in region.

### *Japan's relations with its neighbors*

Although at present, outward foreign direct investment by Asian countries other than Japan remains relatively small on a global scale, regional growth dynamics mean that it is only a matter of time until countries like Taiwan, South Korea and, eventually, China will emerge as significant sources of FDI. Given the role that geographic proximity plays in determining investment flows, as gravity models show, this trend may have important implications for future inflows of direct investment in Japan. However, political tensions with South Korea and, particularly, China mean that economic integration with these two countries and in the region more generally is being hampered, with potentially adverse effects on FDI.

Economic relations between Japan and its two neighbors have deepened rapidly over the past couple of decades. The volume of trade with South Korea has managed to keep pace with the growth in Japan's overall trade, hovering at around 5–6 percent of the total, while trade with China has accounted for an ever-increasing share that reached 17 percent of Japan's total trade volume in 2006. Together, South Korea and China thus now account for almost a quarter of all Japanese trade and in 2003, China overtook the United States as Japan's most important source of imports. In addition, China has become a major destination for Japanese outward FDI and in 2006 was the third-most important recipient country, behind only the United States and the UK.<sup>77</sup> Japanese firms now employ more than one million people in China.<sup>78</sup>

However, in contrast with the deepening commercial relations, political relations with South Korea and China have, if anything, deteriorated in recent years. Overshadowed by history, Japan's relations with the two countries have been difficult even at the best of times. In South Korea, ill-feeling remains strong over Japan's harsh colonial rule of the Korean peninsula from 1910-45 and the perceived failure of Japan to properly atone for its deeds. Relations between the two countries had warmed following the announcement by the world football governing body FIFA, in 1996, that Japan and South Korea were to jointly host the 2002 World Cup. Leaders of both countries met frequently and in 1998, Japan issued a written apology to South Korea, which was accepted by Kim Dae-Jung, South Korea's president at the time. In 2002, Korea lifted its formal ban on cultural imports from Japan and in December 2003, the two sides launched official talks on a bilateral free trade agreement (FTA).

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<sup>77</sup> Based on Ministry of Finance statistics retrieved from <<http://www.mof.go.jp/bpoffice/ebpfdi.htm>> (accessed April 3, 2007).

<sup>78</sup> METI (2006b).

However, triggered by Prime Minister Koizumi's annual visits to Yasukuni shrine in Tokyo, where Japan's fallen soldiers are honored but 14 class A war criminals from World War II are also memorialized, relations deteriorated significantly and tensions have re-emerged. Issues of contention include the history textbook controversy, the question of compensation for "comfort women," and a group of islets called Dokdo by the Koreans and Takeshima by the Japanese. Following Koizumi's visit to Yasukuni shrine in 2005, South Korea cancelled several high-level meetings, including a summit in Japan scheduled for later that year. The frictions have also overshadowed the FTA negotiations, which reached a deadlock in November 2004, mainly because of differences over agricultural and fisheries trade, and no progress has been made since.

Japan's relations with China, if anything, are even worse than those with South Korea. Similar to the South Koreans, the Chinese feel that Japan has never properly atoned for the invasion and atrocities committed in the 1930s and 1940s and have been incensed by Koizumi's visit to Yasukuni shrine. Tensions are further fuelled by a territorial dispute over the Senkaku islands, called Diaoyutai in Chinese, and a growing sense of rivalry for leadership in the region. China's growing economic and political clout has gone hand in hand with large increases in defense spending, while Japan has been pursuing an increasingly assertive defense policy, identifying Taiwan as a security concern share with the United States and describing China as a source of "concern" for Japan in its national defense outline.

Against this background, official contacts between the two countries fell to a minimum during Koizumi's premiership: the last visit to Japan by a Chinese head of state was that by President Jiang Zemin in 1998, while Koizumi's last visit to China took place 2001. In the spring of 2005, tensions between the two countries came to boil when thousands of Chinese took to the streets in violent anti-Japanese protests in response to Japan's bid for permanent membership of the UN Security Council and the Japanese Ministry of Education's approval of school textbooks that play down Japan's atrocities in China in the 1930s and 1940s. Although economic relations between the two countries continued to thrive throughout the period, the political frictions have precluded any attempts to promote further economic integration through formal agreements. A Sino-Japanese FTA, for example, which could have a large potential impact given the size and especially the high complementarity of the two economies, has never been on the table.

Although memories of Japan's deeds during World War II also linger on in other countries in the region, relations with them are generally much better (except, of course, with North Korea). Yet, most of the Southeast Asian countries, for example, are equally wary about Japan as they are about China, with whom several of them have disputes over various islands in the South China Sea and which is a direct competitor for foreign direct investment and in labor-intensive exports. Reflecting the rivalry, tension and diverging interests in the region, initiatives such as APEC (Asia-Pacific Economic Co-operation), ASEAN+3 (the ASEAN countries plus Japan, China, and South Korea) and, most recently, the East Asia Summit have produced few concrete results.

In this context, friction with China and South Korea in Japan increasingly came to be seen not only as hampering the country's ability to pursue diplomatic initiatives, but also to harm its economic interests. It is therefore significant that the new Prime Minister Abe in his first overseas trip, in October 2006, traveled not to Washington, as his predecessors did, but to Beijing and Seoul and that his trip was reciprocated by a visit by China's Prime Minister Wen Jiabao in April 2007. While it appears that the change in Japan's political leadership has significantly reduced tensions with its neighbors, it remains to be seen whether this will lead

to a lasting improvement in relations that will eventually translate into bilateral or regional agreements to facilitate trade and investment.

## **5. What the government can do**

Government policy toward foreign direct investment has certainly come a long way. Following up on the deregulatory measures of the 1990s, the government launched several initiatives to improve the FDI climate in Japan. For example, in 2003, the Japan Investment Council, which is chaired by the prime minister, established the “Program for the Promotion of Foreign Direct Investment in Japan,” which identified 74 measures falling under various headings that include the review of administrative procedures, improving the business environment, and providing information on investment opportunities in Japan.<sup>79</sup> What is more, the Program is being followed up in detailed reports tracking the progress being made in implementing these measures. Yet, more could be done and, as will be suggested below, in certain areas, the situation for foreign companies even appears to have become worse. The following subsections will consider in greater detail what the government can do to attract FDI to Japan. To this end, it is convenient to use the classification of FDI determinants introduced at the outset – i.e., the economic determinants, the policy framework for FDI, and business facilitation measures – and discuss these in turn.

### *Economic determinants*

As mentioned above, economic factors determining a country’s attractiveness for foreign direct investment include aspects such as market size and growth, the supply of different types of resources, the cost of these resources and other inputs, etc. Many of these factors are not susceptible to policy-making or, if so, only in the context of the general policy framework. For example, the size and growth of the Japanese market is subject to policy-making only to the extent that the government can attempt to steer overall economic growth or the growth of particular industries and markets. Similarly, the supply of different resources and their costs, such as natural resources, skilled and unskilled labor, etc., are largely given and government policies affect these only at the margin.

Yet, there are certain areas in which the government could conceivably pursue policies that would have a positive impact on economic determinants and help to increase the attractiveness of Japan. The discussion above, for example, highlighted the difficulties foreign firms face in recruiting skilled personnel with an international outlook. To address this issue, the government could devise or strengthen policies that help to foster a workforce that possesses the skills and attitudes required in an increasingly global economy. Relevant policies could span the fields of education, immigration, labor laws, etc. While such policies would take time to bear fruit, they would also benefit domestic firms as well as foreign ones.

Another area in which the government could try to influence economic determinants through policy is Japan’s high cost structure, which foreign firms frequently cite as a disincentive. There continue to be a large number of areas, ranging from utilities to transport and distribution, that are highly regulated and as a result contribute to the high cost of doing business in Japan. Again, deregulation in such fields, and the lower costs that would result,

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<sup>79</sup> See, e.g., Investment in Japan Information Center, “Promotion of Foreign Direct Investment in Japan,” online: <<http://investment-japan.go.jp/statements/files/20030327-1.pdf>> (accessed April 12, 2007).



would benefit not only foreign firms, but domestic firms and consumers as well. Additional possible measures include trade liberalization and efforts toward regional bilateral or multilateral integration agreements (discussed in greater detail in the next subsection), which would not only further contribute to lowering general cost levels in Japan, but also make Japan more attractive as a node in regional corporate networks.

Far-ranging measures such as these that affect labor supply, market structures, and costs, would probably need to be motivated by a broad policy agenda that aims at improving business conditions in Japan more generally rather than simply targeting FDI. Moreover, tangible effects on inward FDI would take time to materialize. However, these considerations illustrate that policies that improve the business environment for domestic firms in the long-run would also promote inward FDI.

### *The policy framework for FDI*

While governments' options to actively shape the economic factors determining their country's attractiveness for FDI may often be limited, this is certainly not the case when it comes to the policy framework for FDI. Obviously, a favorable policy framework alone will not be enough to attract foreign multinationals if the economic factors are not right; on the other hand, though, unfavorable policies certainly have the potential to deter FDI even if the right economic factors are present. Rules regarding the entry and operations of foreign multinationals, tax policies, policies on the functioning and structure of markets, policies on trade, and international agreements on FDI will all affect the ease with which foreign companies can establish a presence in a particular country. In the case of Japan, each of these areas offers room for measures to raise the country's attractiveness for FDI.

Generally speaking, foreign multinationals enjoy national treatment when investing in Japan. However, a number of exceptions remain, such as in agriculture, fishery, and forestry, mining, telecommunications, air transport, maritime transport, and broadcasting.<sup>80</sup> While lifting the ban on foreign ownership in agriculture, fishing or mining probably would have little impact on FDI inflows, this cannot be said for some of the other sectors. In Japan, foreigners are banned from owning and operating AM, FM and TV broadcasting stations (although since 1999 foreigners are allowed to own and operate cable TV facilities). Yet, broadcasting is an increasingly global business and the inward FDI stock in broadcasting in the U.S., for instance, amounts to approximately US\$28.3 billion, almost on par with retail trade (US\$29.7 billion).<sup>81</sup> Similarly, deregulation of the airline industry in Europe has brought significant cross-border investment in its wake and led to an overhaul of the entire industry.<sup>82</sup> These examples suggest that removing the ban on foreign ownership in the domestic air transport business and broadcasting in Japan could have a substantial effect on FDI inflows. Yet another area is the transport of goods and passengers between Japanese ports, which is reserved to Japanese ships. Allowing foreign shipping lines to trans-ship their own overseas cargo on their own vessels in Japan would reduce the need to trans-ship these cargos in other

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<sup>80</sup> For details, see Paprzycki and Fukao (2005).

<sup>81</sup> Figures are for 2005. Source: Bureau of Economic Analysis, "Foreign Direct Investment in the United States: Selected Items by Detailed Industry of U.S. Affiliate, 2002-2005." Online: <[http://www.bea.gov/bea/di/FDI17\\_0205.pdf](http://www.bea.gov/bea/di/FDI17_0205.pdf)> (accessed April 12, 2007).

<sup>82</sup> Intra-European FDI in the airline industry became possible as part of the introduction of the Single European Market in 1993, although ownership restrictions on non-"Community Carriers" remained in place.

countries and (together with measures to lower port costs through greater competition) consequently increase Japan's appeal as an entrepôt for regional shipping operations.<sup>83</sup>

In addition to removing remaining outright barriers to the entry of foreign firms, there are various other ways in which the Japanese government could facilitate the entry and operations of foreign multinationals in the country. In this context, policies related to M&As play a vital role, given that mergers and acquisitions represent the most important means by which multinationals enter foreign markets, including Japan. The lifting of the ban on triangular mergers in May 2007 mentioned above therefore represents a crucial step in the right direction. However, as so often, the devil lies in the detail, and the impact of this step greatly depends on the particulars of the rules and regulations and how the government interprets and applies them in practice.

The first thing to note with regard to Japanese regulations is that they permit only one particular type of triangular merger (so-called "forward" triangular mergers), compared with many different versions possible in the US. Another issue – in fact, the key issue as far as the foreign business community in Japan is concerned – is whether and under what circumstances sellers receiving shares in an equity swap can defer tax payments. Without deferral, sellers face an immediate tax burden that makes it unlikely that the triangular merger would occur in the first place. Deferral rules thus are a central element in determining the extent to which the triangular merger scheme will provide a useful tool for foreign investment in Japan. Although much will depend on how tax rules are applied in practice, members of the foreign business community point out that deferral rules are cumbersome and qualifying for deferral will be especially difficult, if not impossible, for new foreign entrants.

The implications for government policy are obvious: FDI could be greatly facilitated by further reforming M&A regulations. First steps could include relaxing or abolishing conditions that must be met for triangular mergers to qualify for tax deferral, granting foreign firms similar tax deferral treatment as Japanese ones, and increasing the variety of triangular merger mechanisms available to firms. But the foreign business community in Japan has supported the triangular merger scheme only as a second-best approach to facilitating cross-border deals and would have greatly preferred the introduction of direct cross-border stock swaps instead.<sup>84</sup> Such direct cross-border stock swaps are widely used in the United States and Europe and have been employed in some of the most biggest and most prominent M&A transactions in recent years, including the Vodafone-Mannesmann, Daimler-Chrysler, and BP-Amoco deals. In sum, M&A rules and regulations represent a key area in which the government could facilitate entry and send a clear signal that it is serious about attracting inward FDI.

Another area in which the government could help to ease the difficulties foreign multinationals face is in securing a qualified labor supply. Although immigration laws have been relaxed somewhat, this is unlikely to be sufficient. Members of the foreign business community in Japan are therefore calling on the Japanese government to further stimulate the inflow of workers with skills required by foreign firms, such as in the areas of financial

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<sup>83</sup> However, it should be noted that Japan is not alone in imposing domestic (majority) ownership requirements in industries that are deemed to be sensitive. Examples from other countries (as of 2003) include airlines in the European Union and North American countries and coastal and freshwater shipping in the United States (majority domestic ownership required), fishing and energy sectors in Iceland and the oil sector in Mexico (exclusive domestic ownership required) (OECD 2003: Chapter IV).

<sup>84</sup> See, e.g., EBC, "EBC rejects media reports misrepresenting cross-border swaps in Europe," press release, November 14, 2006.

accounting, IT, or legal services, by recognizing foreign qualifications and diplomas and by granting work visas to people with proven skills but without the university diploma or ten years work experience currently required.<sup>85</sup> Closely related to this issue are also the various restrictions placed on qualifying and practicing as a foreign lawyer (*gaiben*) in Japan, hampering not only the operations of international law firms in Japan, but also limiting the supply of lawyers both qualified to practice in Japan and possessing international experience.

Although policies that directly affect the entry and operations of foreign multinationals are important, policies that affect the structure and functioning of markets more generally also play a significant role. The surge in Japanese inward FDI in the 1990s, for instance, owes not only to the removal of some of the remaining formal barriers, but crucially also to deregulation in such key sectors as telecommunication, finance, and retail. Yet, despite some efforts at liberalization, regulations that hamper competition at the expense of new entrants and hence foreign direct investment remain widespread.

A case in point is large-scale retailing. Although the Large-Scale Retail Store Law was amended in 1992 and 1994 (and became the Large-Scale Retail Store Location Law) to facilitate the establishment of large retail outlets, there are still no definitive rules for submitting applications for new stores. This is further compounded by the need for building permits and environmental impact assessments, which are often used by local governments to impose new conditions, making the process of opening new large-scale stores extremely complex. The European Business Council (EBC) in Japan in its annual report on the business environment therefore notes that “[c]ompanies that are new to the market, or companies with less experience and fewer networks at the local level, are disadvantaged vis-à-vis their domestic competitors in this situation.”<sup>86</sup> Setting down clear rules and streamlining the application process for large-scale retail stores thus would help to create a more level playing field and facilitate foreign investment in this sector.

Members of the foreign business community and organizations representing their interests, such as the EBC and the American Chamber of Commerce in Japan (ACCIJ), cite a substantial number of other areas in which the government could improve regulations and streamline procedures in order to promote a more level playing field and/or help foreign companies to exploit their strengths. Examples include product approval processes in areas as diverse as insurance, medical equipment, and pharmaceuticals; firewall regulations separating the banking and securities business and restrictive rules governing the type of securities that asset managers may deal in; and competitive safeguards in the telecommunications sector.<sup>87</sup> Reforms in each of these areas would not only increase Japan’s attractiveness as a destination for FDI, but would also help to promote competition and increase social welfare through greater consumer choice and/or lower prices.

In this context, one should not ignore the fact that in calling for certain changes, foreign firms are of course also pursuing their own particularistic interests, while government policy should aim at maximizing the welfare of society overall. For instance, complaints about falling reimbursement prices in the health care sector and claims that this hinders the introduction of innovative drugs and equipment, even if justified, have to be balanced against the need to keep health care expenditures in check. However, generally speaking, demands by foreign multinationals are concerned with regulations that skew market access, and the health care

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<sup>85</sup> See, e.g., European Business Council (2005).

<sup>86</sup> European Business Council (2005: 16).

<sup>87</sup> See, e.g., European Business Council (2005). For more details on approval processes in the mentioned industries and firewall regulations, see Paprzycki (2006).

sector provides a host of other examples where regulations (such as the structure of the reimbursement system or product approval processes) do create a bias against foreign products.<sup>88</sup>

Therefore, if the government is serious about attracting more FDI, on the whole it would be well advised to take the issues raised by the foreign business community in the country into account. Annual reports, position papers, and public statements by organizations such as the ACCJ, the EBC, and other foreign business organizations on the business environment in Japan indicate that concerns regarding market structure and access as a result of regulation remain widespread. Addressing these issues would not only dispel the notion that Japan remains a difficult place to do business and make the country more attractive for FDI; it would also contribute to greater competition, not just from foreign firms, and therefore benefit consumers and the economy overall.

Moving on from policies on the functioning and structure of markets, another instrument the government could use to promote inward FDI is tax policy. Reflecting the increasing mobility of multinationals, countries around the world have been lowering corporate tax rates to keep domestic firms from moving abroad and to attract foreign firms. Although this trend has raised concerns about a “race to the bottom,” failing to follow suit would clearly put Japan at a disadvantage. Against this background, effective corporate tax rates were cut in 1999 from 46 percent to 40 percent. However, since then, countries in Europe and East Asia have continued to lower or were in the process of lowering corporate tax rates further. In Europe, the Netherlands reduced the effective corporate tax burden to 20 percent in 2007, Germany decided to lower rates from 2008 from around 38 to 29 percent, and France was considering to cut rates from roughly 34 to 20 percent over a five year period.<sup>89</sup> Similarly, in Asia, Malaysia and Singapore were in the process of lowering, or were planning to lower, corporate taxes.<sup>90</sup> Consequently, at around 40 percent, the level of corporate taxes in Japan seems increasingly out of tune with tax rates of 20 to 30 percent in other parts of the world and there has been a growing debate on lowering corporate taxes to enhance the country’s international competitiveness. Given that Japan continues to have large budget deficits, the Ministry of Finance has been cautious to lower taxes, but, as in other countries such as Germany, the government sooner or later probably will have to redistribute the tax burden by cutting corporate taxes and raising taxes on consumption.

Other tools to encourage FDI are trade policy, international investment agreements, and measures to encourage the free flow of resources, people, and ideas. Trade frequently serves as a springboard for FDI, since firms targeting a new market typically start by relying on exports and increase their presence in the country only gradually. However, Japan’s level of import penetration remains the lowest in the OECD, and tariff and non-tariff barriers as well as product market regulations are partly responsible for this. According to a recent study, the Overall Trade Restrictiveness Index, which measures the combined effect of tariff and non-tariff barriers, is 14.3 percent for Japan, compared with 12.6 percent for the European Union and 8.2 percent for the United States.<sup>91</sup> To some extent, the higher trade restrictiveness may reflect the fact that unlike other advanced economies, Japan is a relative latecomer when it comes to bilateral or regional trade agreements to complement multilateral trade negotiations.

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<sup>88</sup> For details on the regulatory environment and the role of foreign firms in Japan’s health care sector, see Paprzycki (2006).

<sup>89</sup> Nikkei, “Slow to cut corporate taxes, Japan risks losing global edge,” February 3, 2007.

<sup>90</sup> Nikkei, “Slow to cut corporate taxes, Japan risks losing global edge,” February 3, 2007.

<sup>91</sup> Kee, Nicita and Olarreaga (2006), cited in OECD (2006:183).

Yet, while this may explain why Japan's import penetration is low, it also illustrates that there remains ample room for further trade liberalization which would help to boost FDI, too.

Investment agreements, which aim to strengthen the standards of protection and treatment of foreign investors and establish mechanisms for dispute settlement,<sup>92</sup> represent another way to promote FDI. Having relied for many years solely on multilateral trade and investment negotiations, since 2002, Japan has actively pursued bilateral arrangements in the form of Economic Partnership Agreements (EPAs). So called because they cover a range of issues from the removal of tariff and non-tariff barriers to bilateral investment, flows of human resources, and economic and technical cooperation, Japan has entered EPAs with a number of countries. As of April 2007, EPAs had been concluded or agreement had in principle been reached with Singapore, Malaysia, Thailand, Indonesia, the Philippines, Mexico, and Chile. In addition, negotiations were under way or about to start with India, Australia, Vietnam, Brunei, ASEAN as a whole, and the Gulf Cooperation Council, while preliminary discussions were being held with Switzerland.<sup>93</sup> Although EPAs with these countries represent first steps in the right direction, conspicuously absent from this list are Japan's main trading partners: Korea, with which negotiations, as already mentioned, reached a deadlock in 2004, as well as China, the United States and the European Union. Yet, it is with the United States and the European Union that bilateral agreements would have the greatest immediate effect on trade and, in its wake, investment, while agreements with China and Korea would promote investment in the longer term.<sup>94</sup>

Finally, in his 2007 New Year speech, Prime Minister Abe said he would promote the "Asia Gateway Vision" – a collection of measures "with a view to make Japan a place where human resources from Asia and from all around the world gather, enabling Japan to become a center of communication to the world, thereby making Japan an attractive place for Asia and other parts of the world."<sup>95</sup> In order to achieve these goals, ten priority issues are identified, including the liberalization of air travel in Asia, the revision of customs clearance procedures to facilitate trade, promoting student exchanges and opening Japan's university to the world, etc.<sup>96</sup> Such measures could contribute to addressing some of the challenges Japan needs to overcome in order to attract more FDI, such as the low import penetration, the shortage of qualified personnel with an international outlook, and cultural issues more generally, but as is so often the case, the "Vision" is short on detail and unlikely to be implemented quickly. Moreover, even then, many of the measures would contribute to an improved investment climate only in the long run.

### *Business facilitation measures*

In addition to economic factors and the policy framework, a third potential determinant of FDI is government measures to actively attract foreign firms. Such measures may range from

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<sup>92</sup> See UNCTAD (1998: Chapter IV).

<sup>93</sup> Ministry of Foreign Affairs, website on "Free Trade Agreement (FTA) and Economic Partnership Agreement (EPA)" (sic), <<http://www.mofa.go.jp/policy/economy/fta/>> (accessed April 14, 2007).

<sup>94</sup> Japan and China did agree to hold high-level economic talks by the end of year during Chinese Prime Minister Wen Jiabao's visit to Tokyo in April 2007. While this represents a start, such talks are unlikely to yield any tangible results quickly.

<sup>95</sup> Prime Minister of Japan and His Cabinet, "New Year's reflection by Prime Minister Shinzo Abe." Online: <[http://www.kantei.go.jp/foreign/abespeech/2007/01/01shokan\\_e.html](http://www.kantei.go.jp/foreign/abespeech/2007/01/01shokan_e.html)> (accessed April 16, 2007).

<sup>96</sup> Prime Minister of Japan and His Cabinet, "Asia Gateway kiso: Chukan ronten seiri" [Asia Gateway Vision: Interim report on issues"]. Online: <<http://www.kantei.jp/jp/singi/asia/070322ronten.pdf>> (accessed April 16, 2007).

advertising campaigns to change unfavorable perceptions regarding the investment climate to investment incentives and the reduction of “hassle costs.”<sup>97</sup> In Japan, measures to promote inward FDI date back as early as 1984, when the government-owned Development Bank of Japan commenced a loan program specifically aimed at the purpose. Various other measures followed: in 1992, the Import and Inward Investment Promotion Law was passed, offering foreign firms tax incentives and credit guarantees, and a year later, the Foreign Investment in Japan Development Corporation (FIND) was set up to provide foreign companies with investment services and support. The measures were gradually enhanced in the years that followed, but it was only under Koizumi that the promotion of inward FDI became more visible.

Efforts in that direction consist of an information and public relations campaign to signal that Japan is serious about attracting foreign business. The Japan External Trade Organization (JETRO), for example, has held seminars and symposiums in countries around the world on investing in Japan, while Koizumi appeared in a TV spot promoting inward FDI that was aired around 130 times in the United States and Europe.<sup>98</sup> The goals set by Koizumi to double inward FDI, first in 2003, and then again in 2006, could also be regarded as PR measures indicating the government’s determination, since they serve no other real purpose. Other measures have aimed at clarifying, streamlining, and speeding up administrative procedures: JETRO Invest Japan Business Support Centers were established across Japan and one-stop shops in ministries and agencies were set up to provide information and expedite administrative procedures dealing with foreign firms. Moreover, the government has introduced a no-action letter system, which helps to improve the transparency of administrative decisions by providing a written reply to inquiries from companies and individuals about the government’s interpretations of laws affecting them. Finally, the government has attempted to create more favorable employment and living conditions by changing visa regulations, introducing support measures for international schools, and concluding bilateral agreements on pension contributions.<sup>99</sup>

These certainly are useful measures, but more could be done. Advertising that Japan is keen to attract investment may help to change perceptions grown over decades that the country only reluctantly accepts foreign business; but such campaigns are easily undermined when actual policies contradict this message – such as in the case of the postponement of the triangular merger scheme, for example. Similarly, measures to streamline and increase the transparency of administrative procedures and the introduction of the no-action letter system address a long-standing concern of the foreign business community in Japan and therefore have been widely welcomed. Yet, it has also been highlighted that replies are not considered legally binding, oral replies are in some cases still allowed, and the ministries have not actively encouraged its use, so that few no-action letters have actually been issued in areas where they are most needed.<sup>100</sup> There is also further room for improvement when it comes to employment and living conditions. For example, foreigners with a valid visa are still required to obtain a re-entry permit if they wish to leave and re-enter the country; while doing so is little more than a formality, it imposes an unnecessary burden on foreign residents. Another issue is that social security agreements have been entered with only a small number of countries and

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<sup>97</sup> See UNCTAD (1998: Chapter IV).

<sup>98</sup> JETRO (2004b: 31).

<sup>99</sup> See Japan Invest Council, “The follow-up of the Program for Promotion of Foreign Direct Investment in Japan,” Expert Committee Report, April 2006. Online: <<http://www.investment-japan.go.jp/statements/files/20060401-1.pdf>> (accessed April 14, 2007).

<sup>100</sup> European Business Council memo, “Response to queries from OECD on regulatory reform in Japan,” February 18, 2004. Online: <[http://ebc-jp.com/news/OECD%20Briefing%20\(18Feb2004\).pdf](http://ebc-jp.com/news/OECD%20Briefing%20(18Feb2004).pdf)> (accessed April 14, 2007).

mandatory contributions to the Japanese public pension system are refunded to departing expatriates only in part,<sup>101</sup> making working in Japan less attractive than it could be.

An element that governments around the world often rely on to attract FDI but that only plays a negligible role in Japan is investment incentives. Investment incentives typically consist of measures to either increase the return of a particular FDI undertaking or to reduce its costs or risks, for example through reductions in corporate income tax rates, tax holidays, accelerated depreciation, exemption from import duties, etc. In Japan, central government measures are limited to minor tax incentives<sup>102</sup> and loan guarantees.<sup>103</sup> Japan's regions, on the other hand, are increasingly competing to attract FDI, although the incentives offered, such as six-month rent subsidies, are also relatively minor in international comparison.

Generally speaking, this lack of fiscal and financial FDI incentives is probably a good thing. Although a theoretical case for investment incentives focusing exclusively on foreign firms can be made, research suggests that it is rarely a good way to increase national welfare.<sup>104</sup> Moreover, companies are likely to choose a country on the basis of economic determinants and the policy framework for FDI, and incentives can at best play a marginal role. A survey of multinationals covering 74 investment cases, for example, indicates that incentives were frequently not even considered and simply made an already attractive country more attractive.<sup>105</sup>

## 6. Conclusion

Based on the foregoing considerations, the medium- to long-term outlook for FDI in Japan seems rather mixed. On the bright side, the country's economy has finally recovered from its decade-long recession and despite the demographic challenges, there is considerable potential for (catch-up) growth at fairly respectable rates to continue for years to come. Given that the large majority of foreign investments in Japan appear to be of the market seeking variety, improved economic performance should further raise the country's attractiveness, help to raise profit rates and, moreover, facilitate market entry and survival. What is more, the surge in investment seen in recent years in itself may have contributed to lifting the trajectory of FDI inflows into Japan: research suggests that foreign firms learn not only from their own previous investment experience in a foreign country but also from the experience of other firms, helping to raise the likelihood of investment survival.<sup>106</sup> Thus, it is conceivable that the recent wave of FDI may have triggered a positive feedback loop, where the growing presence of foreign firms in Japan helps to attract more multinationals in the future.

Yet, it also needs to be borne in mind that the surge in inward FDI witnessed around the turn of the millennium benefited from a combination of exceptional circumstances, including the global boom in FDI and far-ranging deregulation in Japan. Another significant acceleration in investment inflows, it seems, would require substantial further structural change and deregulation. Because of its high costs, the country is unlikely to become a regional

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<sup>101</sup> See European Business Council (2005).

<sup>102</sup> Designated inward investors are allowed to carry over losses for a period of up to ten years compared with a period of five years for other companies.

<sup>103</sup> See METI, "Details of aid measures." Online: <<http://www.meti.go.jp/english/report/data/cFDI230e.html>> (accessed April 14, 2007).

<sup>104</sup> See, e.g., Blomström and Kokko (2003).

<sup>105</sup> See UNCTAD (1998: 103).

<sup>106</sup> Myles, Mitchell and Yeung (1997).

production or operations base for foreign multinationals. However, it may attract more market-seeking FDI, especially if the government continued to deregulate industries and product markets. In addition, there also appears to be greater potential for FDI of the asset-seeking variety, and in particular the acquisition of firms that possess technological and production capabilities as well as other intangible assets. Japan certainly does not lack firms that would make potentially attractive investment targets for foreign multinationals – be it for market-seeking or asset-seeking reasons. But foreign investors still face a range of obstacles when trying to acquire a Japanese firm – ranging from lingering suspicion toward foreign investment to corporate anti-takeover measures and government policies on M&As that still make it much more difficult to acquire a firm in Japan than in other advanced economies.

Against this background, the most likely scenario for future investment inflows into Japan is one of moderate increases. Overall, the country's economy continues to gradually open up, as is illustrated by the lifting of the ban on triangular mergers, which goes some way toward facilitating the acquisition of Japanese firms and thus raise inward FDI. At the same time, however, Japan is embracing globalization only reluctantly and remains weary of the economic forces unleashed by reforms and structural change. It therefore seems unlikely that the country will be ready any time soon to accept the kind of cross-border M&A activity seen in Europe and the US. Inward FDI penetration therefore is bound to continue to trail significantly behind that of any of the other major advanced economies.



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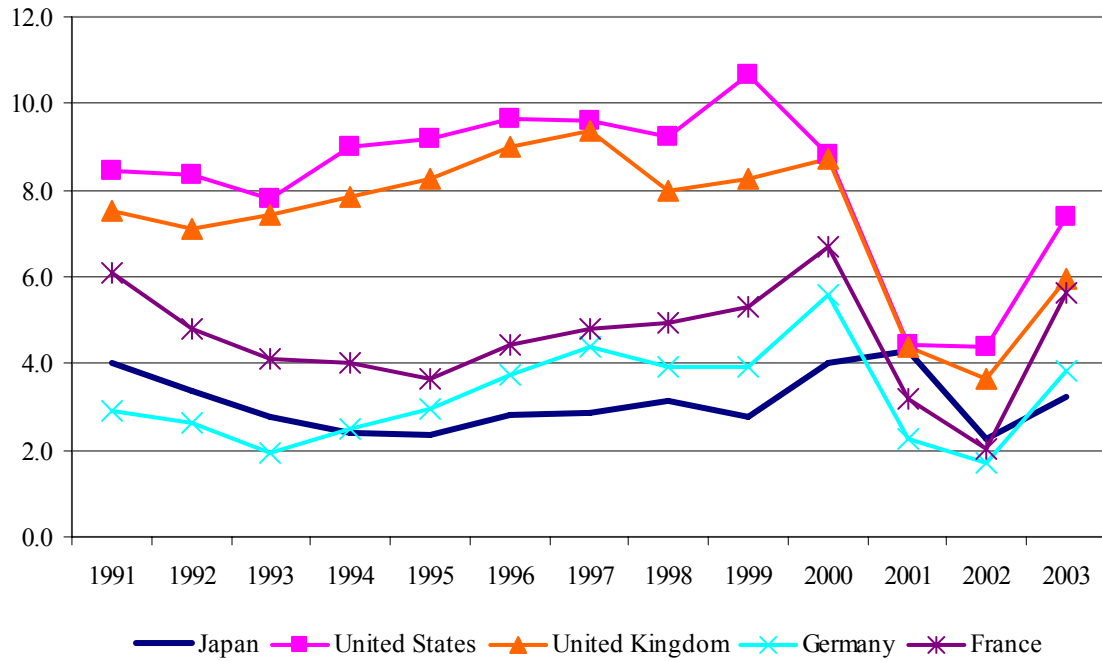
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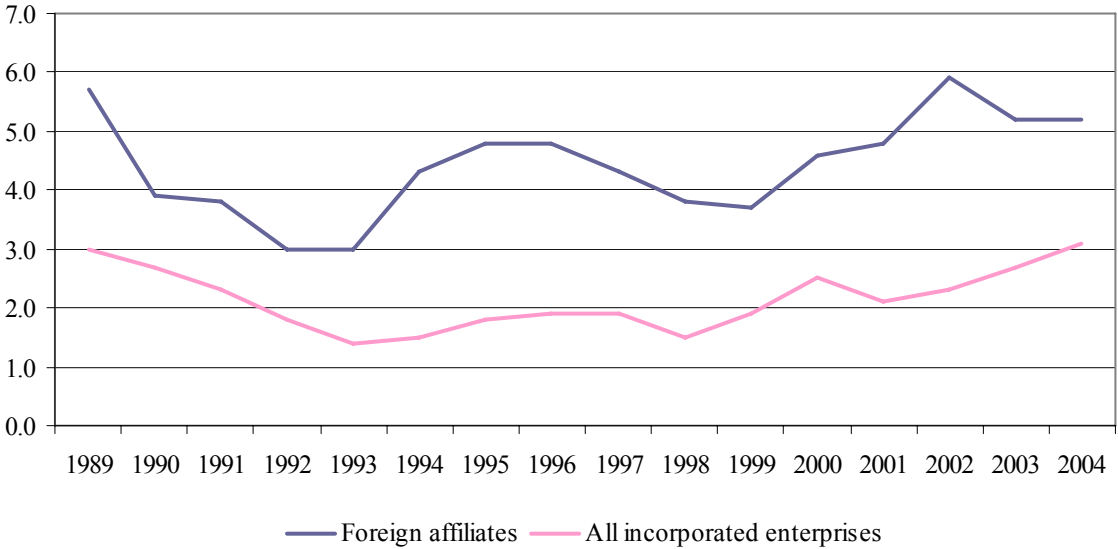
## Figures

**Figure 1: Return on assets in the corporate sector (percent, mean weighted by market capitalization)**



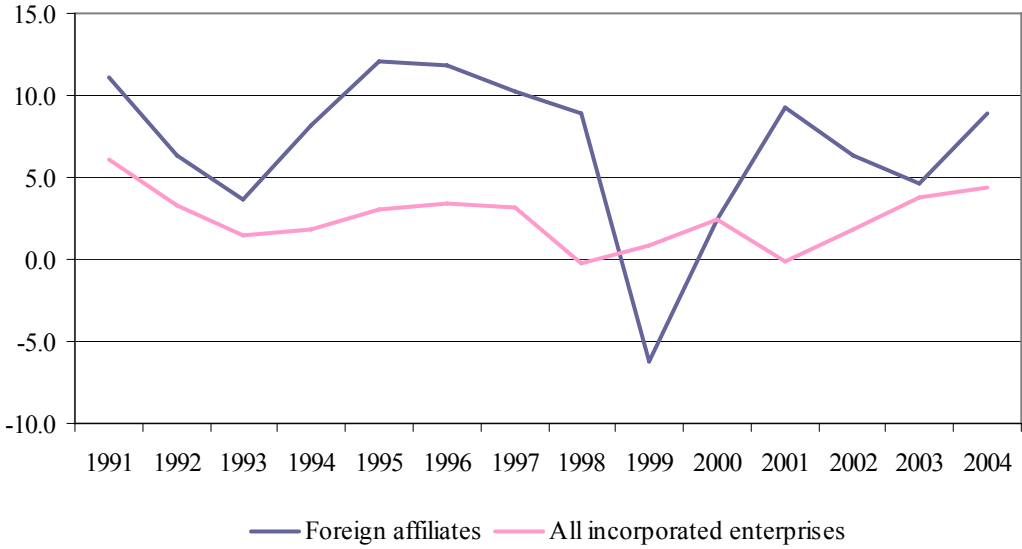
Source: IMF, *World Economic Outlook*, September 2005. Online: [http://www.imf.org/external/pubs/ft/weo/2005/02/chp1data/fig1\\_14.csv](http://www.imf.org/external/pubs/ft/weo/2005/02/chp1data/fig1_14.csv) (accessed April 14, 2007).

**Figure 2(a): Ratio of ordinary profits to sales (percent)**



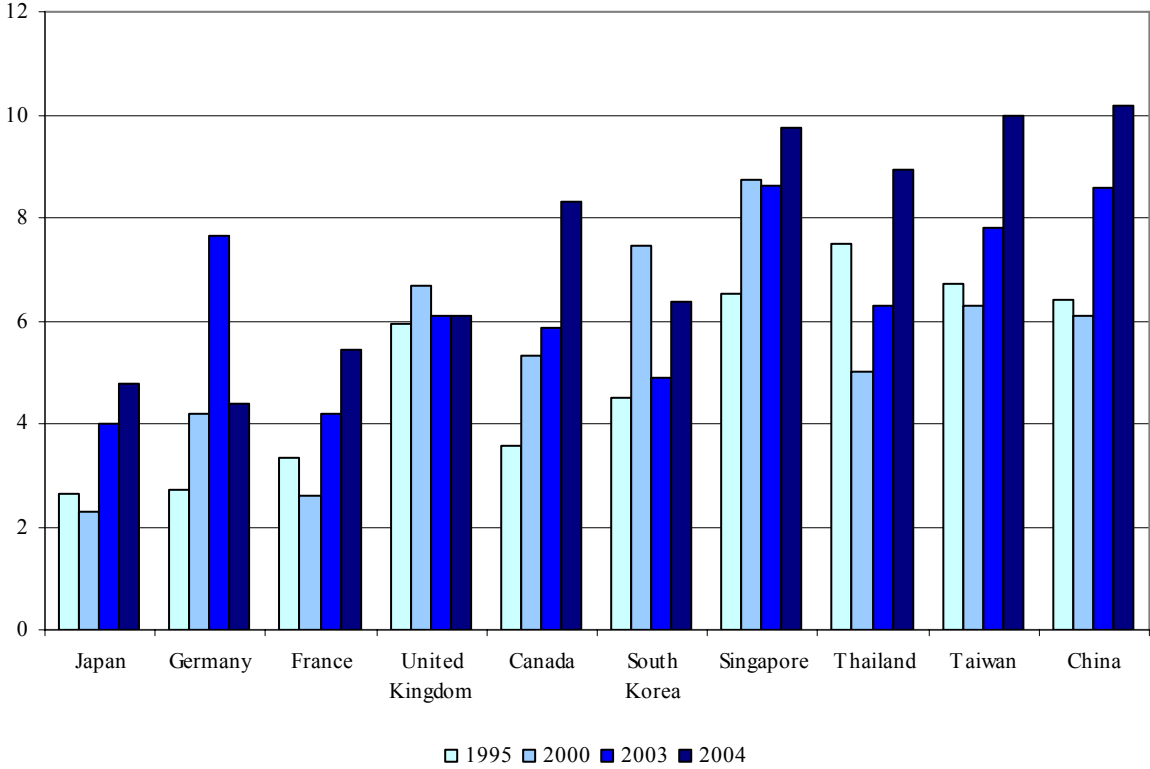
Sources: METI, “Summary of the 1999 Survey of Foreign Affiliates’ Business Activities,” July 2000. Online: <<http://www.meti.go.jp/english/statistics/downloadfiles/h2c201be.pdf>> (accessed April 14, 2007). METI, “The 39<sup>th</sup> Survey of Trends in Business Activities of Foreign Affiliates (Summary),” April 27, 2006. Online: <<http://www.meti.go.jp/english/statistics/downloadfiles/h2c200he.pdf>> (accessed April 14, 2007).

**Figure 2(b): Returns on equity (ROE) (percent)**



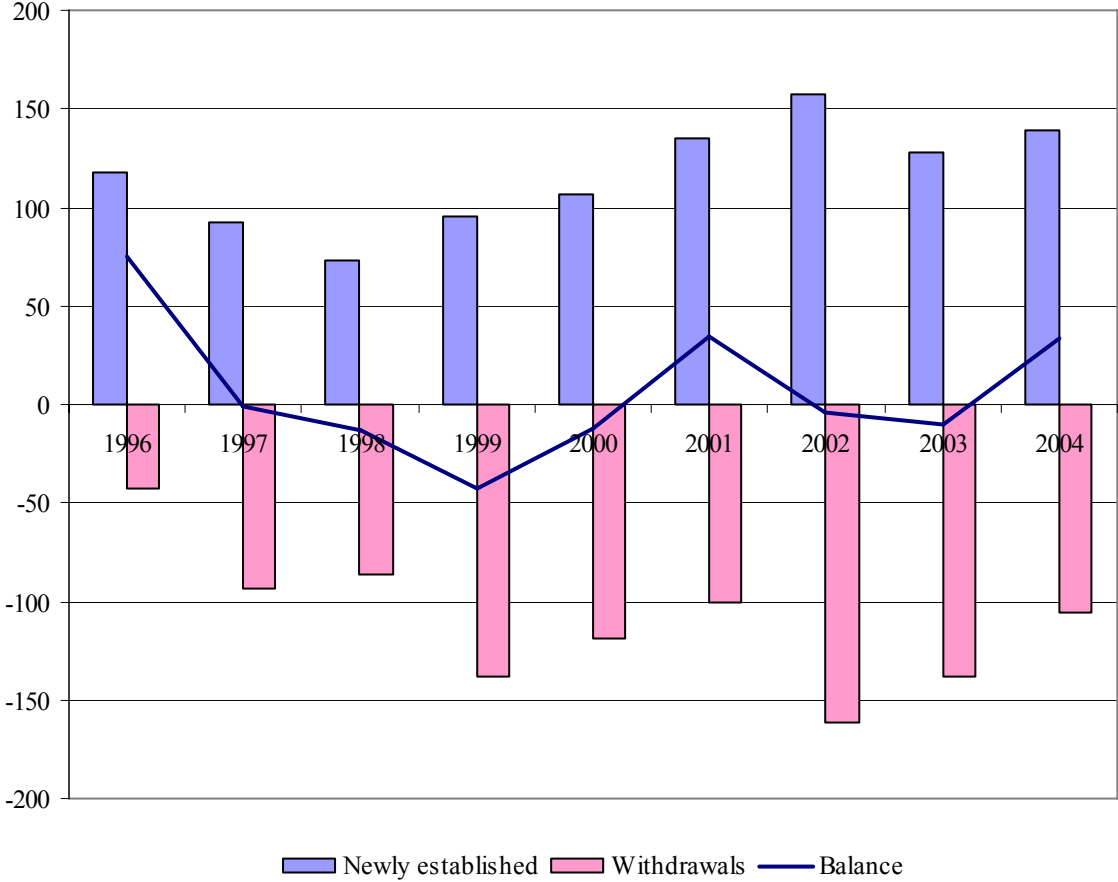
Sources: See Figure 2(a).

**Figure 3: Net income/sales ratio of US affiliates by host country (in percent)**



Source: Bureau of Economic Analysis, “U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates.” Online: <<http://www.bea.gov/bea/ai/iidguide.htm#USDIA1>> (accessed April 2, 2007).

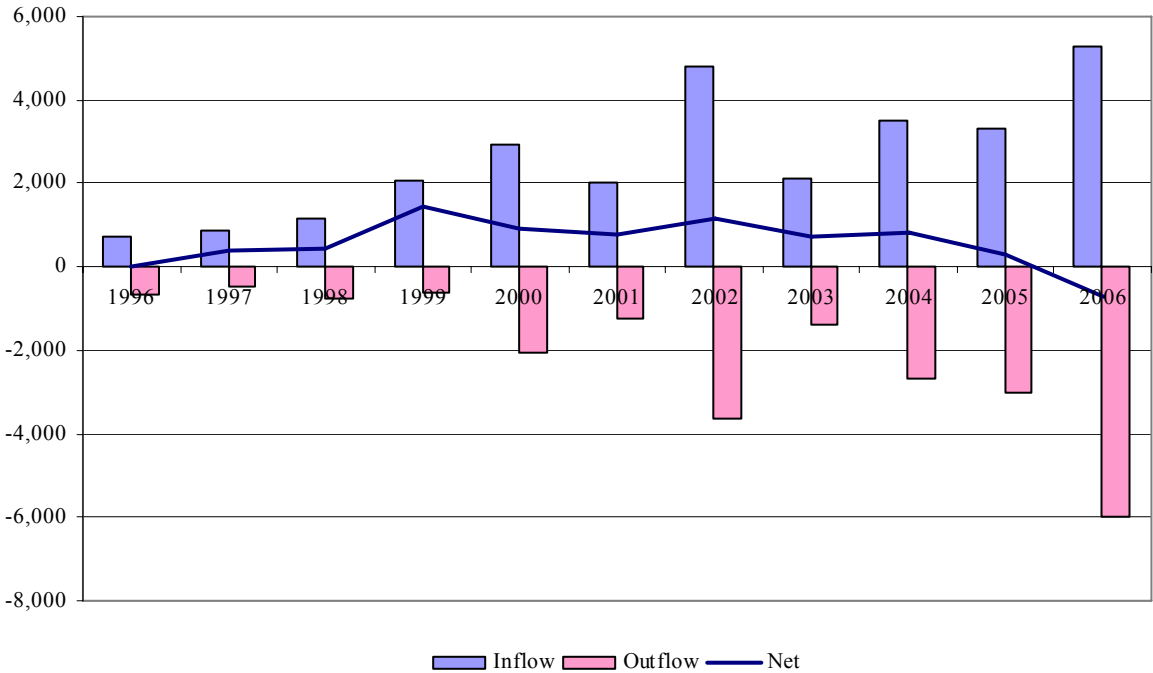
**Figure 4: Number of newly established foreign affiliates and number of enterprises withdrawing**



Sources: METI, “The 37<sup>th</sup> Survey of Trends in Business Activities of Foreign Affiliates (Main Points),” July 27, 2004. Online: <<http://www.meti.go.jp/english/statistics/downloadfiles/h2c200fe.pdf>>. METI, “The 39<sup>th</sup> Survey of Trends in Business Activities of Foreign Affiliates (Summary),” April 27, 2006. Online: <<http://www.meti.go.jp/english/statistics/downloadfiles/h2c200he.pdf>> (both accessed April 14, 2007).

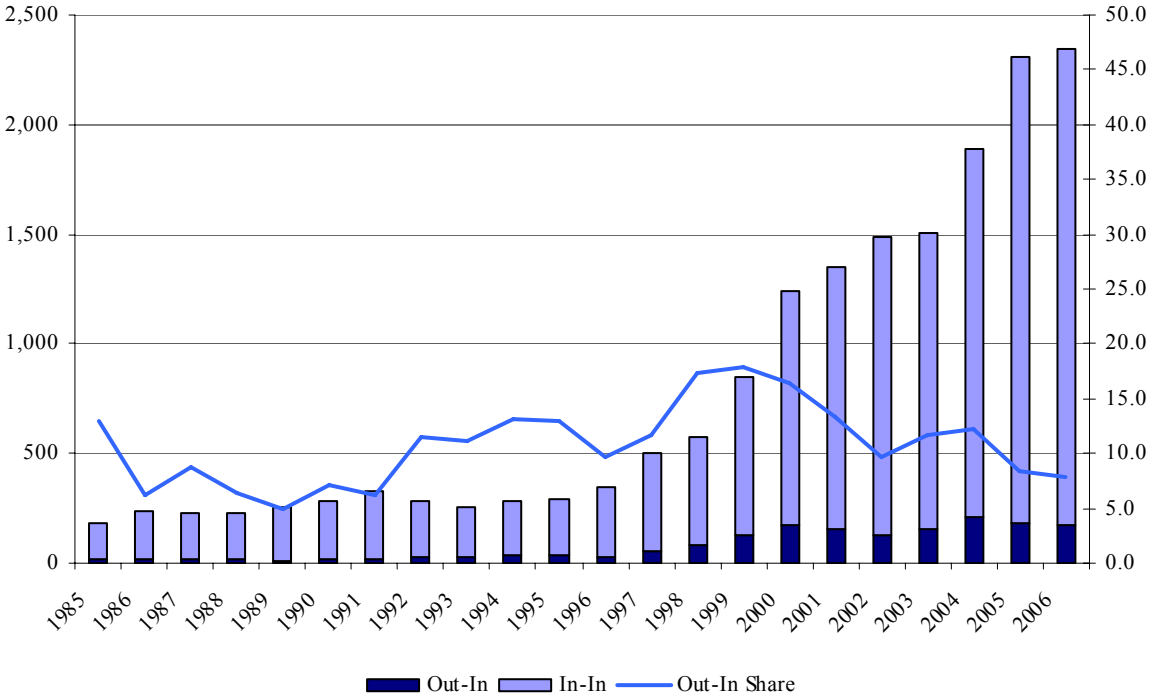


**Figure 5: FDI in Japan: Inflows and outflows (¥ billion)**



Source: Ministry of Finance. Online: <<http://www.mof.go.jp/bpoffice/bpdata/fdi/efdi2bop.htm#bm1>> (accessed April 2, 2007).

**Figure 6: In-in and out-in M&As in Japan (no. of cases; percent)**



Source: RECOF.