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**The Impact of Foreign Direct Investment in Japan:
Case Studies of the Automobile, Finance, and Health Care Industries**

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ABSTRACT

Having historically received very little foreign direct investment, Japan has experienced a substantial increase in such inflows in recent years. This paper analyzes the impact of the growing presence of foreign firms on the Japanese economy through detailed case studies on the automobile, finance, and health care industries. The wholesale & retail and the telecommunications sector are also briefly examined. The case studies show that in the sectors considered, foreign firms in one way or another are contributing to a greater degree of competition, are exposing domestic firms to global best practice, and are increasing the range of products and services available in Japan. In many of the sectors, they are also contributing to changes in industry structure and employment practices. The case studies thus illustrate that foreign direct investment – even at its present levels, which, although large by Japanese standards, are still low in international comparison – can be an important catalyst for change and hence help to reinvigorate the Japanese economy.

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The Impact of Foreign Direct Investment in Japan: Case Studies of the Automobile, Finance, and Health Care Industries

1. Introduction

In recent years, Japan has experienced what by its own historical standards amounts to a veritable boom in inward foreign direct investment (FDI). From 1998 to 2002 alone, investment receipts eclipsed the total for the entire post-war period,¹ and although off their record highs, inflows continue at levels well above those witnessed during the 1990s.² What is more, there is mounting evidence that the presence of foreign companies in Japan is increasingly making a difference to the economy, at least in a number of select industries.

Yet, although FDI has been possible in most sectors for decades,³ the role that foreign companies are playing in the Japanese economy has to date received little research interest.⁴ The large majority of studies, instead, has focused on trying to explain why FDI in Japan has been so low and has rarely looked beyond this.⁵ While such neglect may be understandable in the context of the 1980s and even the 1990s, when inward FDI was indeed miniscule, this is no longer the case today. For example, following the surge in FDI into Japan, foreign-owned firms now account for more than 10 percent of employment in industries as diverse as drugs & medicine, chemicals, electrical machinery, motor vehicles & parts, miscellaneous transport equipment, financial intermediary services, and insurance (see Table 1 below for details). What is more, even in sectors where foreign firms continue to make up only a relatively small proportion of economic activity, they can have a significant impact in their industries and beyond – for example, through the products, management skills, and business models they introduce and the competitive pressure they exert.

The purpose of this paper is to investigate this impact in greater detail through a series of case studies of different sectors of the economy. In particular, the aim is to show how foreign companies are contributing to changes in the “landscape” of their respective industries. Multinational companies investing in a foreign country do so on the strength of their intangible assets, such as managerial skills, accumulated know-how, intellectual property, business models, brand names, etc., and, by deploying these assets in an acquired company or a newly-established entity, potentially introduce novel business practices and products and change the competitive parameters of their industry.

The approach chosen in this study is to examine the various ways in which foreign multinationals have done just that. To this end, the individual case studies examine the particular structure of an industry, the regulatory framework (where this has played a role in shaping the industry) and recent changes therein relevant for foreign direct investment. They then consider the role of foreign direct investment in the sector, hone in on prominent cases of

¹ Calculated on a notification basis.

² For a detailed description and analysis of recent trends in inward FDI in Japan, see Paprzycki (2004).

³ For a historical overview of foreign direct investment in Japan and FDI regulations, see Paprzycki and Fukao (2005).

⁴ Probably the only in-depth analysis of the role of foreign companies in Japan is the excellent historical overview provided by Mason (1992), which, however, ends in 1980.

⁵ Examples are Lawrence (1993), Weinstein (1997) and the various chapters in Yoshitomi and Graham (1996).

FDI, and show how the presence of foreign multinationals in one way or another has affected domestic firms or the industry as a whole.

Sectors examined in detail include the automobile industry, banking and insurance, and the health care sector (pharmaceuticals, medical devices, and health care services). Brief consideration will also be given to the wholesale & retail sector and telecommunications. As this list indicates, the scope of sectors covered is quite broad, ranging from manufacturing to services and from industries wide-open to foreign direct investment to those in which government regulations in effect continue to make FDI impossible. The analysis thus covers a fairly representative cross-section of Japanese industry.

The remainder of the paper is organized as follows. Section 2 looks at the automobile industry, focusing in particular on Renault's acquisition of Nissan and the growing presence of foreign suppliers in Japan. Section 3 turns to the financial sector, examining in detail the areas of investment banking, retail banking and insurance. Section 4 discusses the health care industry, concentrating on the pharmaceutical industry and the medical devices industry, but also considering health care services, a sector in which foreign direct investment remains impossible as a result of entry regulations on corporate providers. Section 5 then presents a brief examination of two further sectors – wholesale & retail and telecommunications – which have attracted substantial amounts of FDI, but which cannot be considered in detail here. Section 6, finally, provides a synthesis of the individual case studies and concludes.

2. Automobile industry

There is probably not a more suitable industry with which to begin the sectoral analysis of foreign direct investment in Japan than the auto industry. This is by far the country's most internationalized industry: motor vehicles and parts account for a large share of all Japanese merchandise exports, and overseas production by the car industry is far ahead of that of any other Japanese industry.⁶ Conversely, foreigners have been able to invest in the sector for decades, and General Motors (GM) and Ford acquired substantial stakes in Japanese auto makers in the early and late 1970s, respectively. As a result, even before the wave of FDI in the late 1990s, the auto industry was already the sector in Japan with the highest share of employment by foreign-owned companies (Table 1).

Insert Table 1

Yet, at the same time, even this relatively internationalized sector has remained essentially Japanese. Although foreign companies have acquired controlling stakes in a number of Japanese automakers, no wholly foreign-owned manufacturer actually produces cars in Japan;⁷ foreign parts makers have only recently begun to penetrate the market; and foreign

⁶ In 2004, motor vehicles and parts exports made up 19.3 percent of Japan's merchandise exports. The overseas production ratio of the Japanese car industry reached 32.6 percent in 2003, followed by the electronics industry with an overseas production ratio of 23.4 percent (Overseas production ratios from: Ministry of Economy, Trade and Industry, *Kaigai Jigyo Katsudo Kihon Chosa, Dai-34-kai (2003) [The 34th Survey of Overseas Business Activities]*. Online: <<http://www.meti.go.jp/statistics/downloadfiles/h2c402gj.pdf>> (accessed 26 January, 2006).

⁷ For this reason, the Japan Automobile Manufacturers Association (JAMA) has no foreign members, since a prerequisite for membership is to have manufacturing operations in Japan.

brands continue to be relatively exotic. Though fiercely competitive, the Japanese market has been and continues to be dominated by domestic car makers. Imports of foreign cars account for less than 5 percent of total domestic sales. Compare this with the situation in Europe or the United States, where both imports and local production by wholly-owned foreign subsidiaries have long commanded considerable market shares. In Europe, for example, non-European makers alone accounted for about 39 percent of new car registrations in 2004.⁸

What is more, until recently, foreign participation in Japanese car makers has had little impact on the way the Japanese car industry operates. Despite substantial shareholdings by GM and Ford, the “Suzuki production system” or the “Mazda production system” have not been very different from the famous “Toyota production system” characterized not only by just-in-time production and lean manufacturing (now copied by most Western competitors), but also by a number of other Japanese business practices, such as close and long-term ties with dedicated (Japanese) suppliers, lifetime employment, and the reluctance to close factories in difficult times.⁹ Thus, though the car industry appears relatively internationalized by Japanese standards, in comparison with other countries it still remains very much a home-grown affair.

Nevertheless, the Japanese car industry today looks quite different from a decade ago as a number of international and domestic factors paved the way for foreign companies to gain a greater foothold in the Japanese market. On the international side, factors include the resurgence of volume producers in Europe and the U.S. during the 1990s as the former managed to strengthen brand images and the latter achieved quality improvements that diminished the competitive advantage of Japanese carmakers. At the same time, the 1990s were a period of global industry consolidation as carmakers entered vertical and horizontal alliances for the complementation of vehicle types and marketing areas.¹⁰ All the while, global capacity was growing and Japanese manufacturers were not always well positioned to react to shifts in consumer tastes (such as the growing popularity of light trucks in the United States). Factors on the domestic side include the prolonged malaise of the Japanese economy and the maturation of the Japanese car market – annual car sales in Japan dropped from a peak of 5.1 million units in 1990 to a trough of 4.1 million in 1998 – as well as difficulties at some companies to adapt to the new environment.¹¹ International and domestic factors combined to erode the competitiveness of Japanese carmakers and meant that the industry consolidation that was sweeping the globe eventually also reached Japan.

By far the most conspicuous cases were the acquisition of a controlling interest in Nissan by the much smaller French rival Renault and the tie-up between DaimlerChrysler and Mitsubishi Motors Corporation (MMC), which made headlines worldwide. But, as shown in Table 2, there were also a number of other, less conspicuous deals involving car assemblers. General Motors progressively increased its stakes in Suzuki and Fuji Heavy (Subaru) to 20 percent each, while Ford increased its holdings in Mazda to 33.4 percent, the ownership share required to gain a measure of management control. Meanwhile, in an entirely domestic tie-up,

⁸ This figure counts the European sales of Japanese and Korean makers and of the two core brands of the American auto giants GM (Opel/Vauxhaul) and Ford. Source: European Automobile Manufacturers Association.

⁹ However, it should be noted that not all car manufacturers have used this “Japanese” production system with equal success. Research by Ito (2004) and Ito and Fukao (2001) indicates that some assemblers were much better than others at squeezing cost reductions out of their suppliers during the early 1990s. Although information for individual companies is not available, it seems almost certain that Toyota was much more successful at this than other firms such as, for example, Nissan.

¹⁰ Development Bank of Japan (2000).

¹¹ Car sales have recovered somewhat from the low in 1998, reaching 4.8 million units in 2004. Figures from Japan Automobile Manufacturers Association. Online: <http://www.jama.org/statistics/motorvehicle/sales/mv_sales_year.htm> (accessed 9 February, 2006).

Toyota boosted its investment in Daihatsu to 51 percent. What is more, foreign investment in the sector has not been confined to final assemblers as foreign parts suppliers have also increased their presence in Japan. Examples include Bosch (Germany), Valeo (France), Autoliv (Sweden), and Mahle (Germany), which all have acquired stakes in Japanese parts suppliers in recent years.

Insert Table 2

Case study: The Renault-Nissan alliance

Before examining changes in the Japanese car industry more generally, it is useful to have a closer look at the alliance between Renault and Nissan. Not only has this been the foreign investment in Japan that has received by far the most attention, it is also the one that has probably had the greatest impact on the Japanese car industry and beyond.

Prior to the alliance with Renault, Nissan was a company in long-term decline: the Japanese car maker's share both of the domestic and the global market were dropping, production volumes were falling, and the company was on the verge of bankruptcy, having registered losses in six of the seven years between 1992 and 1999, including the record loss of almost ¥700 billion in 1999. The desperate state meant that the new management team from Renault led by Carlos Ghosn had considerable leeway to undertake drastic restructuring measures.

The most publicized and controversial among these was the reduction of excess capacity by closing five factories in Japan and cutting the global workforce by 21,000, with 16,000 jobs axed in Japan. Similarly controversial was the dissolution of Nissan's *keiretsu*, i.e. the sale of many of the company's non-strategic assets, including stakes in the large majority of its more than 1,100 suppliers. This step went hand-in-hand with a streamlining of supplies. Whereas Nissan's purchases of parts and materials had previously been organized by country or region, they were now to be organized on a global scale and combined with those of Renault through the newly established Renault Nissan Purchasing Organization. Internal comparisons between Renault's and Nissan's purchasing costs had revealed that the latter was paying a substantial premium on identical parts and components, and using common purchasing represented one way in which it was possible to lower costs. Another was the reduction in the number of suppliers for parts and materials to 600, allowing those suppliers that continued to do business with Nissan to enjoy economies of scale.

A further area in which operations were streamlined and global best practice was introduced is Nissan's financial operations. Nissan had no chief financial officer until 1996 and when one was introduced, he did not have access to all necessary information.¹² As a result, Nissan did not know whether a particular car it was selling was making money for the company or not. In addition to the sale of non-core assets, one pillar in the effort to reduce Nissan's crippling debt burden consequently was to make the management of the company's financial operations a top priority, centralizing financial functions in Tokyo, and repatriating debt to Japan.

¹² Ghosn and Riès (2005).

But the overhaul of the way Nissan does business did not stop there. Other areas affected were the company's employment policies, where merit-based promotions and remuneration replaced the traditional seniority-based system; the introduction of outside talent not only from Renault, but also from other Japanese companies such as the new head of design, who came from rival car maker Isuzu; and the company's communication with the press, shareholders, and employees, establishing a culture of corporate transparency.

What many of the measures have in common is that they have instilled a profit-orientation into Nissan's operation that was previously lacking and have turned the company from one that only had a strong worldwide presence into one that actually coordinates all its activities from a global perspective. This approach is most visible in the reorganization of Nissan's purchasing policy and the relationship with its suppliers. But it can also be seen in the company's financial operations, its product design strategies, and the deployment of assets.¹³

The outcome of the restructuring effort is well-known: a turnaround from the record loss in 1999 to successive record profits in every one of the following years and industry-leading operating margins. What is more, the declining trend in domestic sales has been reversed and Nissan appears to have been able to steal market share from rivals Honda, Mazda and Mitsubishi, the latter having suffered a collapse in sales in recent years due to ongoing quality problems. The number of Nissan's worldwide employees, on the other hand, has continued to contract slightly to about 123,700, down from 141,500 before the restructuring efforts began.

Renault-Nissan: The repercussions

The repercussions of the alliance between Renault and Nissan go considerably beyond its immediate impact on the Japanese carmaker itself, its suppliers, and its rivals. From the start, the Renault-Nissan case has been in the public eye like few other foreign direct investments, meaning that it has played an important role in shaping public perceptions of foreign companies and their business methods in Japan. For example, cutting the global workforce by 10 percent, closing five factories in Japan, and selling most of Nissan's shareholdings, were drastic steps by Japanese standards. But because they were quickly vindicated by greatly improved business results, they have probably helped to make such measures more acceptable, though so far no other major car manufacturer, none of which have been in similarly dire straits, has followed suit.

Turning to the impact of the alliance on Japan's auto industry, it would be difficult to claim that Renault's investment in Nissan has led to greatly increased price competition or introduced qualitatively new products in the market. Of course, Nissan's renewed strength exerts pressure on its rivals, but, as already mentioned, Japan's car industry is used to fierce competition at home. Similarly, Nissan's revival of course partly owes to newly developed products that appeal to consumers, but these do not represent a genuinely new type of product previously unavailable in Japan.

However, there are at least two areas in which the Renault-Nissan alliance has had an impact on its peers and the wider industry. The first of these is managements' focus on profitability. For much of the post-war era and continuing well into the 1990s, Japanese business strategies

¹³ For example, design units in Japan and the United States now work closely together to build a global brand identity. And almost at the same time that Nissan was closing factories in Japan, where it was suffering from excess capacity, it was building a new factory in the United States for the production of pick-up trucks for the North American market.

tended to focus on market share; profitability, in contrast, often was a secondary objective. In recent years, though, a greater emphasis on profits and profitability can be observed. For example, in Toyota's annual report for FY2000, the word "profitability" appears only three times, and each time only in a general discussion of what factors might affect the company's financial results. But that number increases to twelve in the FY2004 annual report, which is littered with statements such as: "[O]ne of the major management tasks that Toyota faces today is the optimal deployment of its existing management resources to facilitate business expansion, *strengthen profitability*, and train personnel" [emphasis added].¹⁴ While no similar linguistic shift can be observed at Nissan's and Toyota's main rival, Honda – the term "profitability" does not occur once – the FY2004 annual report does carry this statement: "[W]e consider redistribution of profits to shareholders as one of our most important management issues."¹⁵ An important reason for the growing emphasis on profitability and shareholder value probably is the increasing ratio of shares held by foreign portfolio investors.¹⁶ However, another contributing factor is likely to have been Ghosn's single-minded focus on bottom line results at Nissan. Not only has this increased the pressure on other company's do likewise, Nissan's industry-leading operating margins have also raised the bar for its competitors.

The other area where the Nissan-Renault alliance has had wider repercussions is in the supplier industry. As mentioned above, the reorganization of Nissan's parts purchases consisted of two elements: first, the streamlining of such purchases on a global scale through the Renault Nissan Purchasing Organization. Traditionally, Nissan had placed orders for the same part with more than one *keiretsu* supplier. Now, however, mass orders were to be placed with one global supplier. For Renault and Nissan, this meant they were able to exploit synergies and gain bargaining power vis-à-vis suppliers as a result of the increased scale of orders, while suppliers were able to exploit economies of scale, helping them to lower costs. But for Nissan's traditional *keiretsu* suppliers, the new arrangement also meant increased competition and screening out as the number of Nissan's suppliers was halved from around 1,200 to about 600.¹⁷

The second element in the reorganization of parts purchases was the dissolution of Nissan's *keiretsu*, i.e. the sale of its stakes in all but four of the 1,394 companies in which Nissan held stocks. Rather than indiscriminately offloading its shareholdings, though, Nissan typically sought to arrange tie-ups with other Japanese or with foreign companies.¹⁸ The most important among the domestic tie-ups was that between Calsonic and Kansei, creating a global player that has been able to boost sales by 70 percent from a combined ¥405 billion before the merger (2000) to ¥695 billion in 2004. Meanwhile, the car electronics business of Unisia Jecs, another major *keiretsu* supplier, was sold to Hitachi (which turned the company into a wholly-owned subsidiary in 2002), while the transmission division was sold to Valeo of France, one of the biggest parts makers in Europe and the largest parts suppliers to Renault.¹⁹

¹⁴ *Toyota Annual Report 2004*, p.11.

¹⁵ *Honda Annual Report 2004*, p.3.

¹⁶ The percentage of shares held by foreign investors in Toyota in March 2005 was 23.3 percent, while the corresponding figure for Honda was 35.8 percent. Source: *Japan Company Handbook* (Japanese version).

¹⁷ See Ikeda and Nakagawa (2002) and Magee (2003).

¹⁸ In selling its stakes in suppliers, Nissan was careful not let suppliers fall into the hands of its Japanese competitors. This explains why a large number of suppliers were sold to foreign companies. For the same reason, suppliers were also not sold to financial firms, because these might resell suppliers to domestic competitors. See Economic and Social Research Institute (2005).

¹⁹ Further examples of domestic tie-ups involving Nissan suppliers abound, including the acquisition of a 6.5 percent stake in Kinugawa Rubber by Toyo Tire and Rubber (1999), a 23.4 percent stake in Exidy by Aisin Seiki (2001), a 23.7 percent stake in Fuki Kiko by Koyo Seiki (2001), etc. Source: JETRO (2005a).

Valeo was also encouraged by Ghosn and his team to acquire Nissan's shareholdings in Ichikoh Industries, which in turn invested capital in Valeo.²⁰ Other international tie-ups involving major Nissan suppliers were the sale of seat maker Ikeda Bussan to Johnson Controls of the U.S., and of a 30.8 percent equity stake in suspension maker Yoruzu to Tower, also of the U.S.

The dissolution of the Nissan *keiretsu* thus has allowed a number of foreign companies to become suppliers to Nissan for the first time. More than that: it has provided them with production bases in Japan through the joint ventures and capital tie-ups they entered with former Nissan affiliates. But the alliances also provide benefits for the Japanese side. The tie-up between Valeo and Ichikoh, for example, includes the shared utilization of plants, thus giving the latter a foothold in Europe and elsewhere, helping it to meet Nissan's requirement for suppliers that are competitive on a global scale.

Suppliers and the keiretsu

The described tie-ups between former Nissan *keiretsu* members and foreign parts makers represent only a fraction of the growing tide of collaborations between Japanese suppliers and foreign counterparts. Between 1997 and 2004, there were at least 24 cases in which foreign parts manufacturers have acquired stakes in Japanese companies or entered joint ventures.²¹ This development forms part of a worldwide trend toward modularization and systematization, in which suppliers deliver parts to auto manufacturers in the shape of partially assembled units (modules) and functionally integrated units (systems), with parts suppliers assuming responsibility for design and development as well as assembly, and which, in turn, has led suppliers to broaden their capabilities through joint ventures and mergers and acquisitions.²² Driven largely by American and European mega-suppliers such as Delphi and Visteon (the former in-house part manufacturing departments of GM and Ford), Bosch (Germany), ZF Sachs (Germany) and Valeo (France), the supplier industry thus has seen a similar trend toward global integration as the car assembly industry itself.

Despite the size of Japan's car industry, only two of the country's suppliers, Denso and Aisin Seiki, both affiliates of Toyota, rank among the global top ten. Most other suppliers, though strong in specialized niche markets, lack the scale of their foreign competitors, as indicated by their respective sales, which for many Japanese parts makers are in the order of several hundred billion yen (several billion US\$), compared with several trillion yen (tens of billion US\$) for the likes of Bosch, Delphi, or Visteon.²³ This means that many Japanese suppliers are struggling to muster the financial and managerial resources to provide the global supply capacity and enhanced development capability required by carmakers today.²⁴ While some Japanese parts makers have acquired foreign affiliates, accepting foreign capital through M&As or entering joint ventures often represents the best way to respond to globalization and the need for modularization and systemization.

²⁰ Ikeda and Nakagawa (2002).

²¹ Based on JETRO (2005a: 70-71), Figure 49.

²² Development Bank of Japan (2000).

²³ Calsonic and Kansei, the two former Nissan *keiretsu* suppliers, for example, had sales of ¥280 billion and ¥130 billion, respectively, in 2000, the year before their merger. Even after the merger and rapid growth, the sales of about ¥700 billion in 2004 reached only about a quarter of Delphi's or Bosch's (automotive technology only), which were in the region of US\$30 billion.

²⁴ Development Bank of Japan (2000).

The dismantling of the Nissan *keiretsu* with the aim not only of returning Nissan's balance sheet to an even keel but also of creating a network of world-class suppliers that can shoulder greater responsibilities in terms of independent design and development of modules clearly fits in with this pattern. However, it is important to note that the issue of supplier-manufacturer relationships is not a question of "superior" Western management techniques versus "outdated" Japanese practices. A case in point is Toyota, which has gone from strength to strength, overtaking Ford as the world's second-largest automotive manufacturer in terms of sales (if the sales of truck maker Hino are included). Yet, Toyota has gone in the opposite direction from Nissan, raising its shareholding in compact car maker Daihatsu to a majority stake in 1998 and making truck maker Hino a subsidiary in 2001, while its closest affiliate and former parent, Toyoda Automatic Loom, increased its ownership of Toyota's most important suppliers, Denso and Aisin Seiki.²⁵ Such steps have been interpreted as defensive moves to reassert control over *keiretsu* members at a time when these large suppliers were becoming increasingly independent-minded and foreigners were acquiring stakes in parts makers that were also important suppliers to Toyota.²⁶ Yet, it is interesting to note that Nissan, too, has recently moved to strengthen its ties with remaining *keiretsu* suppliers again. Having at one point considered selling its stake in Calsonic to Delphi, Nissan raised its shareholding in the merged Calsonic Kansei in November 2004 from 27.6 percent to 41.7 percent, turning it into a consolidated subsidiary in order to retain close control over a supplier that provides the company with key technology.²⁷ Thus, it remains to be seen what kind of supplier network configurations will prove more successful in the future. What is clear, though, is that the growing presence of both foreign carmakers and parts suppliers has led to a greater diversity in organizational arrangements.

The Toyota example also shows that the *keiretsu* and traditional supplier-assembler relationships continue to matter in large parts of Japan's automotive industry. One important reason that Toyota has strengthened the relationship with its suppliers is that it wants to retain close control over product development for parts and components. This type of strategy, however, has also led to complaints from foreign parts companies that suppliers are still expected to "build-to-print" the traditional Japanese way, suggesting that they continue to face difficulties in doing business in Japan as a result of the reluctance to outsource product development on a global basis.²⁸ Similarly, even though European suppliers have been able to expand their sales in Japan, the supplied parts and components are largely for vehicles destined for export to European markets only and not for models sold in Japan, the U.S. or other overseas markets. While this helps Japanese car manufacturers to meet European standards and reduce political friction, it limits European suppliers' prospects in Japan.²⁹

Finally, another illustration of the continuing importance of the *keiretsu* is provided by the hapless DaimlerChrysler-Mitsubishi Motors alliance. MMC's membership of the larger Mitsubishi *keiretsu*, the core of which includes Tokyo Mitsubishi Financial Group, Mitsubishi Corporation, and Mitsubishi Industries, is generally considered to be a major reason why the alliance failed. Not only did the tightly-knit *keiretsu* relationships make it more difficult for the new German management to overhaul supplier relationships. The knowledge that in an emergency the other group companies would come to the rescue, as they eventually did, also

²⁵ Hino website; Ahmadjian and Lincoln (2001).

²⁶ See *Purchasing.com*, "Supplier landscape shifts as companies seek global strategies", 13 January, 2000

²⁷ Economic and Social Research Institute (2005) and *The Nikkei Weekly* (online), 24 January, 2005, "Ghosn recasting keiretsu supplier." The latter quotes Ghosn as saying: "Not everything about the *keiretsu* is wrong. It simply did not function properly under Nissan in the past. From now on, we need stronger ties."

²⁸ *Autoasia*, Q1, 2004, p.68.

²⁹ A.N.R. Millington, Director General of the Tokyo Office of the European Automobile Manufacturers Association, interview on 13 May 2005.

meant that at MMC there was much less of a sense of crisis and much greater resistance to change than at Nissan. Following scandals involving cover-ups of defective vehicles and mounting losses, MMC was abandoned to its fate by DaimlerChrysler in August 2004 and its future remains highly uncertain.

Summary

Globalization of the car industry has proceeded rapidly over the past decade or so, and today, most major players operate, either directly or through alliances, in the major markets of North America, Europe, Asia and beyond. Among Japan's industries, too, the automotive sector has been at the vanguard of internationalization, both through exports and overseas production. Yet, Japan's car industry remains much less globalized than its counterparts in Europe and the United States. Not only is there no wholly-foreign carmaker manufacturing vehicles in Japan. If the Nissan case is representative, Japanese companies, although operating internationally, have also been slow to adopt an integrated global business perspective.

At least to some extent, this has begun to change in recent years. Foreign companies have been able to make inroads, entering equity participations or joint ventures with Japanese companies. In the process, they have introduced advanced management techniques (such as in Nissan's financial operations) and Western-style employment practices (such as performance-based promotion and remuneration). They have also contributed to a shift in the management objective of Japanese companies from market share to profitability.

But probably the most important area in which foreign companies have been a catalyst for change is in industry structure. The dissolution of the Nissan *keiretsu* has meant that, on the one hand, about half of the company's traditional suppliers have lost (one of) their main customer(s). On the other hand, the reorganization of parts procurements at Nissan has helped some traditional suppliers, such as Calsonic Kansei, to expand, and has opened the door to new, often foreign suppliers. But consolidation in the supplier industry has not been confined to Nissan *keiretsu* members, as a growing number of foreign companies have acquired stakes in other Japanese counterparts or entered joint ventures. This not only has made the composition of the car industry in Japan more international but has also helped Japanese suppliers to strengthen their global capabilities to serve customers worldwide.

3. Banking and insurance

Long cosseted by government regulation and structural entry barriers, the banking and insurance sectors provide a vivid illustration both of the substantial changes that have taken place in Japan over the past decade and of the remaining challenges ahead if the country is to develop globally competitive service industries. To be sure, much of the transformation of Japan's financial sector is the result of domestic forces and foreign companies have at best played a marginal role. Yet, in those areas where foreign players have gained a foothold, their impact is clearly visible.

However, to understand the role of foreign direct investment in the sector, it is necessary to make a brief excursion and consider banks' and, to a lesser extent, insurance companies' place in Japan's economic system. Financial institutions have been at the heart of what by the 1980s often came to be referred to as "Japan Inc.", the monolithic *keiretsu* system with the

banks and insurance companies at the center of tightly-knit webs of cross-shareholdings. A central element of this arrangement, in turn, was the main-bank system, characterized by strong established ties between domestic banks and their corporate clients. Loans from city banks (commercial banks) would typically provide the main source of external funds for most companies and banks often held significant equity interests in their corporate clients, getting closely involved in companies' managerial affairs in time of financial distress. Similarly, insurance companies would be major long-term shareholders in firms belonging to the same business grouping. Under this arrangement, stringent government regulation of the financial sector and the "convoy system" – meant to guarantee stability by preventing laggards from falling behind and leaders from moving too far ahead – thwarted competition and innovation in products and services and conventional lending to corporate clients provided the major source of income for Japanese banks. Likewise, insurance companies all tended to offer the same standardized services and products.

However, the traditional system has come under substantial strain as a result of the ongoing economic malaise, financial deregulation, and other economic reforms. In the banking sector, non-performing loans – a hang-over from the burst of the bubble economy – and failure on the part of the government to decisively deal with the problem meant that by the end of the 1990s, the entire financial system was teetering on the brink of collapse. Between 1997 and 2003, a number of securities firms, including one of the country's Big Four, Yamaichi, two of the three long-term lending banks, Long Term Credit Bank and Nippon Credit Bank, and several regional banks, including Hokkaido Takushoku, Kofuku, and Ashikaga banks, went bankrupt and, in most cases, were nationalized.

The life insurance industry was similarly creaking under the burden of negative carrying costs – the shortfall between guaranteed pay-outs to customers on insurance products and the minimal or negative return on assets resulting from the Bank of Japan's zero interest rate policy and slumping stock and real estate markets. All in all, a total of 20 banks, 27 credit unions, 181 credit unions, seven life insurers, two property and casualty insurers, and seven securities companies went bankrupt in the period between 1992 and 2003.³⁰

A complete meltdown of the financial system was averted only through the injection of massive government funds, resulting in the quasi-nationalization of a large part of the banking sector and providing the impetus for substantial industry consolidation across traditional *keiretsu* lines. The Industrial Bank of Japan, Fuji Bank, and Dai-ichi Kangyo Bank, for example, merged to form the Mizuho Financial Group, while Sumitomo Bank and Sakura Bank joined forces to become the Sumitomo Mitsui Banking Corporation. The mergers were made possible by a series of financial sector reforms commonly labeled as Japan's "Big Bang" in reference to Britain's financial market deregulation in 1986. The reforms for the first time since before the Second World War allowed Japanese firms to form holding companies and led to further financial sector consolidation in other areas such the securities industry.

But the "Big Bang" reforms were intended to achieve much more than aid industry consolidation, aiming, as they did, at turning Tokyo into a global financial center on par with London and New York. To this end, controls on foreign exchange transactions, fixed share-trading commissions, and government-stipulated uniform insurance premiums were abolished. In addition, for the first time, banks were allowed to enter the securities business and barriers between the insurance business and banking, securities, and trust banking were lifted.

³⁰ Number of bankruptcies from Horiuchi (2004).

While it remains a moot point whether these reforms deserve the “Big Bang” label,³¹ they certainly form part of a long-term transition in Japan’s financial system from a bank-centered to a financial-market centered one. The beginnings of this trend date back to the late 1980s, when large Japanese corporations began raising external funds through foreign and domestic bond issues. Since then, bank debt as a source of funding for large, publicly traded firms has declined further in importance.³² Shrinkage and consolidation in the banking sector therefore are likely to continue. On a brighter note, however, Japanese banks finally appear to be making progress in the disposal of non-performing loans – one important reason why the economic gloom over Japan has finally lifted.

Foreign direct investment in the financial sector – an overview

Foreign direct investment trends clearly reflect the changed conditions in Japan’s financial sector. Government regulations and close ties between banks and corporate customers meant that foreign financial institutions have long struggled to penetrate the Japanese market, and until the mid-1990s, banking and insurance accounted for less than 5 percent of total FDI inflows. Since then, however, FDI in the sector has skyrocketed, accounting for 41 percent of total inflows between 1997 and 2004, making banking and insurance by far the leading industry in every year, with the sole exception of 1999, when it was eclipsed by the car industry.³³ As a result, financial intermediary services and insurance today are the industries with by far the highest share of employment by foreign-owned companies in the service sector in Japan (see Table 1). What is more, foreign investment in the finance and insurance sector has remained buoyant, setting a new record in 2004, rather than, as in other sectors, contracting again as the global FDI boom subsided.

Three major reasons for the increase in foreign investment in the banking and insurance sector can be identified. The first and most obvious is deregulation. Although foreign banks continue to complain that Japan’s financial industries remain more heavily regulated than their American or British counterparts,³⁴ the Big Bang reforms have broadened the areas in which foreign financial institutions can bring their expertise to bear. The same is true for the insurance sector, where deregulation has allowed life and non-life insurers to enter each others’ business, abolished government-stipulated premium rates, and streamlined the approval of new insurance products (see below). The second reason is the gradual transformation of Japan’s financial system from a bank-centered to a capital-market centered one. As securities markets as an alternative source of funding gain in importance, the role of established main-bank relationships is diminishing, removing one of the major obstacles for foreign banks operating in Japan.

But in and of themselves, these two factors probably would not have been sufficient to draw the substantial amounts of foreign direct investment actually witnessed. Rather, they provided the backdrop to the third major event: the deepening economic and financial crisis that produced a significant number of take-over targets. Generally reluctant to take over operating banks and insurance companies because of the heavy risks involved, foreign investors were much more willing to acquire failed institutions and, as indicated above, they were spoilt for choice. In the banking sector, Merrill Lynch, for example, took over the distribution network

³¹ See, e.g., *The Economist*, “Bang, pop or splutter?”, 7 May 1998.

³² See Hoshi and Kashyap (2001), chapter 7.

³³ Based on MOF notification statistics.

³⁴ A frequently cited example of remaining obstacles is Article 65 of the Securities and Exchange Law, which separates the banking and securities business.

of Yamaichi Securities; a group of foreign investors, led by Ripplewood Holdings, bought the failed Long-Term Credit Bank of Japan, since revived as Shinsei Bank; and Nippon Investment Partners, a special-purpose fund set up by the Asia Recovery Fund, bought the operations of Kofuku Bank, a regional institution that collapsed in 1999 and has since been reopened as Kansai Sawayaka Bank (KS Bank). Meanwhile, in the insurance sector, foreign investors have snapped up five out of the nine life insurers that failed between 1997 and 2001. (In contrast with the banking sector, there were also four instances in which foreign insurers bought Japanese counterparts that had not (yet) gone bankrupt. See Table 3 below).

Although foreign-owned firms continue to account for only a fraction of the banking and insurance business overall, they have been able to carve out significant market shares in some areas which, moreover, are typically growing much more rapidly than the traditional segments in which domestic firms dominate. Much of this success owes to the global capabilities, professionalism, and sophisticated risk management techniques foreign multinationals have developed while operating in the more advanced and deregulated markets of the United States and Europe. The presence of such global players as well as the products and services they offer have affected their industries in various ways. The following sections examine this impact in greater detail, looking at investment banking, retail banking, and the life insurance industry respectively.

Investment Banking

The banking and finance sector spans a wide range of services, including retail and commercial banking, investment banking, securities trading, and asset management. It is in the latter areas – investment banking, securities trading and asset management – that foreign financial institutions have made by far the greatest inroads into the Japanese market. What is more, although most of the major international players have been in Japan since the 1980s, it is only since the second half of the 1990s that they have begun to make their presence felt. This success has been based on a combination of the developments described above – deregulation, the transition to capital markets-based financial system, and economic malaise – and foreign investment banks' expertise, which has allowed them to compensate for what they lack in local knowledge and access, on which traditional relational banking is based, with transactional and technical know-how.

The following examples illustrate the interplay between structural change, the demand for investment banking services, and the role of foreign companies providing such services. Even before the Big Bang, the ongoing recession created what is often called the “distress business”, such as the disposal of bad loans, the unwinding of cross-shareholdings, the raising of capital from foreign investors for cash-strapped companies, and the development of derivatives that provided firms with ways to offload risk or disguise financial problems. Requiring extensive technical expertise and access to foreign institutional investors that would buy these sophisticated financial products, foreign investment banks were often the only ones able to provide such services.³⁵

Structural change and economic reforms have also led to a large increase in M&A activity in Japan since the mid-1990s. Not only have out-in M&As as the preferred means of market entry for foreign firms jumped with the overall rise in FDI; there has also been a substantial growth in domestic M&A activity, and foreign investment banks have been able to get hold of

³⁵ *The Economist*, “Rich pickings for the gaijin”, 14 May, 1998.

a large share of this business as well, based on their international experience in M&A deals. In 2004, seven out of the top ten financial advisors for M&A deals were foreign investment banks.³⁶

The transition from a bank-centered to a capital market-based financial system, meanwhile, means that companies increasingly access capital markets directly to meet their financing needs by issuing bonds and equities. Although in most cases, the main underwriter of such securities typically still is Japanese, foreign investment banks often are joint book runners thanks to their superior access to international investors.³⁷ Such access to international investors, in turn, has grown in importance as foreigners have been the most important net buyers of Japanese shares in recent years.³⁸ In fact, to a large extent as a result of the unwinding of cross-shareholdings, the percentage of Japanese shares held by foreign investors has risen from only 4.7 percent (in terms of market value) in 1990 to 23.7 percent in 2004.³⁹ What is more, foreigners tend to be more active shareholders than their Japanese counterparts, buying and selling shares more frequently, so that foreigners now account for about a third of all trading on the Tokyo Stock Exchange (Figure 1). And since foreign investors prefer dealing with foreign firms, it is widely thought that this trend has helped to lift the share of turnover conducted by foreign securities firms.⁴⁰

Insert Figure 1

But another reason that foreign investment banks have been able to gain a larger share in trading volume is their investment in information technology and IT skills. Morgan Stanley, for example, has heavily invested in a trading engine that is able to execute trades much quicker and at much larger volumes than most of its competitors, allowing it to offer better prices for its customers, including many Japanese ones.⁴¹ Yet another growth area in which foreign financial institutions have been able to make inroads is asset management. The amount of assets managed by investment advisors has risen fivefold from ¥34.8 trillion in 1992 to ¥112.5 trillion in 2005,⁴² but while foreign-affiliated companies have been able to build up assets under management, domestic ones have been losing them.⁴³

³⁶ Source: Thomson Financial press release. Online: <http://www.thomson.com/cms/assets/pdfs/financial/league_table/mergers_and_acquisitions/4Q2004/4Q04_MA_PR_Jap_Finl_Adv.pdf> (accessed 23 June, 2005).

³⁷ According to Bloomberg, the top 10 underwriters of stock and convertible bond sales in Japan were ranked as follows: Nikko Citigroup – jointly owned by Citigroup of the U.S. and Nikko Cordial, Japan’s third-biggest brokerage – led the pack with a market share of 27.3 percent and 15 issues, followed by Nomura, Daiwa, and Mizuho with a combined market share of 50.0 percent and a total of 57 issues. Among the remaining six firms of the top 10, only one was Japanese (Shinko Securities, market share: 1.9 percent, 13 issues), while the other five were foreign: Morgan Stanley, Goldman Sachs, JPMorgan, UBS and Merrill Lynch with a combined market share of 17.9 percent, but only 6 issues (*Bloomberg*, “Nikko Citigroup eclipses Nomura as Top Japan Stock Underwriter”, 30 March, 2005).

³⁸ *The Economist*, “The last, best game”, 20 October, 2005.

³⁹ Figures from: *2004 Share Ownership Survey*. Online: <<http://www.tse.or.jp/english/data/research/english2004.pdf>> (accessed 23 June, 2005).

⁴⁰ Mitsui Kaijo Kiso Kenkyujo (2001: 49).

⁴¹ Thomas Riley, Managing Director, Morgan Stanley Japan, interview on 12 October 2005.

⁴² Source: *Japan Investment Advisers Association*, Statistical Releases, June 2005 (Online: <http://jsiaa.mediagalaxy.ne.jp/toukei_e/index.html>, accessed 25 October 2005).

⁴³ Nikkei Net Interactive, 20 November 2003, “Market scramble: Foreign asset management firms hone edge” (Online, accessed 25 October 2005).

As these examples have illustrated, foreign financial institutions have been able to gain significant market shares in a number of investment banking, securities, and asset management-related areas. There are a number of reasons that explain this success. The first is that, as Japan makes the transition from a bank-centered to a capital market-centered financial system, there is a growing demand for the services that investment banks offer. Not only are traditional bank loans, and with them established main-bank relationships diminishing in importance, while securities markets as alternative sources of funding are playing a larger role. The financial troubles experienced by many Japanese companies also meant that there was ample need for innovative approaches to the restructuring of corporate finances, for example through the securitization of assets and liabilities.

The second, and closely related, reason is that, with their global presence and capabilities, foreign investment banks are well placed to capitalize on this shift to capital market-based corporate financing and other structural changes taking place in the Japanese economy. Investment banking is a business that requires advanced technologies and extensive expertise, including, for example, sophisticated computer software, mathematical talent, and portfolio modelling capabilities to manage risk and develop innovative financial products – areas in which most Japanese banks have lagged behind.⁴⁴ Combining these capabilities with an understanding of global markets, foreign investment banks, according to a foreign industry insider, have introduced a degree of professionalism to the investment process in Japan that was previously missing.⁴⁵ In the process, they have developed financial products such as credit derivatives that were previously unavailable in Japan or investment products sold through smaller securities firms that broaden the choice available to private investors.

The third reason that foreign investment banks have been able to gain market share is that Japanese banks have been slow to close the gap with their overseas competitors in this business area. There appear to be a number of factors explaining why this is the case. The first is that investment banking has been low in Japanese financial institutions' order of priorities, as is illustrated by the importance attached to the various parts of the financial conglomerates. In the case of the Mitsubishi Tokyo Financial Group, for example, the holding company takes pride of place, followed by commercial banking (Bank of Tokyo Mitsubishi), trust banking (The Mitsubishi Trust and Banking Corporation), and only then investment banking (Mitsubishi Securities, a minor player in the industry).⁴⁶ The second and closely related reason why Japanese banks have failed to close the gap is their organizational framework, which continues to be dominated by rigid hierarchies and pay structures.⁴⁷ Unable or unwilling to pay competitive salaries, Japanese banks, find it difficult to attract the necessary talent, for example by poaching experienced staff from their foreign rivals.⁴⁸ Rather, the flow has generally been one way, with staff from Japanese banks moving to their foreign counterparts. What is more, foreign investment banks in recent years have become one of the most sought-after destinations among high-flying university graduates.⁴⁹ A third reason is that, despite the Big Bang, Japan's financial sector continues to be more tightly regulated than its counterparts in the United States and many European countries. Coupled with Japanese banks' weak presence in more advanced overseas markets, this means that Japanese banks have little opportunity to develop the skills necessary to compete with their industry-leading

⁴⁴ See, e.g., Rapp (1999).

⁴⁵ Jean-Francois Minier, Chairman of the EBC Banking Committee, interview on 11 May, 2005.

⁴⁶ I am grateful to Jean-Francois Minier, Chairman of the EBC Banking Committee, for this point.

⁴⁷ *The Economist*, "Rich pickings for the gaijin", 14 May 1998. Though dating from 1998, this observations applies as much today as it did back then.

⁴⁸ This, of course, assumes that they would be interested in doing so in the first place.

⁴⁹ *The Nikkei Weekly*, "Foreign investment banks flourishing from local talent", 2 May, 2005.

Western counterparts. Compare this not only with the large American investment banks, with their home base in the world's most advanced financial market and a presence in all major financial centers, but also with some of the German, Swiss, or Dutch banks. Even though the financial markets of the latter's home base may not be as large or advanced, they have a strong presence in New York and London, providing exposure and hence learning opportunities in the most sophisticated markets.

That Japanese financial institutions do not accord a higher priority to investment banking and revise organizational hierarchies and pay structures to attract high-flyers indicates that Japanese banks either continue to be preoccupied with bringing their core business – commercial lending – into order; or that, to date, foreign investment banks are not perceived as a threat. The latter hypothesis is supported by a Japanese report on the effect of foreign competition in the financial industry on domestic players, which comes to the conclusion that with the exception of foreign-currency related business and share and bond issues, at present there is little direct rivalry between foreign and domestic institutions – they live in different “habitats.”⁵⁰

The same report also suggests that the presence of foreign banks has provided little direct stimulus to Japan's financial industry as a whole – simply because the overlap is so small.⁵¹ Nevertheless, the products, services, business models, and employment practices of Japanese banks are becoming more like those of their Western competitors. Japanese banks, for example, have become active in areas such as project finance and derivatives trading and have adopted risk management techniques and more meritocratic salary schemes. What is more, although Japanese banks continue to lag behind in the development of innovative financial products, they have actively copied such products developed by foreign companies and in the process have learned from them. In other words, there are knowledge spillovers from foreign investment banks through product imitation. Thus, even if the gap in terms of technical expertise and innovative capabilities persists, the presence of foreign banks is raising the level of capabilities in Japanese financial institutions.

But given the important role financial institutions play in the allocation of capital, it is important to look beyond the impact of foreign investment banks on the Japanese banking industry alone. One of the problems plaguing the Japanese corporate sector in recent decades has been the poor returns on capital. Although the effects are difficult to quantify, it seems fair to say that the products and services offered by foreign banks have helped to put capital resources to better use. One example is the services related to the restructuring of corporate finances, such as through the purchase and resale of distressed debt through securitization or, similarly, the purchase of poorly managed real estate, the introduction of professional management, and its resale through real estate funds, helping firms to return to financial health.

In sum, rather than entering the low-margin corporate lending business, foreign banks in this segment appear content to concentrate on more profitable areas in which they can overcome whatever handicap they suffer from their lack of long-term relations through superior products, services, and technology previously unavailable in Japan. While this means that their activities remain confined to the investment banking business, this is a field that is bound to continue to grow in the future as Japan makes the transition to a capital-markets based financial system. And although the impact of foreign players on Japan's banking sector has

⁵⁰ Mitsui Kaijo Kiso Kenkyujo (2001: 54).

⁵¹ Mitsui Kaijo Kiso Kenkyujo (2001: 55).

remained limited, their products and services contribute to the ongoing restructuring of the country's corporate sector more generally.

Retail and commercial banking

Whereas the investment banking, securities and asset management business has lured dozens of foreign firms to Japan, the number of foreign investments in the retail and commercial banking sector can be counted on one hand. What is more, the small number of cases there are fall into two distinct groups. The first consists only of Citibank as the sole foreign bank to have established retail operations in Japan. Citibank, in fact, traces its origins in Japan as far back as 1902, when its progenitor, the International Banking Corporation, opened a branch in Yokohama.⁵² The second category, on the other hand, is made up of four Japanese banks that failed during the financial crisis in the late 1990s and that were purchased and subsequently revived by foreign investors: Shinsei Bank (formerly Long Term Credit Bank of Japan), Kansai Sawayaka Bank (KS Bank, formerly Kofuku Bank), Tokyo Star Bank (formerly Tokyo Sowa Bank), and Aozora Bank (formerly Nippon Credit Bank).⁵³ Despite their very different histories, these two groups have a number of features in common that distinguish them from their domestic counterparts.

The first of these common features is that their operations are comparatively small. Citibank, for example, operates only 25 branches in the whole of Japan (most of them in the Tokyo area), Shinsei Bank has 36 branches (including seven sub-branches), and Tokyo Star Bank has 32 branches, all in the capital.⁵⁴ These figures compare with the hundreds of branches that Japan's city banks operate throughout the country. A second common feature is the attention paid to innovative (by Japanese standards) customer services. For example, as any foreign visitor to Japan will soon notice, even today it is difficult to find automated teller machines (ATMs) that operate 24 hours and/or accept foreign-issued debit or credit cards. Citibank, followed by a number of the resuscitated banks, has been the first to introduce such services, typically without the charges levied by the city banks for the use of cash dispensers outside business hours. Other ways in which these banks distinguish themselves is by offering bright, modern branches (with the back office hidden from the customer) and by introducing new products and services, including personal financial advisors, multipurpose and multicurrency accounts and, in the case of Citibank, services directed at internationally oriented customers such as commission free overseas cash withdrawals.

A third common feature is that both Citibank and the revived smaller banks pursue more focused business models than their large Japanese counterparts, and one important area on which they have concentrated is consumer lending. Consumer finance is a segment which banks in Japan were historically barred from entering due to the government's determination to channel scarce financial resources to investment rather than consumption during the country's post-war industrialization drive. This situation gave rise to a vibrant consumer finance industry which, however, has enjoyed a dubious reputation due to the high rates of interest charged and tabloid stories of overborrowing by low-paid workers and housewives.⁵⁵

⁵² Harner (2000: 181).

⁵³ Aozora's case is somewhat different from the three other failed banks in that the rescue was initially led by Japan's Softbank. However, in 2003, the U.S. investment fund Cerberus, which had already held a minority stake in the bank, also acquired Softbank's share, bringing Cerberus' total stake to 62 percent.

⁵⁴ In fact, a significant reduction in the number of branches was one of the measures to turn the failed banks around.

⁵⁵ For an overview of Japan's consumer finance industry, see, e.g., Harner (2000).

In recent years, however, banks have started to move into consumer finance as well, with Citibank and the revived banks leading the way. Following the rescue by foreign investors, KS Bank, for example, streamlined its business to concentrate on lending to small and medium retailers and on consumer lending.⁵⁶ Similarly, Tokyo Star Bank has focused on high-profit margin business such as credit cards, car loans, housing loans and lending to small and medium-sized companies.⁵⁷

This clear focus has helped Citibank and the resuscitated banks to be profitable at a time when Japan's other banks have found it difficult to derive much value from their retail banking and commercial lending operations. However, focus provides only part of the explanation and this is where the stories of Citibank and the resuscitated banks part. Citibank's operations in Japan form part of a long-term commitment to the Japanese market that has gradually evolved over the decades. Re-entering Japan as soon as the Second World War had ended, the bank handled foreign currency-related business on behalf of local counterparts during the 1950s, lent foreign currency to Japanese companies during the 1960s, and became involved in providing corporate loans and trade finance during the 1970s. It was not until the 1980s, following the first wave of financial deregulation in Japan, that Citibank began to move into retail banking. Expanding only gradually at first, Citibank's retail operations received a significant boost as a result of the deepening financial crisis and weakening yen during the late 1990s, when worried savers flocked to the bank to open foreign currency accounts.⁵⁸ As a result, the deposit base more than quadrupled in the space of only a few years.⁵⁹ Today, the operations of Citigroup, Citibank's parent, in Japan also include Nikko Citigroup, the highly successful joint venture with the country's third-largest brokerage.⁶⁰ As this brief overview illustrates, Citibank's position as the only foreign bank with retail operations in Japan is the result of unrivalled dedication to the Japanese market coupled with the ability to continuously innovate, adapt and exploit niches as they presented themselves.

Compared with Citibank, the resuscitated banks represent foreign direct investment of an altogether different nature. Consisting of the purchase of existing, albeit bankrupt, banks, the acquisitions were backed, not by foreign banks that wanted to gain a foothold in Japan, but by private equity funds whose aim was to turn the banks around to sell them off again at a profit. Because of this focus on short-term gain, such funds, feeding off the "carcasses" of failed firms by stripping their assets, have often been labeled as "vulture funds."

Taking a closer look at the cases of Kofuku/KS Bank, LTCB/Shinsei Bank and Tokyo Sowa/Tokyo Star Bank, however, yields a less negative picture. The first thing to note is that in each of these instances, private equity investors, by overhauling management, introducing a more focused business model, investing in information technology and cutting costs, were able to restore these bankrupt banks to profitability. At Tokyo Star Bank, for example, almost half of the branches were shut and back-office operations were centralized in a Tokyo suburb. Staff levels were cut from 1,100 to 700, but have since increased again to around 900. As a result of these and other measures, profits jumped from ¥7.3 billion in 2002 to ¥13.1 in 2005. Once turned around, KS Bank was subsequently sold to the Bank of Kansai in 2003, while

⁵⁶ ACCJ, FDI Case Studies, Kansai Sawayaka Bank (KS Bank). Online: <http://www.accj.or.jp/document_library/FDICaseStudies/1069040587.pdf> (accessed 27 October, 2005).

⁵⁷ Nikkei Net Interactive, "Tokyo Star Bank makes weak debut on price concerns", 25 October 2005 (Online: <<http://www.nni.nikkei.co.jp/AC/TNKS/Search/Nni20051025D25JF825.htm>>, accessed 25 October 2005).

⁵⁸ Harner (2000: 181-190).

⁵⁹ Harner (2000: 189).

⁶⁰ On a less positive note, Citibank suffered a serious setback in Japan when it was ordered, in 2004, to close its private banking business due to improper transactions and a flawed system of controls (see, e.g., *The Economist*, "Sayonara", 23 October 2004).

Shinsei Bank and Tokyo Star Bank successfully returned to the stock market in 2004 and 2005, respectively. This outcome provides a stark contrast with the situation only five years earlier, when the government was hard-pressed to find investors to take the nationalized banks off its hands.⁶¹

But it is also important to note that this turnaround could not have been achieved had the government not assumed a large portion of the banks' bad loan burden. Nor were the new management methods without controversy. In particular, Shinsei's refusal, in 2000, to participate in the debt forgiveness scheme for ailing retailer Sogo earned the bank much criticism from the political establishment. What is more, doubts remain regarding the long-term prospects of Shinsei – despite its successful IPO in 2004 – and Aozora, the other former long-term credit bank.⁶²

Considering that taxpayers shouldered a large part of the bad debt burden, whether the large gains that the private equity funds were indeed able to pocket upon the (partial) sale of their investments are justified remains a moot point.⁶³ Leaving such questions aside, what is clear, however, is that under foreign ownership, these banks have brought a breath of fresh air into Japan's banking sector. Offering innovative services and consumer financial products, Citibank and the revitalized banks have led the way in providing consumers with greater choice and convenience – moves that some of the city banks are slowly beginning to follow.⁶⁴ They have also broken with the mold of providing almost automatic debt forgiveness. In the Sogo episode, Shinsei Bank's refusal to participate in the debt write-off led the government to attempt a bailout of the stricken retailer. However, following a public outcry, the government was forced to abandon this plan, resulting in Sogo's collapse. The practice of keeping zombie firms alive nevertheless continues.

Overall, although foreign-owned banks have introduced novel ideas and practices to Japan and, on occasion, have created quite a stir, their impact on the Japanese banking sector or the corporate world beyond has been rather limited. This is not surprising given their relatively small size. Even the largest of the revived banks, Shinsei Bank, which in its former incarnation as LTCB at one stage was the ninth-largest in the world, today only has a fraction of the assets (¥6.4 trillion) of Japan's biggest, Mitsubishi Tokyo Financial Group (¥108.4 trillion) before its merger with UFJ. And even taking Citibank and the other four foreign-owned banks together, their branch networks pale in comparison with those of the country's leading financial institutions. Therefore, the role of foreign-owned retail and commercial banks in Japan is at best marginal and is likely to remain so, given that it is highly improbable that foreigners will want to or be able to purchase any of the country's large city banks.

⁶¹ See, e.g., *The Economist*, "Hard bargains", 24 June 1999.

⁶² On Shinsei, see, e.g., *The Economist*, "Reborn, remade, resold", 15 January, 2004.

⁶³ In the case of Tokyo Star Bank, the offering of about 30 percent of outstanding shares was estimated to more than double Lone Star's initial investment, and including the unsold portion, Tokyo Star was worth about 7 times the initial investment (*The Standard*, "Tokyo Star IPO set at top of range", 18 October, 2005). WL Ross is said to have earned an 85 percent return on its \$220 million investment when it sold most of its stake to Bank of Kansai (*BusinessWeek Online*, 23 February, 2004). And Ripplewood's ¥120 billion investment was estimated to be worth ¥1.5 trillion at the time of flotation in 2004 (*The Economist*, "Reborn, remade, resold", 15 January, 2004).

⁶⁴ See, e.g., *The Economist*, "At your service", 25 September, 2003.

Insurance

In many ways, Japan's insurance industry has traditionally shared many of the characteristics of the banking sector. Like the banks, insurance companies in Japan have been at the heart of the *keiretsu* system, acting as long-term stable shareholders in companies belonging to the same business group. Insurance companies also fell under the supervision of the Ministry of Finance, enjoying – like the banks – an explicit government guarantee but also having to submit to strict regulation. Analogous to the separation of business fields in the banking sector, there used to be strict barriers between the life and non-life insurance business. And just as there were restrictions on the range of financial products available in the banking sector and commissions were fixed, insurance products and premium rates were subject to approval by the Ministry.

As in the banking sector, these arrangements created an industry in which the range of products on offer was limited, innovation was stunted, companies tended to be weak in managing risk, and competition followed its own peculiar logic. One major business area for insurance companies, for example, was the so-called *dantai hoken* (group insurance) covering all employees of a particular firm in one contract. Since insurers were unable to compete on price or through product differentiation, one important way in which they strove to secure such business for themselves was through *keiretsu* shareholdings, thus providing one important explanation for this central feature of the Japanese economy. Another example of the type of inefficient competition that government regulation of the insurance sector gave rise is the door-to-door sale of life insurance products through so-called “bicycle ladies” who make up about 90 percent of the sales staff at life insurance firms.⁶⁵ Japan's largest life insurer, Nippon Life, alone employed 53,000 such women.⁶⁶

What is more, operating in a large and, until the mid-1990s, growing home market, Japanese insurers neither saw the need nor possessed the skills to become international players.⁶⁷ At the same time, although foreign insurance companies were allowed to operate in Japan in principle, licenses for new entrants were only granted if they introduced novel products, which, however, were subject to lengthy approval procedures. The outcome was not that there were no foreign insurers operating in Japan. On the contrary: American Insurance Group (AIG) entered Japan as early as 1946, followed by American Family Assurance Company of Columbus (AFLAC) and Prudential in the 1970s, and each of these companies was able to build a successful business in the country.⁶⁸ But once established in Japan, these foreign players became as much part of the system as their domestic counterparts, barred from offering insurance products in rival business areas but also protected on their own turf from outside competition. Thus, despite some foreign participation, Japan's insurance market was largely sheltered from full international competition.

Much of this, however, has changed dramatically since the mid-1990s. As in the banking sector, deregulation and financial problems triggered by the deterioration of assets prices provided the trigger. Starting in 1996, the government introduced a series of amendments to the Insurance Business Law (the first modifications of the law in 56 years) that allowed life

⁶⁵ *Nikkei Net*, “Nippon Life to hire more men for sales positions”, 3 March, 2005.

⁶⁶ *Nikkei Net*, “Nippon Life to hire more men for sales positions”, 3 March, 2005.

⁶⁷ Even today, the overseas insurance business of Japan's largest life insurer, Nippon Life, for example, remains limited to relatively minor operations in the United States, China, the Philippines, and Thailand.

⁶⁸ American International Underwriters (AIU), a non-life insurer that belongs to AIG came to Japan as early as 1946. It was followed by Alico Japan, a branch of American Life Insurance Company that is also part of AIG, in as well as AFLAC in the early 1970s. Prudential first entered the Japanese market in 1979 by forming a joint venture with Sony.

and non-life insurers to enter each other's business, lifted the ban on insurance holding companies, changed product registration from an approval- to a notification-basis for many types of insurance, and streamlined the approval process, thus allowing greater product competition and innovation.⁶⁹ During the same period that these regulatory changes were enacted, insurance companies – and especially the life insurers – were falling on increasingly hard times. Having suffered a decade of losses caused by high guaranteed pay-outs to policy holders and dismal investment returns, nine life insurance companies and two non-life insurers collapsed between 1997 and 2001. Most of the failed life insurers were snapped up by foreign competitors, as were four life insurers that were bought before they went bankrupt (see Table 3). In addition, a number of foreign insurers established subsidiaries in Japan, meaning that most global players now have a presence in the country.

Insert Table 3

In contrast with the banking sector, the entry of foreign firms in the insurance sector is contributing to substantial structural and other changes in the industry. One important reason is that in the banking sector, foreign investments have generally been confined to the establishment of subsidiaries in specialized niche markets (e.g. investment banking) or the acquisition of collapsed banks by private equity funds aiming to turn them around and then sell them on.⁷⁰ In contrast, foreign investments in the insurance industry, especially in the life insurance sector, primarily consisted of the acquisition of failed or struggling insurers by companies from the same industry aiming to gain a presence in the market.

The most immediate measure of the impact of FDI in the insurance sector is foreign firms' market share, which has grown rapidly in recent years. In the life insurance business, foreign companies' market share in Japan in terms of premium income has risen from less than 5 percent in 1997 to 25 percent in 2004.⁷¹ What is more, foreign life insurers have been able to enjoy rapid growth – the premium income of the 16 foreign companies offering life insurance products in Japan jumped by 38 percent in 2004⁷² – at a time when the overall life insurance market has been shrinking.⁷³

Foreign life insurers' success in Japan greatly owes to their dominant position in the so-called third sector. Comprising products such as medical and nursing care insurance that fall between the traditional categories of life insurance on the one hand and property & casualty (p/c) insurance on the other, the third sector was long a niche market that only in recent years

⁶⁹ For a detailed chronology of deregulation measures, see *The Life Insurance Association of Japan*, "Deregulation and Liberalization of the Japanese Life Insurance Market". Online: <<http://www.seiho.or.jp/english/pdf/2004-2005/2005-04-c.pdf>> (accessed 10 February, 2006).

⁷⁰ Of course, there are a number of exceptions, such as the purchase of the remnants of failed Yamaichi Securities by Merrill Lynch or joint ventures such as those between Citibank and Nikko in the securities business or, more recently, between Merrill Lynch and the Mitsubishi Tokyo Financial Group in private banking.

⁷¹ Sources: *Nikkei Net*, "Foreign Insurers Seek Novel Policies", 12 May, 2003; *Nikkei Net*, "Foreign Life Insurers Grab 25% Share of Domestic Market", 1 December, 2004; NLI Research Institute, "Financial Overview of Life Insurance Companies in Fiscal 2003", online: <<http://www.nli-research.co.jp/eng/resea/life/li040913.pdf>>, Figure 1 (accessed 10 February, 2006).

⁷² *Nikkei Net*, "16 Foreign Life Insurers Boost Premium Income 38% in FY04", 7 June, 2005.

⁷³ Life insurance business in force in Japan peaked in 1997 and has been steadily shrinking ever since. See *The Life Insurance Association of Japan*, online: <<http://www.seiho.or.jp/english/pdf/2004-2005/2005-04-a.pdf>> (accessed 10 February, 2006).

has grown in popularity, accounting for about 30 percent of new policies in 2004. In contrast, death benefit products, the staple of Japanese life insurers, have steadily fallen out of favor.⁷⁴

A number of factors have contributed to foreign insurers' strong position in the third sector today. The first is that third-sector insurance products in Japan were in fact pioneered by foreign companies, with American Family (AFLAC) being the prime example. When AFLAC entered Japan in 1974, it was the first company to offer cancer insurance in a country where the disease was surrounded by social taboos and awareness was limited. Almost single-handedly creating a market for such a product in an effort that spanned more than two decades, AFLAC by the late 1990s held 80 percent of the cancer insurance market.⁷⁵ In addition to introducing cancer insurance to Japan, AFLAC was also the first company to offer further innovative third-sector insurance products such as nursing care and specialized medical care insurance as supplements to Japan's national health care system.⁷⁶

In addition to leadership in product innovation, a second factor behind foreign insurers' success in Japan is price competitiveness. Foreign insurers generally have been able to offer products at low premiums that, moreover, are easy for customers to understand, while Japanese companies tend to sell more complex products with various additional benefits.⁷⁷ As a result, AFLAC's medical insurance, for instance, is almost 40 percent cheaper than similar products available from the major domestic firms.⁷⁸ Underlying this cost competitiveness is the much greater degree of foreign insurers' specialization. AFLAC's concentration on third-sector products is in stark contrast with traditional life insurers in Japan, which tended to be much less focused. In fact, imitating Nippon Life, the country's largest life insurer, they would typically offer the entire product range, from A to Z, even if only a dozen policies of a particular type of insurance were sold.⁷⁹ Following deregulation and increasing competition, Japanese life insurers have been trying to become more focused, but this is a slow process as by far the largest proportion of business is with existing customers.

Finally, AFLAC and other foreign companies have also benefited from a controversial deal struck between the Japanese and U.S. governments in 1996 that delayed the entry of Japanese firms into the third sector by first- and second-sector companies until 2001. Since complete liberalization in 2001, however, competition in the third sector has increased considerably, with major domestic life insurers offering specifically targeted third sector products.⁸⁰ The third sector is thus turning into a primary battleground in the life insurance industry.

In other areas, too, Japanese life insurers are now trying to develop original and innovative products. They have begun to become more flexible in the premium discounts offered to individual customers, started to add various riders to traditional life insurance products, and developed investment-type life insurance products that were previously unavailable. In

⁷⁴ See, e.g., *Nikkei Net*, "6 Major Foreign Life Insurers' Premium Revenue Up 15% in FY04", 31 May, 2005.

⁷⁵ *Nikkei Net*, "Foreign Insurers Cut Deeply Into Japanese Market", 9 February, 2004.

⁷⁶ Harner (2000: 238).

⁷⁷ *Nikkei Net*, "6 Major Foreign Life Insurers' Premium Revenue Up 15% in FY04", 31 May, 2005.

⁷⁸ *Nikkei Net*, "6 Major Foreign Life Insurers' Premium Revenue Up 15% in FY04", 31 May, 2005.

⁷⁹ Hitoshi Morita, President and CEO, PCA Life, interview on 17 May, 2005.

⁸⁰ In 2004, Asahi Mutual Life, for example, began selling medical plans that cover operations to prevent varices, while Dai-ichi Mutual Life introduced lifelong medical care insurance that does not require premium payments if policy holders need nursing care (*Japan Times*, "Insurers race to get into medical policies as population ages", 26 February, 2005). Other traditional life insurers that have begun offering medical insurance products or life insurance products that also provide hospitalization and surgery benefits include Sumitomo Life, Nippon Life, and Meiji Yasuda Life (JETRO (2005b); *Nikkei Net*, "6 major foreign life insurers' premium revenue up 15% in FY04", 31 May, 2005).

addition, life insurers are trying to improve their service, allowing customers, for example, to use ATMs at post offices and banks for insurance-related transactions.⁸¹

But product innovation and price competition are only two of the areas in which deregulation and increased foreign participation have led to a transformation of the industry. Other important areas include skill requirements, services, sales and distribution channels, and employment. These issues are obviously closely related. To stay with the example of third-sector medical insurance, both the development and the marketing and sales of such products require skills that many Japanese insurers used to lack. Consequently, Nippon Life, for instance, set up a new medical research unit in 2005 that, consisting of a staff of 19, including seven physicians, is responsible for analyzing medical data with a view to developing new forms of medical insurance.⁸²

The proliferation of new insurance products and the decline in sales of standard life insurance products also requires more professional sales forces. Nippon Life, for example, has found that the sales performance of its “bicycle ladies” has plummeted.⁸³ But again it is foreign companies that have been leading the way in the professionalization of sales forces at the Japanese insurers they acquired, cutting the number of traditional sales agents, retraining personnel, hiring experienced salespeople from other industries, and moving to a sales system based on consulting services and “financial planners.”⁸⁴ Following its acquisition of Daihayku in 2001, Manulife, for instance, embarked on halving the number of sales agents at the Japanese company but was at the same time retraining remaining sales staff and recruiting 100 new sales people every month. One corollary, and gauge, of this professionalization is that the number of male sales staff is on the rise. Following the cue of foreign insurers, Sony Life, a relatively new market entrant, is stepping up insurance sales by male employees, who now account for more than 10 percent of overall insurance sales staff. Similarly, Nippon Life was planning to hire men with sales experience in real estate and other sectors and train these in life insurance. Beginning with 200 such personnel, the company was intending to eventually increase this number to 1,000.⁸⁵

Similarly, again as a result of deregulation and led by foreign companies, insurers have been broadening their marketing channels. A number of them, including the AIG affiliates in Japan (Alico Japan, AIG Star Life, and AIG Edison Life), have expanded into direct marketing, including internet sales.⁸⁶ More important are the alliances that foreign insurers have forged with major as well as smaller second-tier and regional banks to sell individual pension insurance policies. Such ties have flourished since the ban on banks to sell insurance policies was lifted in October 2002 and foreign life insurers have teamed up with more than 200 financial institutions. Alico Japan, for instance, has signed up with 81 banks, including all four megabanks. But other foreign insurers are not far behind. Having established ties with

⁸¹ The Life Insurance Association of Japan, *Yearbook 04/05*, “Changes in life insurance products in Japan.” Online: <<http://www.seiho.or.jp/english/pdf/2004-2005/2005-04-a.pdf>> (accessed 21 November, 2005).

⁸² JETRO (2005b).

⁸³ *Nikkei Net*, “Nippon Life to hire more men for sales positions”, 3 March, 2005.

⁸⁴ See, e.g., *The Economist*, “Cautionary Tales”, 5 June, 2003; *Nikkei Net*, “Foreign life insurers overhauling Japanese sales forces”, 16 October, 2003; *Nikkei Net*, “Foreign insurers contribute to rise in male sales staff” 22 January, 2005.

⁸⁵ *Nikkei Net*, “Nippon Life to hire more men for sales positions”, 3 March, 2005; *Nikkei Net*, “Foreign insurers contribute to rise in male sales staff”, 22 January, 2005.

⁸⁶ See, e.g., *Nikkei Net*, “16 Foreign Life Insurers Boost Premium Income 38% in FY04”, 7 June, 2005.

However, the extent to which direct marketing adds to insurers’ bottom line seems questionable because of high advertising costs. PCA Life President and CEO Hitoshi Morita, for example, therefore thinks such efforts are primarily an attempt to raise brand awareness (interview, 17 May, 2005).

regional banks earlier, ING Life in 2004 linked up with Mizuho and UFJ Bank, while AXA joined forces with Bank of Tokyo-Mitsubishi. The latter, in turn, also sells policies for Manulife, with which BOT-Mitsubishi has an equity tie-up.⁸⁷ Providing insurers with new marketing channels while allowing banks to diversify their insurance offerings, such tie-ups are one major factor behind the expansion in foreign life insurers' market share in Japan.

The tie-ups also demonstrate that in the insurance sector foreign firms have become and established part of the landscape. Not only are they forging links with domestic financial institutions; consumers also do not appear to make any distinction between domestic and foreign providers.⁸⁸ Or, if considerations of nationality do play a role, this may actually play into the hands of overseas insurers given the failure of domestic providers around the turn of the millennium.

Thus, comparing the role of foreign companies in the insurance and the banking sector, substantial differences can be observed. In the latter, the presence of foreign banks has only had a limited impact on their domestic counterparts. The insurance sector provides a stark contrast. Here, foreign companies have rapidly gained significant market share, contributed to increased price and product competition, and led the way in corporate restructuring. Operating in a deregulated and more competitive environment, Japanese insurers have been forced to follow suit, introducing third-sector products and upgrading skills by investing in product development capabilities and professionalizing sales forces. In other words, the entire *modus operandi* of the Japanese insurance industry has been transformed as a result of deregulation and foreign participation. In addition, with prices, product differentiation, and service levels now the defining competitive parameters, and a considerable number of insurers now in foreign hands, long-term shareholdings and *keiretsu* relationships, too, no longer play the role they once did. Thus, although there are of course many other reasons for the unwinding of cross-shareholdings among Japanese corporations, the competitive transformation of the insurance sector has been one contributing factor to the demise of this defining feature of the country's post-war economy.⁸⁹

The realignment of the Japanese insurance industry is likely to continue apace. Despite their success as a group, not all foreign insurers are thriving in Japan and their number has shrunk from a peak of 18 out of 41 life insurers operating in Japan in 2003 to 16 in 2005. At the same time, however, the total number of life insurers in Japan is very small compared with the 354 companies found in the U.S., the 455 in Germany and the 400 in the UK.⁹⁰ Thus, there seems to be considerable room for more competitors in Japan.

4. Health care

Health care is a sector of vital importance in any economy. Not only does it account for a significant proportion of economic activity, especially in industrialized countries; it also has an important impact on social welfare. In Japan, total expenditure on health accounts for 7.9

⁸⁷ *Nikkei Net*, "Foreign life insurers expand sales network through bank alliances", 25 July, 2005.

⁸⁸ Hitoshi Morita, President and CEO, PCA Life; interview on 17 May, 2005.

⁸⁹ The ratio of long-term shareholdings dropped from around 45 percent in the early/mid-1990s to 24.3 percent in 2003 (NLI Research Institute 2004). In fact, the NLI Research Institute has now stopped publishing its annual cross-shareholding report since, as it explains, the ratio is now so low that cross-shareholdings are either difficult to discern in the data or have disappeared altogether.

⁹⁰ JETRO (2005b).

percent of GDP. Although substantial, this figure is in the lower range of comparable OECD countries, indicating that Japan has managed to contain health care costs more effectively than other developed nations.⁹¹ What is more, this has been achieved while providing comprehensive health coverage to all citizens and without the rationing seen, for example, in the U.K. And although health care is of course only one contributing factor, the Japanese today enjoy the highest life expectancy in the world.

Yet, despite its apparent success, Japan's health care sector has its fair share of problems. Peculiarities in the country's health care system and health care regulation have fostered an environment in which competition from foreign firms in the pharmaceutical and medical devices industries was limited, leading Japan's manufacturers to fall behind their international rivals. Other areas, in particular health care provision (i.e., doctors, hospitals, clinics), have been even more sheltered from competition, with the effect that, according to one study, the productivity of the Japanese health care system is only about 75 percent of the U.S. level.⁹² What is more, these problems are compounded by the demographic challenge – the aging and shrinking of the population – which is going to impose a growing burden on the national health care system and hence government finances. Already, the co-payment share of employees covered by the national health insurance has had to be successively raised from 10 percent in the 1990s to 30 percent today.

The health care sector makes an interesting case study of foreign direct investment in Japan for a number of reasons. First of all, it spans a number of subsectors with very different characteristics, regulatory regimes, and patterns of foreign participation. Potential areas to look at include pharmaceuticals, medical equipment, medical diagnostics, blood products, and health care services. This section considers three of these: pharmaceuticals, medical equipment and health care services. Including two manufacturing industries and a service sector, these three categories are fairly representative of the entire health care spectrum.

A glance at two of these sectors, drugs & medicine and medical services, for which separate data on the employment accounted for by foreign affiliates as a share of total employment are available (see Table 1) shows a stark contrast in the extent of foreign penetration: Together with the car industry, drugs & medicine is in fact the segment with the highest share of foreign employees of any industry in Japan. In contrast, in the medical services, health and hygiene segment, foreign companies are almost non-existent and account for less than 0.2 percent of total employment in the sector. While this is not a sector that readily lends itself to foreign direct investment in any country, the figure for Japan is less than a tenth of that for the United States.

The reasons for this contrast between the pharmaceutical industry and health care services are easy to find. Whereas foreign direct investment in the pharmaceuticals sector has been possible for decades, current regulations prohibit for-profit companies to provide health care services. The health care service sector therefore provides a useful illustration of a “sanctuary” where the absence of FDI is not the outcome of any discriminatory policies against foreign companies but rather the result of more general entry barriers that also inhibit the entry of domestic operators. This lack of competition in health care services – in areas where competition is appropriate – is an important factor contributing to the observed low productivity in Japan's health care system.

⁹¹ Health expenditure amounts to only 7.7 percent of GDP in the U.K., but to 10.1 percent in France, 11.1 percent in Germany and 15.0 percent in the United States. Data are for 2003. Source: *OECD Health Data 2005*.

⁹² McKinsey Global Institute (2000).

But it is not only in the area of services that the regulatory framework has had detrimental effects. Heavy regulation has also been responsible for delaying the introduction of new drugs and treatments developed overseas and for fostering pharmaceutical and medical devices industries that were largely inward looking. Regulatory and other changes in the 1990s since have made it much easier for foreign companies to introduce drugs in Japan and, as the following sections will show, the impact has been far-reaching.

The pharmaceutical industry

At first glance, Japan's pharmaceutical industry seems to present a paradox. At almost US\$60 billion in 2004, the country's drug market is the second-largest in the world, behind only that of the United States (ca. US\$230 billion), and about twice as large as third-ranked Germany's.⁹³ Japanese firms have long dominated their home market,⁹⁴ and given such a strong domestic demand base, one might expect Japan's drug makers to be among the leading pharmaceutical companies in the world. Yet, not one Japanese firm ranks among the global top 10 in the industry, and the country's three largest (ranked 15th, 16th, and 20th) together account for less than 4 percent of global sales.⁹⁵ What is more, this figure obviously includes sales in Japan. The country's export market share (out of all OECD countries) is smaller still and even shrinking, having fallen from 3.3 percent in 1997 to 2.1 percent in 2003.⁹⁶

Thus, unlike in the car or electronics industry, a large home market has not translated into a competitive advantage abroad. In fact, Japan has consistently run a trade deficit in pharmaceuticals, and this deficit has grown rapidly in recent years (see Figure 2). Furthermore, the dominant position of Japanese firms in their home market has been slipping in recent years: Still controlling 85 percent of the market in 1990, Japanese firms' share shrank to less than two-thirds in 2004.⁹⁷ And while in 1990, no foreign firm made it into the top 10 in Japan and only one into the top 20, by 2004, four had broken into the top 10 and another three into the top 20 (see Table 4).

Insert Figure 2, Table 4

These figures highlight two major features Japan's pharmaceutical industry: the dominance of domestic firms in their home market despite their lack of international competitiveness; and the inroads by foreign firms into the Japanese market in recent years. How this situation came about, and the role foreign direct investment plays in it, can only be properly understood in the context of the particular "ecosystem" in which the health care industries operate in Japan.⁹⁸ This ecosystem is the outcome of political interactions over the years among three key players: the Liberal Democratic Party (LDP), the Japan Medical Association (JMA) representing 156,000 doctors (about 60 percent of all physicians in Japan), and the Ministry of Health and Welfare (MHW; now the Ministry of Health, Labour and Welfare, MHLW). The

⁹³ Figures from *Scrip Magazine*, "Growth, in moderation", February 2005.

⁹⁴ See, e.g., Thomas (2001: chapter 8).

⁹⁵ Figures from *Pharmaceutical Executive*, May 2005 (IMS Health data).

⁹⁶ OECD, *Main Science and Technology Indicators*, 2005/1.

⁹⁷ Figures from IMS Health, quoted in Mahlich (N.D.) and Swiss Chamber of Commerce and Industry in Japan, "Pharmaceutical Industry in Japan in 2004", online: <www.sccij.org/reports/pharmaceuticals.html> (accessed 1 December 2005).

⁹⁸ The term "ecosystem" is borrowed from Thomas (2001) and this brief outline is based on chapters 3 and 4 of his detailed study of Japan's pharmaceutical industry.

interplay of these three actors has given rise to a regulatory framework in which the special interests of the medical doctors represented by the JMA have often taken precedence over other considerations such as economic efficiency, the creation of internationally competitive health care industries, or the welfare of society as a whole.⁹⁹

Critically important elements of the ecosystem this situation has given rise to are the lack of separation (*bungyo*) between the prescription and dispensing of medication and the “doctor’s margin”: doctors both prescribe and dispense drug which they purchase from wholesalers at a discount from the official retail price. Since the Ministry of Health reimburses doctors for all drugs at the official retail price, doctors pocket the difference. This system presents doctors with a strong incentive to over-prescribe products – Japanese patients have been described as *kusurizuke*, or pickled in drugs – and had led to a rapid increase in pharmaceutical demand. In order to keep healthcare expenditure under check, the government therefore began in 1981 to steadily lower the reimbursement prices for drugs. Drug prices in Japan have fallen by roughly 5 percent a year as a result. Crucially, owing to health ministry regulation, it is prices for established products that drop rapidly, creating incentives for doctors to prescribe the latest and most expensive drugs and for pharmaceutical firms to proliferate many minor, imitative new drugs. As a result, product life cycles in Japan have been much shorter than in the United States, Britain or Germany, R&D resources have been fragmented rather than concentrated on a handful of important products, and Japan has produced few drugs with any likelihood of diffusion overseas.

Another element of the ecosystem in which Japan’s pharmaceutical industry has had to operate and which explains its lack of competitiveness is the clinical trial system and drug approval procedures. Based on very different practices and standards as those found in the United States or European countries, results of clinical trials in Japan are “acceptable and respected almost nowhere else in the world.”¹⁰⁰ Japanese firms with global ambitions therefore have typically been forced to conduct clinical trials in the United States or in Europe; but lacking financial muscle and marketing know-how, most have chosen to license internationally successful drugs to foreign partners rather than selling them under their own brand name. At the same time, Japan until recently refused to accept clinical trial results from abroad.¹⁰¹ Foreign firms wishing to introduce a product already being sold around the world therefore had to spend large sums of money and a lot of time (sometimes years) simply to replicate trials already conducted abroad. The effects have been detrimental both to Japan’s drug firms and to the country’s patients: hampered in their ability to compete overseas and largely insulated from international competition at home, Japan’s pharmaceutical industry became increasingly disconnected from advances abroad, while patients failed to benefit from many innovative drugs developed overseas.

A final element that it is necessary to mention in this brief outline is the distribution system. Over 90 percent of drugs in Japan are distributed by wholesalers, and more than four-fifth of this share is directly dispensed by prescribing hospitals and doctors. Distribution thus is highly complex and fragmented and wholesale prices – which determine the “doctor’s

⁹⁹ For an excellent and detailed description of the political economy of Japan’s health care sector, see Thomas (2001).

¹⁰⁰ Thomas (2001: 52).

¹⁰¹ It is important to note, however, that this refusal was not based on the fact that these trials were foreign but that they were different. Referring to a specific case in which approval for a drug application by a foreign firm took a total of 44 months (compared with only 5 months for the same drug in the United States), Thomas (2001: 81) observes: “[...] there was no explicit bias against foreign products or even foreign clinical and preclinical trial data here. The expert committee for Taxol never rejected foreign clinical trials because they were foreign, but rather because they were different from established Japanese practice.”

margin” – are directly negotiated between wholesalers and doctors, creating the need for large armies of distributors and salesmen. Few wholesalers provide national coverage and many are vertically linked with domestic drug manufacturers. (In fact, many Japanese drug firms evolved out of wholesalers.) The traditional ties between certain wholesalers and manufacturers have made it difficult in the past for other drugs makers – smaller Japanese as well as foreign ones – to gain access to doctors and most foreign firms operating in Japan have had to team up with one of the five large Japanese firms that used to dominate the wholesale network in the country.¹⁰²

The lack of *bungyo* (separation between prescription and dispensing) and the “doctor’s margin,” the health ministry’s reimbursement pricing scheme, the clinical trial system, the distribution system, and a host of other elements – it is this distinctive ecosystem that explains why Japan’s pharmaceutical firms are relatively uncompetitive internationally but still have dominated their home market. The ecosystem also explains why, by the mid-1990s, a significant “drug lag” had opened up between Japan and other developed countries, manifesting itself in the fact that a large number of global products, many of them significant innovations with important therapeutic effects, were not available in Japan.¹⁰³ Finally, it also explains why the market share of generic drugs – drugs that are exactly the same as a brand name drug but that anyone is allowed to produce since the original drug’s patent has expired – in Japan is so small. Until 1992, the initial reimbursement price for generic drugs was set at 100 percent of the price of the original drug. Since then, reimbursement prices for generics have been successively lowered and now range from 15 to 70 percent of the original drug, with an average of around 50 percent.¹⁰⁴ Nevertheless, reimbursement prices for generics still remain considerably higher than in other comparable countries.¹⁰⁵ In any case, Japan’s over-the-counter market is small and doctors, the main dispensers of drugs, face incentives to prescribe more expensive brand drugs rather than low cost generic alternatives. It is little surprise, then, that the market share of generics in Japan is only 12 percent (on a quantity basis), compared with around 50 percent (in terms of prescriptions written) in the U.S.A., the U.K. and Germany.¹⁰⁶

The stage is now set to consider foreign companies’ role in Japan’s pharmaceutical sector and recent industry dynamics. The first thing to note is that foreign direct investment in the sector has been possible for decades.¹⁰⁷ In fact, part of the implicit protection of Japan’s pharmaceutical industry was the requirement that firms wanting to sell drugs in Japan needed to have manufacturing facilities in the country. With takeovers, as in the rest of the economy, unheard of until the late 1990s, foreign direct investment typically took the form of joint ventures with Japanese partners. These provided foreign firms with access to local manufacturing expertise as well as help in navigating the complexities of the drug approval process and the distribution system. Given the relative backwardness of Japan’s pharmaceutical industry, the overriding motive for investing in the country has been, and

¹⁰² Thomas (2001: 59-62).

¹⁰³ Thomas (2001), chapter 1. One indicator of this drug lag is that at the time Thomas wrote his study, 130 out of the 230 global drugs since 1985 were unavailable in Japan. One prominent example of a drug unavailable in Japan until only very recently that most of those familiar with Japan will be aware of is, of course, the contraceptive pill. Although used by millions of women worldwide, “the pill” was banned in Japan as a result of pressure by the Japan Medical Association (JMA). Abortion as a principal means of birth control represented a major source of income for Japan’s medical profession.

¹⁰⁴ Riku (2005).

¹⁰⁵ Bill Bishop, Director, Corporate Affairs, Wyeth K.K., interview on 7 October, 2005.

¹⁰⁶ Figures are for 2002. Source: JETRO (2005c).

¹⁰⁷ Merck, for example, having established a joint venture as early as 1954, gradually began building up a majority stake in its local partner, Banyu, twenty years ago.

continues to be, access to the Japanese market for the sale of drugs developed in the United States or Europe – a fact that is clearly reflected in Japan’s persistent and growing trade deficit in pharmaceuticals shown in Figure 2.¹⁰⁸ Another avenue for overseas pharmaceutical firms to sell their products in Japan has been through licensing deals, and the distribution of foreign drugs used to be an important source of income for domestic firms.

Beginning in the late 1990s, however, the status quo in Japan’s drugs industry began to crumble, thanks to regulatory changes that could be labeled Japan’s “pharmaceutical big bang.” Not only are firms selling drugs in Japan no longer required to have production facilities in the country. The government also started to introduce measures to simplify and accelerate the approval of marketing applications. Steps were taken to make the use of foreign clinical trial data easier and a new, better-staffed regulatory body, the Pharmaceutical and Medical Devices Agency (PMDA), was set up with the aim of reducing the review of drugs applications to less than 12 months.

The implications of these regulatory steps are far-reaching. In effect largely removing the hurdles that had hitherto afforded Japanese firms a degree of protection, the measures have led to a rapid realignment in the industry. Simply by introducing drugs long established overseas, Western multinationals have been able to gain significant market share (see above) and earn a tidy profit – in some cases, thanks to the lack of competition from generics, even on products whose patents have already expired. As a result, even though the Japanese pharmaceutical market has more or less stagnated over the past decade or so as a result of the government’s reimbursement pricing policy, the same policy at present is providing foreign drug makers with ample profit opportunities.

The new opportunities have also led to an increased interest in investing in Japan. In line with patterns observed in other sectors, acquisitions of Japanese companies became a common mode for foreign companies to establish or expand their presence in Japan. In addition to the headline cases presented in Table 5, many Western firms are buying out former joint ventures with domestic manufacturers in order to increase the recognition of their brands.¹⁰⁹ These developments indicate that foreign drug makers no longer need their local counterparts. In fact, they go hand in hand with another important trend: foreign pharmaceutical firms have been aggressively expanding their own sales forces in the country in order to sidestep the complex distribution system, obviating the need to pay distribution fees to local rivals, providing greater efficiency, and further enhancing brand recognition. In early 2004, the top five foreign pharmaceutical firms, led by Pfizer from the U.S. and AstraZeneca from the U.K., had a combined sales force of 9,030 in Japan, compared with 6,500 for the top domestic manufacturers.¹¹⁰

Insert Table 5

Meanwhile, Japanese companies are struggling. Not only are they losing their licensing business because Western firms increasingly sell their drugs on their own; there is also little they can do to respond to the onslaught of competition in a stagnating market. Because of the

¹⁰⁸ It should be noted, though, that Japan runs a surplus in the technology balance of trade in the sector to the tune of ¥99.5 billion (2003), roughly 20 percent the size of its deficit in the merchandise balance of trade.

¹⁰⁹ An example is Wyeth’s gradual acquisition of Takeda’s stake in their joint venture in Japan, Wyeth K.K.

¹¹⁰ IMS Global Insight, “Sumos wrestle into Japan.” Online: <http://www.imshealth.com/web/content/0,3148,64576068_63872702_70261002_70960269,00.html> (accessed 7 December 2005).

nature of the domestic ecosystem, Japanese companies have invested less in R&D than their foreign peers and have few promising products in the “pipeline.” What is more, despite dwindling profits, they have long resisted consolidation even as their European and American rivals have grown bigger through mergers and acquisitions and devoted ever larger sums to R&D. However, this began to change in 2005 with the merger of Yamanouchi Pharmaceutical and Fujisawa Pharmaceutical to form Astellas Pharma, followed by the announcement of similar tie-ups between Sankyo and Daiichi Pharma as well as Dainippon Pharmaceutical and Sumitomo Pharmaceutical. Yet, doubts remain whether these mergers will create sufficient synergies to overcome underlying weaknesses in the development of blockbuster drugs and create sufficient financial muscle to compete on a global scale.¹¹¹ Moreover, the alliances are seen partially as preemptive moves in anticipation of regulatory changes taking effect in 2007 that will make it easier for foreign companies to acquire Japanese firms using stock swaps.¹¹²

Overall, the outlook for most Japanese drug manufacturers is bleak. At best a handful are expected to be able to compete internationally, and in order to do so, they have to become much more globally oriented, quickly. Many already have set up R&D operations and conduct clinical trials abroad in order to tap the all-important U.S. market. What is more, some of the larger players, led by Takeda, are in the process of expanding their sales forces abroad in order to avoid missing out on overseas profits on drugs sold under license, as has happened in the past.¹¹³ Medium-sized companies, on the other hand, are likely to find it much more difficult to survive. If not swallowed by a bigger domestic or a foreign firm, they may quit the brand-name drug business and instead concentrate on generic drugs or drug manufacturing services for other companies. As in other industries, there is a growing division of labor among increasingly specialized firms, and liberalization, begun in 1997 and continuing today, is gradually removing the barriers for contract sales organizations, site management organizations, contract research organizations and, most recently, drug manufacturing service companies – specialized companies which first appeared in Europe and the United States as early as the 1970s and 1980s.¹¹⁴

Another area in which the presence of Western pharmaceutical firms is clearly being felt is distribution. Bypassing the traditional distribution system by boosting their own sales forces, foreign drug makers have contributed to the deteriorating profitability of traditional wholesaler, forcing these into mergers and tie-ups. As a result, the number of member companies of the Japan Pharmaceutical Wholesalers Association (JPWA) has shrunk by 70 percent from 486 in 1985 to 137 in 2005.¹¹⁵ Merger and reorganization activity accelerated around 1999, leaving behind only four major drug wholesalers with their various subsidiaries today.¹¹⁶

Japan’s pharmaceutical sector is at present undergoing a major transition. Leading a sheltered existence in the country’s idiosyncratic ecosystem until the late 1990s, Japanese drug manufacturers failed to participate in many of the trends that have been shaping the industry

¹¹¹ Bill Bishop, Director, Corporate Affairs, Wyeth K.K., interview on 7 October, 2005. Also see Pharmiweb.com, “Mergers emerge in Japan,” 29 November 2005. Online: <http://www.pharmiweb.com/features/feature.asp?ROW_ID=698> (accessed 7 December 2005)

¹¹² *Nature Reviews Drug Discovery*, “Mergers in Japan help firms retain own products,” 29 April 2005. Online: <http://www.nature.com/news/2005/050425/pf/nrd1744_pf.html> (accessed 7 December 2005).

¹¹³ *Nature Reviews Drug Discovery*, “Mergers in Japan help firms retain own products,” 29 April 2005. Online: <http://www.nature.com/news/2005/050425/pf/nrd1744_pf.html> (accessed 7 December 2005).

¹¹⁴ JETRO (2005c).

¹¹⁵ Figures from the JPWA website: <<http://www.jpwa.or.jp/jpwa/members-e.html>> (accessed 8 December, 2005).

¹¹⁶ JETRO (2005c).

elsewhere. However, as a result of the regulatory reforms initiated over the past six or seven years, Japan's vast market has become a battleground for the world's foremost pharmaceutical companies, exposing domestic manufacturers for the first time to the full forces of global competition. The presence of foreign companies in Japan thus is a key factor underlying the current transformation of the industry. At least three major trends can be distinguished. The first is globalization and can be seen not only in the growing market share of foreign companies in Japan but also in Japanese firms' efforts to expand R&D efforts and sales forces overseas and build market recognition.¹¹⁷ The second is consolidation. The number of pharmaceutical companies in Japan peaked at 1,646 in 1993 but then declined to 1,062 in 2003 as a result of market exits and mergers and acquisitions.¹¹⁸ Market concentration has also gradually been rising, with the sales share of the top 5 drug manufacturers increasing from 21.3 percent in 1990 to 28.6 percent in 2003.¹¹⁹ The third trend, finally, is the increase in outsourcing of R&D, manufacturing, sales and site management, leading to growth in the number of firms specializing in these activities.

The most important issue from a Japanese perspective is whether the industry can transform itself quickly enough to ensure its continued existence. The scale of the challenge is formidable. According to one observer, "[n]othing short of a complete merger of every existing Japanese drug firm into a monolith would yield a true competitor to foreign firms such as Merck or Glaxo."¹²⁰ Others argue it is difficult to imagine how the industry can survive in the long-run without significant further consolidation and partnership with foreign manufacturers.¹²¹ Foreign firms thus look set to play a key role in shaping the future of Japan's pharmaceutical industry.

A final important point that is quite unrelated to any immediate economic considerations but that forms part and parcel of the presence of foreign firms in Japan is the increase in "product variety" and "consumer choice" they bring with them. In the case of pharmaceuticals, these are particularly valuable gains given that the product in question are drugs which may have a vital impact on patients' well-being. And these gains are all the greater because of the size of the gap that had opened up between the drugs available in Japan and overseas, which may have deprived patients of potentially life-saving medication available abroad but not at home

Medical devices

In many regards, the situation in the medical devices sector resembles that in the pharmaceutical industry. Japanese firms dominate their domestic market but are relatively weak in the international arena, and their position at home appears increasingly vulnerable: Domestic firms account for 60 percent of sales in Japan, but the country's largest medical device makers, Olympus and Terumo, rank only 12th and 13th in the world. Japan also has a large and growing deficit in the trade in medical devices, with imports more than twice as large as exports (see Figure 3). What is more, foreign (that is, American) firms already

¹¹⁷ See, e.g., *Nature Reviews Drug Discovery*, "Mergers in Japan help firms retain own products," 29 April, 2005. Online: <http://www.nature.com/news/2005/050425/pf/nrd1744_pf.html> (accessed 7 December, 2005).

¹¹⁸ JETRO (2005c).

¹¹⁹ JETRO (2005c).

¹²⁰ Thomas (2001: 175).

¹²¹ European Business Council in Japan (EBC), *Position Paper: Foreign Direct Investment*, 25 May, 2005.

Online: <[http://www.ebc-jp.com/news/2005%20EBC%20Position%20Paper%20on%20FDI%202005%20\(English\)-May.pdf](http://www.ebc-jp.com/news/2005%20EBC%20Position%20Paper%20on%20FDI%202005%20(English)-May.pdf)> (accessed 8 December 2005).

account for eight out of the thirteen leading firms by sales in the country.¹²² As in the case of drugs, Japanese firms have been ill-prepared to cope with the increase in competition that gradual deregulation in the medical devices market as part of the wider health care reform effort has brought about.

Insert Figure 3

This lack in competitiveness again is the result of the ecosystem in which the industry has had to operate in Japan. Regulations are one factor. Like drugs, medical devices require the approval of the health ministry, and the Japanese environment is generally considered to be very restrictive, conservative, and highly regulated.¹²³ Companies – domestic and foreign alike – have often complained about the cost and time required for product registrations, which in some instances has taken so long that by the time products were approved, they were already outdated,¹²⁴ and it seems reasonable to assume that lengthy approval procedures have acted as a brake on domestic innovation.¹²⁵ What is more, approvals do appear to have taken longer for foreign than for domestic products, although, as in the case of drugs, this may be less due to any bias against foreign products or clinical evidence *per se* and more due to differences with established Japanese practice and the fact that applications by domestic manufacturers tend to be for incremental innovations, while foreign firms often introduce completely new technologies.¹²⁶

But in addition to restrictive regulation, there are other unfavorable factors which are likely to have put Japanese manufacturers at a disadvantage. One of these is that until the 1980s, Japan's population was relatively young when compared with those of the United States or Europe, meaning that the demand for medical devices for age-related conditions (such as pacemakers) was limited.¹²⁷ Another is that Japan lags far behind the United States and other countries in the adoption of new technology in the medical profession, partly as a result of doctors' reluctance to replace time-tested techniques with high-tech equipment.¹²⁸ Yet another reason is that Japanese firms are reluctant to get involved in medical devices used in situations where patients' life may be in danger (again, pacemakers are an example) for fear of litigation and damage to the firm's reputation.¹²⁹

Heavy regulation, combined with the peculiarities of the Japanese market (such as the difficulties involved in negotiating the multilayered distribution system and the need to provide the free technical support Japanese customers expect) have afforded domestic medical equipment manufacturers some shelter from international competition in their home market. As a result, Japanese firms dominate the domestic market for relatively mature, standardized

¹²² Based on unpublished data obtained from the Japan Medical Devices Manufacturers Association (JMED).

¹²³ See, e.g., Pacific Bridge Medical, "Opportunities in Japan's Medical Device Market", August 2001. Online: <<http://www.pacificbridgemedical.com/publications/html/JapanAugust01.htm>> (accessed 8 December, 2005).

¹²⁴ Takeshi Fujiwara, President, Gambro K.K., interview on 30 June, 2005.

¹²⁵ Implantable Cardioverter Defibrillators (ICD), for example, were not approved until these devices had been in use in other countries for ten years.

¹²⁶ Takeshi Fujiwara, President, Gambro K.K., interview on 30 June, 2005.

¹²⁷ Akihiro Yamamoto, Managing Director, Japan Medical Devices Manufacturers Association (JMED), interview on 12 September, 2005.

¹²⁸ Pacific Bridge Medical, "Opportunities in Japan's Medical Device Market", August 2001. Online: <<http://www.pacificbridgemedical.com/publications/html/JapanAugust01.htm>> (accessed 8 December, 2005).

¹²⁹ Akihiro Yamamoto, Managing Director, Japan Medical Devices Manufacturers Association (JMED), interview on 12 September, 2005; Takeshi Fujiwara, President, Gambro K.K., interview on 30 June, 2005.

products in which manufacturing quality and after-sales services are the decisive competitive parameters. Prime examples of such products are dialysis equipment and blood purification products, in which domestic production accounts for more than 80 percent of domestic shipments. On the other hand, imports account for 70 percent or more of total domestic shipment in the case of generic catheters, orthopedic implants, and wound treatment materials and for more than 90 percent in the case of surgical implants and pacemakers and related products. Out of 13 categories in total, domestic products occupy a market share of more than 50 percent in five, while imports predominate in the remaining eight.¹³⁰

These patterns go hand in hand with another characteristic of Japan's medical devices industry: compared with their international counterparts, domestic firms tend to be comparatively small and spend little on R&D.¹³¹ Of course, this does not mean that Japan has no globally competitive firms in this sector. A notable case is Olympus, which (in 2001) commanded a 68 percent share in the global market for endoscopes.¹³² But Olympus is the exception that proves the rule and its strength in the medical business largely rests on electronic and optical technologies honed in other industries.

For foreign companies, Japan is again primarily attractive as a market. While most multinationals in the industry have established themselves in Japan, the majority concentrate on the import and sale of products manufactured abroad and on after-sales services. Of course, this does not mean that foreign firms do not pursue other activities in the country. A number of foreign firms have been in Japan for decades and have gradually expanded their operations. Becton Dickinson Japan (BDJ), for example, established as a liaison office in 1971 and set up its first manufacturing plant and distribution center in 1987; activities in Japan were further expanded 2002 to include R&D.¹³³ Other examples include Baxter, which also invested in manufacturing, and Boston Scientific Japan (BSJ), which has set up a training facility in order to teach doctors how to use the company's products.

Foreign companies' role in the Japan medical devices industry is only bound to grow as deregulation and the streamlining of product approvals make it easier for them to sell their products. The outlook for domestic firms, on the other hand, is grim. Already lacking in international competitiveness, Japanese firms face the added disadvantage of operating in an environment that is missing many of the ingredients necessary for innovation in this field.¹³⁴ Japanese patients (and taxpayers), finally, are likely to benefit from the better treatment options and potential cost savings afforded by the availability of a greater range of more advanced medical devices.

¹³⁰ Based on unpublished data obtained from the Japan Medical Devices Manufacturers Association (JMED).

¹³¹ According to unpublished data obtained from the Japan Medical Devices Manufacturers Association, a comparison of a sample of Japan and American firms shows that R&D expenditure for the former is equivalent to only 4.6 percent of turnover vis-à-vis 10.2 percent for the U.S. firms.

¹³² Based on unpublished data obtained from the Japan Medical Devices Manufacturers Association (JMED).

¹³³ JETRO, "Becton Dickinson finds reward in Japan's health care market", October 2002. Online: <http://www.jetro.go.jp/en/invest/whyjapan/month_2002oct.html> (accessed 14 December 2005).

¹³⁴ For example, according to unpublished information from JMED comparing medical engineering-related university education and research in Japan and the United States, there were just 25 such courses or faculties in Japan versus 96 in the United States. The gap in terms of professor, lecturers, and researchers was even greater: 72 versus 450 to 500.

Health care services

The provision of health care services is predominantly a local industry and foreign participation is rare in all countries. Nevertheless, it is worthwhile to briefly examine this sector as it provides a vivid example of a “sanctuary” where government regulations, by restricting entry more generally, act as a barrier to foreign direct investment. What is more, the sector provides at least one prominent case of a foreign company that is keenly interested in expanding into Japan, but is barred from doing so by current regulations.

A key element of these regulations, which have grown out of the ecosystem described above, concerns the role of for-profit operators in the provision of medical services. As in other developed countries, for-profit operators in Japan are allowed to offer peripheral services (clinical tests, clerical services, meal services to patients, etc.). However, in contrast with the United States and European countries, they are effectively banned from providing the core medical services of diagnosis and treatment (Table 6). As a result, while in Japan, only 0.7 percent of hospitals are operated by for-profit providers, the equivalent share in the U.S. is 15.1 percent, that in Germany is 19.9 percent, and that in France even 41.6 percent.¹³⁵ Coupled with other elements of the regulatory framework, such as reimbursement for each procedure and on a *per diem* basis for hospital stays rather than a flat fee for a particular diagnosed condition, this ban has led to a proliferation of small, unprofitable, and highly inefficient hospitals run by medical doctors with little training in management techniques.¹³⁶

Insert Table 6

Recognizing the potential gains of greater competition, patient choice, and diversification in funding, the Japanese government has recently begun experimenting with allowing companies to manage hospitals in “special zones” if they offer “advanced medical care” in designated fields.¹³⁷ However, because such services are not covered by the national health insurance, no such hospitals have sprung up to date. What is more, once non-reimbursed services reach a threshold level of 50,000 procedures, they would be eligible for reimbursement. Thus, any service provider in the “special zones” that is successful would lose its market, because others could offer the service.¹³⁸ The government is also trying to attract foreign direct investment in peripheral medical services in showcase medical industry development zones such as the “Finland Health and Welfare Center” in Sendai and the “Kobe Medical Industry Development Project”, although the services.¹³⁹ Crucially, however, the ban on corporate ownership of hospitals and clinics outside the experimental special zones remains firmly in place.

Although health care services represent a sector that is much less internationalized than other service industries, a number of global companies in this field do exist. A case in point is Fresenius Medical Care from Germany, the world leader in renal care that both manufactures dialysis products and runs dialysis clinics around the world. As of September 2005, the company was treating 130,400 patients in 1,670 clinics in North and Latin America, Europe,

¹³⁵ JETRO (2002: 5).

¹³⁶ See McKinsey (2000) and JETRO (2002) for details. JETRO (2002:59), for example, reports that 65.4 percent of all hospitals in Japan were losing money.

¹³⁷ JETRO (2005d).

¹³⁸ The author is grateful to Guy Harris, Chairman of the ACCJ Committee on Healthcare Services, for pointing out this.

¹³⁹ JETRO (2005e).

Africa, and the Asia/Pacific region.¹⁴⁰ With approximately 250,000 dialysis patients, Japan is the biggest dialysis market in Asia/Pacific and the second-largest in the world, and Fresenius is naturally keen to invest in the country. In fact, the company has been in Japan since 1990 and today has offices on all four main islands of the archipelago. It also has two manufacturing facilities – one in a joint venture with a local company – for the production of dialysis products, which are gaining in market share.¹⁴¹ Obviously, Fresenius is eager to also open dialysis clinics in Japan, but despite persistent efforts has failed to obtain permission to do so.¹⁴²

Renal care service are just one example of treatments where the specialization and economies of scale of corporate providers could generate substantial productivity gains and cost-savings in the Japanese health care system.¹⁴³ Other areas in which allowing corporate ownership could contribute to cost, productivity, and quality improvements in Japanese health care services are the outsourcing of radiation therapy, rehabilitation care, telecare and other health care services that are repetitive and/or pose little risk to patients.¹⁴⁴ Finally, for-profit providers could help to give rise to a cadre of professional hospital managers (as, for example, in the United States) that could transfer best practice thinking from other industries to the hospital sector.¹⁴⁵

Given the many other distortions in Japan's health care system, lifting the ban on corporate ownership of hospitals and clinics would, of course, only be part of the answer. What is more, even in the United States and most Western European countries, less than one-fifth of hospitals are operated by for-profit providers and foreign participation in the sector is low. Foreign direct investment in medical services therefore would at best account for a small portion of the overall market in Japan, although there is potential in certain specialized areas, as the Fresenius example illustrates. A final consideration to take into account is that it is often the corporate sector in which innovations occur and in the absence of FDI, Japan risks falling (further) behind in the introduction of effective and cost-reducing treatments developed overseas, to the detriment of the country's patients and taxpayers.

5. Other sectors

There are of course a considerable number of other sectors which would have made instructive in-depth case studies. The chemical industry, business services, but in particular the telecommunications and the wholesale & retail sectors have experienced large inflows of FDI around the turn of the millennium and the growing presence of foreign companies has contributed to important structural changes in these sectors. At the same time, other industries,

¹⁴⁰ Source: Fresenius Medical Care, patient care statistics. Online: <<http://www.fmc-ag.com/internet/fmc/fmcag/agintpub.nsf/Content/Statistics>> (accessed 19 January, 2006).

¹⁴¹ Fresenius AG *Annual Report 2004*.

¹⁴² According to people familiar with the case, Fresenius has been trying for years to quietly lobby the government. However, details are difficult to come by as the company is trading carefully so as not to alienate hospital owners, the customers for its dialysis products.

¹⁴³ International comparisons of the cost of dialysis treatments are difficult to find. However, one study (De Vecchi, Dratwa and Wiedemann, 1999) using admittedly dated information suggests that center haemodialysis treatments in Japan at US\$46,800 per patient per year (in 1994) cost more than twice as much as in the United States (US\$22,500 in 1990).

¹⁴⁴ The author is grateful to Guy Harris, Chairman of the ACCJ Committee on Healthcare Services, for these examples.

¹⁴⁵ McKinsey (2000).

such as the utilities sector, which has seen considerable M&A activity elsewhere in the world in recent years following deregulation, have received little FDI, largely as a result of market entry barriers. Although these industries cannot be considered in detail here, it is nevertheless worthwhile to briefly consider two of these sectors, the telecommunications and the retail industry.

Wholesale and Retail

Ranging from the large-scale outlets of retailers such as Toys “R” Us and Costco to the consumer temples of Western luxury brands in the fashionable areas of Tokyo, retail probably represents the sector in which the presence of foreign companies is most visible to the ordinary consumer. In contrast with many of the other sectors, retail has seen a steady inflow of foreign direct investment since the 1980s, although this segment, too, witnessed a rapid increase toward the end of the 1990s. One reason is that deregulation started earlier than in most other sectors. The Large-Scale Retail Store Law, enacted in 1973 and intended to protect small retailers from the incursion of larger retail stores, was amended in 1992 and again in 1994 to facilitate the establishment of large retail outlets.

A pioneering case of foreign direct investment in the sector was the opening of a gigantic store (by Japanese standards) of 3000m² in Ibaraki prefecture near Tokyo by the American toy retailer Toys “R” Us in 1991. The company has since grown into Japan’s largest toy retailer with more than 160 stores (as of 2005) all over the country. Like many other sectors in Japan, the toy industry used to be characterized by a multi-layered distribution structure in which manufacturers distributed their products through wholesalers to retailers. Toys “R” Us broke with this practice and employed a central buying system for large-lot purchases direct from the manufacturer, passing on the savings to consumers through lower retail prices.

Other foreign retailers and wholesalers have since followed suit. In addition to similarly circumventing the complex distribution system, a number of these have introduced retail business concepts new to Japan, such as membership warehouse clubs (Costco), hypermarkets (Carrefour) and membership food wholesalers (Metro). However, while some foreign retailers have prospered in Japan, others have already exited again, including OfficeMax, Sephora, and Boots, typically because of strategic mistakes and/or a misjudgment of the Japanese market. The most prominent case of these failures is probably Carrefour, which, having entered Japan only in 2001, sold its eight hypermarkets in the country to a Japanese retailer in 2004.

Despite failures such as these, foreign retailers have triggered a transformation of Japan’s retail and distribution sector. Domestic rivals have been forced to streamline their own purchasing operations, and although even today, few directly do business with manufacturers, there has been a clear trend toward consolidation in the wholesale sector as a result of increased competition.¹⁴⁶ In addition, superstores have become a common sight in Japan, and even though their number has stagnated in recent years following a rapid increase during the 1990s, the sales area per store has continue to rise.¹⁴⁷ As a result, productivity in the retail sector, which according to one study toward the end of the 1990s only reached 50 percent of the U.S. level, is likely to have increased.

Other areas in which foreign retailers have had a significant impact on the Japanese market is in the rise of specialty chain stores – examples of investment cases, in addition to Toys “R”

¹⁴⁶ JETRO (2004: 44).

¹⁴⁷ JETRO (2004: 13).

Us, include Sports Authority and Office Depot – and in the luxury segment. In the latter, European and American firms such as Louis Vuitton, Chanel, Prada and Coach have gained a virtually iconic status and their products and stores have become an integral part of Japan's fashion and architectural landscapes.

Today, there is a long list of foreign retailers doing business in Japan that demonstrate that it is possible to be successful in the country. A closer look at the failures (whose number is also not insubstantial) on the other hand typically shows that the reasons are to be found in strategic management errors and a lack of understanding of the Japanese market. The retail sector thus is likely to continue to attract considerable amounts of foreign direct investment in the future, for the simple reason that few globally operating retailers can ignore a market the size of Japan's.

Telecommunication

Having received virtually no foreign direct investment until the late 1990s, the telecommunications industry was one of the key drivers of the boom in inward FDI in Japan around the turn of the millennium. Investments were driven by two coinciding developments. The first was global consolidation in the telecommunications sector. For example, in 1999, Vodafone of the U.K. acquired AirTouch Communications of the U.S. in a deal worth US\$60 billion and then, in the following year, Germany's Mannesmann in what was the world's largest corporate merger in history worth US\$183 billion. Other large deals at that time include France Telecom's acquisition of Britain's Orange (worth US\$46 billion) and Deutsche Telekom's purchase of Britain's One 2 One (worth US\$14 billion).

The second important development spurring FDI in Japan's telecommunications sector was deregulation. In WTO negotiations concluded in 1997, Japan had agreed to remove all foreign investment limitations on Type I carriers (carriers using their own infrastructure) except for NTT and KDD. Taking effect in 1998, the changes paved the way for the country to participate in the global FDI boom in the sector. Inflows jumped from ¥3.3 billion (about US\$27 million at the exchange rate of the time) in 1997 to ¥750.8 billion (approximately US\$6.8 billion) in 2000. Although FDI in the sector, in line with global trends subsided, in 2002 and 2003, it was strong again in 2004.

What is interesting about the telecommunications industry case is that the FDI trends in this sector have been almost exclusively shaped by one case: the acquisition of Japan Telecom, first by British Telecom and AT&T and then by Vodafone.¹⁴⁸ What is more, in the second prominent, though considerably smaller, FDI case of that period, the takeover of International Digital Communications (IDC) by Cable & Wireless, the British company has since withdrawn from Japan, selling its stake in IDC to Softbank in 2004. Although, also in 2004, the private equity group Carlyle acquired a 60 percent stake in personal handy phone operator DDI Pocket from KDDI, these developments leave Vodafone as the only foreign phone company with significant operations in the Japanese market.¹⁴⁹

¹⁴⁸ It is also largely the Vodafone case that is responsible for the recovery in FDI inflows in this sector in 2004 following the retrenchment in 2002 and 2003. In the summer of 2004, Vodafone increased its stake in its Japanese affiliate in a transaction worth US\$ 4 billion. See JETRO (2005f: 18).

¹⁴⁹ There are also a number of other foreign companies operating in Japan, but these only provide small-scale services to local offices of their compatriot firms.

A further interesting point to note is that even Vodafone, the world's largest mobile phone operator, has met with only mixed success in the country. The acquisition of J-Phone in 2001 at a stroke made the company the third largest mobile phone operator in Japan by number of subscribers. Yet, Vodafone's subscriber numbers have stagnated in recent years (see Figure 4), while those of its closest rivals, NTT DoCoMo and KDDI (au) have continued to rise. Since hitting a peak of 17.4 percent in the summer of 2003, Vodafone's market share subsequently slipped to 16.0 percent at the end of 2005.

Insert Figure 4

Vodafone's difficulties in Japan are most likely the result of a combination of factors. First of all, Japan's mobile phone industry today is generally considered to be a year or two ahead of the rest of the world (with the exception of Korea). Any foreign entrant thus would face a considerable challenge to compete in a market as advanced as Japan's. A second factor is that the way in which the Japanese mobile phone industry operates differs in important ways from patterns found in Europe and the United States. Whereas in Europe and the United States, customers tend to feel loyal to handset-makers rather than providers (a fact encouraged by legislation to make mobile phone numbers "portable"), mobile phone operators in Japan have considerably greater power. Working closely with handset makers and selling their handsets under their own brands, it is the providers that determine the features and functions mobile phones offer. Able to roll out its third-generation (3G) networks and handsets in Japan only much later than NTT DoCoMo and KDDI, this delay has lost the company customers to its domestic competitors, especially since it was compounded by a third factor: In an attempt to drive down handset prices, Vodafone introduced handsets that were similar to those in the rest of the world, but offered far fewer features than rival models offered by NTT DoCoMo and KDDI.¹⁵⁰ Thus, a strategic management mistake appears to have compounded the challenges posed by the technology gap and the idiosyncratic market structure.

A possible fourth factor which may have contributed not only Vodafone's travails but also the withdrawal of Cable & Wireless and the absence of any other foreign players in Japan is the role of government regulations and the dominant position of the former state monopoly, NTT. The European Business Community in Japan (EBC), for example, complains that fixed-line interconnection charges in Japan are much higher than in the rest of the world and that NTT engages in anti-competitive behavior.¹⁵¹ However, if such allegations are justified and, if so, to what extent they put foreign operators at a disadvantage, is difficult to assess.

Even though Vodafone has only met with limited success in Japan to date, the company's investment in Japan has certainly not been without wider repercussions. For Vodafone itself, the aim of investing in Japan was not only to expand its customer base, but to learn from being exposed to the world's most advanced mobile phone market and gain access to J-Phone's technical knowledge. In this respect, the deal appears to have been a success: Technology developed by J-Phone has, for example, served as the basis for Vodafone's cellular internet service, Vodafone live!, which the company has since introduced in other markets around the world.¹⁵²

¹⁵⁰ *The Economist*, "Not so big in Japan", 30 September 2004; *The New York Times*, "A major backfire in Japan deflates Vodafone's one-size-fits-all strategy", 5 September 2005.

¹⁵¹ European Business Community in Japan (2004).

¹⁵² Kushida (2005); *The Economist*, "Not so big in Japan", 30 September 2004.

Vodafone is also helping to reshape Japan's handset industry and market, in which NTT DoCoMo used to call all the shots. Working with a select group of manufacturers, NTT DoCoMo wielded considerable influence over the terms on which these manufacturers could sell the same handsets to other providers.¹⁵³ While this would have put Vodafone at a distinct disadvantage, the British company was able to win over newcomers like Sharp, Sanyo, and Toshiba that were not part of the in-group with NTT DoCoMo to collaborate with it in the development of Vodafone-specific handsets. It was able to do so because of the access to overseas markets that it could offer to these manufacturers, substantially boosting their export sales.¹⁵⁴ Vodafone has also introduced foreign handsets into the Japanese market, although with limited success. Thus, previously largely isolated from the rest of the world, thanks to Vodafone, Japan's market for handsets is gradually becoming more international, with both more Japanese models being sold abroad and more overseas models being sold in Japan.

Whether Vodafone can turn its Japanese venture into a success remains yet to be seen. While in early 2005, there even were rumors that Vodafone might withdraw from Japan,¹⁵⁵ recent news have been more positive. On the whole, it is difficult to gauge Vodafone's longer-term prospects and impact. Japan's mobile phone industry has a considerable lead over the rest of the world, but this lead is closely associated with the power of mobile operators in the country and the proprietary technologies they develop in cooperation with handset makers. Outside of their own country, Japan's mobile operators have so far failed to significantly capitalize on their technological advantage.¹⁵⁶ Vodafone thus at present occupies unique position as the only company that has both a strong global presence and a solid foothold in Japan.

6. Synthesis and conclusion

The preceding case studies have shown that although the degree of market penetration by foreign-affiliated firms varies across industries, there are by now a considerable number of sectors in which their impact on the Japanese business "landscape" is highly visible. The most dramatic instance of this perhaps is the stunning turn-around at Nissan following the acquisition by Renault. But, as the analyses of the financial and the health care sectors have shown, even where there are no such showcase examples, the presence of foreign multinationals has had an effect on their respective industries and beyond.

In order to synthesize the findings presented above, it is useful to consider the impact of foreign companies from five different angles. The first of these concerns foreign firms' effect on the degree of competition in their respective industries. In this context, it is important to note that an important reason for the stagnation of the Japanese economy since the early 1990s has been the disappointingly low rate of total factor productivity (TFP) growth, one of the underlying causes of which has been the lack of competition in a wide range of sectors.¹⁵⁷ By contributing to greater competition, foreign firms force domestic competitors to "shape up" and raise their productivity if they want to survive. In the case studies, the revival of Nissan and the growing market share of foreign insurers and pharmaceutical firms provide clear examples of how foreign companies are turning up the heat on their domestic rivals.

¹⁵³ Kushida (2002).

¹⁵⁴ Kushida (2005).

¹⁵⁵ See, e.g., *BusinessWeek*, "Vodafone's bad connection in Japan", 21 February 2005.

¹⁵⁶ NTT DoCoMo, for example, has tried to popularize its "i-mode" wireless media platform abroad, but has found fewer subscribers than Vodafone Live!

¹⁵⁷ See Paprzycki and Fukao (2004) for details.

The exposure to global best practice they provide is the second angle from which to consider the impact of foreign companies. Apart from simply raising the number of competitors in a particular industry, foreign multinationals typically also bring with them business expertise and know-how honed in often more advanced and/or competitive markets overseas. Again, the case studies provide a wide array of examples, ranging from purchasing practices and financial operations at Nissan via portfolio modeling, risk management, and product development skills techniques and skills at foreign investment banks to the R&D capabilities of foreign pharmaceutical firms. In each of these cases, exposure to global best practice has elicited some sort of response by Japanese firms. In the car industry (as in many other sector), there has been a greater emphasis on profitability; in the financial sector, domestic banks have copied products developed by foreign competitors and have become active in areas such as project finance and derivatives trading; and in the pharmaceutical industry, the introduction in Japan of foreign firms' global blockbuster drugs has forced domestic companies to strengthen their R&D, clinical trials, and marketing efforts overseas.

Foreign firms' contribution to the range of products and services available in Japan represents the third angle from which to consider their impact. Here, too, the case studies provide numerous examples, ranging from the goods and shopping experience provided by European and American luxury goods makers to previously unavailable third-sector insurance products such as cancer, nursing care and specialized medical care insurance. In addition, foreign investment banks have provided corporate customers with specialized financial services helping them to restructure their finances, while banks such as Citibank offer distinct retail services such as 24-hour ATM machines and longer opening hours.

A fourth angle from which to view the role of foreign firms is in terms of their impact on industry structures. In this area, the case studies contain a number of examples where the impact so far has been rather limited, such as in the telecommunications industry or the banking sector, where, with the notable exception of investment banking, foreign financial institutions have to date failed to make significant inroads. But in other sectors, the impact has been substantial. In the car industry, Renault's acquisition of Nissan was followed by a wider reorganization of the company's supplier network, opening the door to further foreign entrants. In the insurance, wholesale & retail, and pharmaceutical sectors, foreign companies were the first to overhaul or by-pass established distribution channels – moves that domestic rivals are beginning to follow and that have triggered a consolidation in the wholesale & retail as well as pharmaceutical distribution sectors. But the clearest evidence of the impact on industry structures can probably be found in the pharmaceutical sector, where the onslaught of competition from foreign drugs makers has set in motion a consolidation process among domestic manufacturers that is likely to accelerate in the coming years.

The fifth angle, finally, from which to examine the role of foreign multinationals in Japan is with regard to employment practices. Although it is hazardous to generalize from just one case, the Nissan example conforms with the widespread notion that foreign firms tend to be more willing to lay off workers when this is necessary. Foreign firms also tend to break with the traditional Japanese seniority-based system and instead rely on merit-based promotions and remuneration. Examples in the case studies illustrating this include again Nissan and the investment banks. Furthermore, although it would again be hasty to draw any general conclusions from this without more broad-based evidence, the insurance sector provides an example where foreign companies are leading the way toward greater professionalism by retraining staff and hiring personnel with experience in sales, a move that is gradually followed by domestic rivals. On the other hand, in the banking sector, despite moves to more

meritocratic pay schemes in some domestic financial institutions, they provide no match for the high salaries paid by foreign investment banks.

Another more general trend to which foreign companies are contributing is greater flexibility in employment practices and the labor market as a whole. Whereas only ten years ago, foreign firms often found it difficult to recruit personnel, working for a foreign company has gained in popularity in recent years and there is, in fact, a growing number of firms, both Japanese and foreign-owned, that specialize in recruitment services for foreign companies. Two of the industries considered here – the financial and the pharmaceutical/medical sector – are among the busiest for such recruitment consultancies.¹⁵⁸ Thus, “Western style” employment practices are spreading, and although there are other, structural reasons for this and it is consequently difficult to gauge the extent to which foreign firms are responsible, their growing presence is certainly playing a role.

A final question that it is worth briefly considering is what determines the degree of penetration by and impact of foreign companies in a particular industry. Although the number of case studies presented here is clearly insufficient for a rigorous analysis, they do allow some conjectures. Obviously, FDI is absent in sectors where regulatory entry barriers remain (such as health care service). Apart from that, one factor determining the degree of foreign penetration appears to be the relative importance of “local knowledge” versus “global capabilities.” In the banking sector, for instance, foreign penetration remains low in areas where local knowledge, such as access to clients through long-term relationships, is important. On the other hand, in the area of investment banking, where global capabilities prevail over the advantages of long-term relationships, foreign penetration is much higher. Similarly, in the pharmaceutical industry, foreign penetration remained low as long as local knowledge – the ability to navigate the complex drug approval process – outweighed the importance of global R&D and marketing capabilities, but increased rapidly as regulatory changes simplifying the drug approval process tipped the balance the other way.

Other obvious factors are the strength of domestic companies in an industry and the international competitiveness of that industry more generally. Japan’s insurance and pharmaceutical industries for different reasons are both relatively weak in international comparison, making it easy for foreign firms to gain market share through superior products. In contrast, Japan leads the world in mobile telecommunications, and foreign firms (basically, Vodafone) have struggled to make a large impact. In the case of this industry, the high degree of concentration and NTT position as the former state monopoly probably have been exacerbating factors. The one sector that does not neatly fit into this pattern is the car industry. On the one hand one of Japan’s strongest industries with one of the strongest companies in the world (Toyota), this sector also has the highest penetration of foreign firms of any industry.

A final observation is that deregulation (such as in the financial and the telecommunications sector) and regulatory reform (such as in the pharmaceutical and medical devices industries) clearly have played an important role in spurring foreign direct investment. However, no clear pattern can be discerned that would suggest that foreign firms have been more successful, or less, in newly deregulated than in other industries. While they certainly have been very successful in the pharmaceutical and medical devices industries, the same cannot be said for the telecommunications sector.

¹⁵⁸ Richard Mason, Associate Director, JAC Japan, interview on 19 May 2005.

The case studies presented here have demonstrated that foreign direct investment in Japan, even at its current low levels,¹⁵⁹ is playing a significant role in reshaping the country's economy. Although greater competition may be painful for some segments of the economy (such as the country's pharmaceutical and medical devices industries), foreign companies contribute to the revitalization of the Japanese economy and, in a break with the past, the government is now actively promoting inward direct investment. The impact of FDI on the Japanese economy thus can only grow.

¹⁵⁹ FDI stocks as a percentage of GDP were still only 2.1 percent in 2004, compared with 12.6 percent in the United States, 12.9 percent in Germany, 26.5 percent in France, and 36.3 percent in Britain. Source: UNCTAD (2005).

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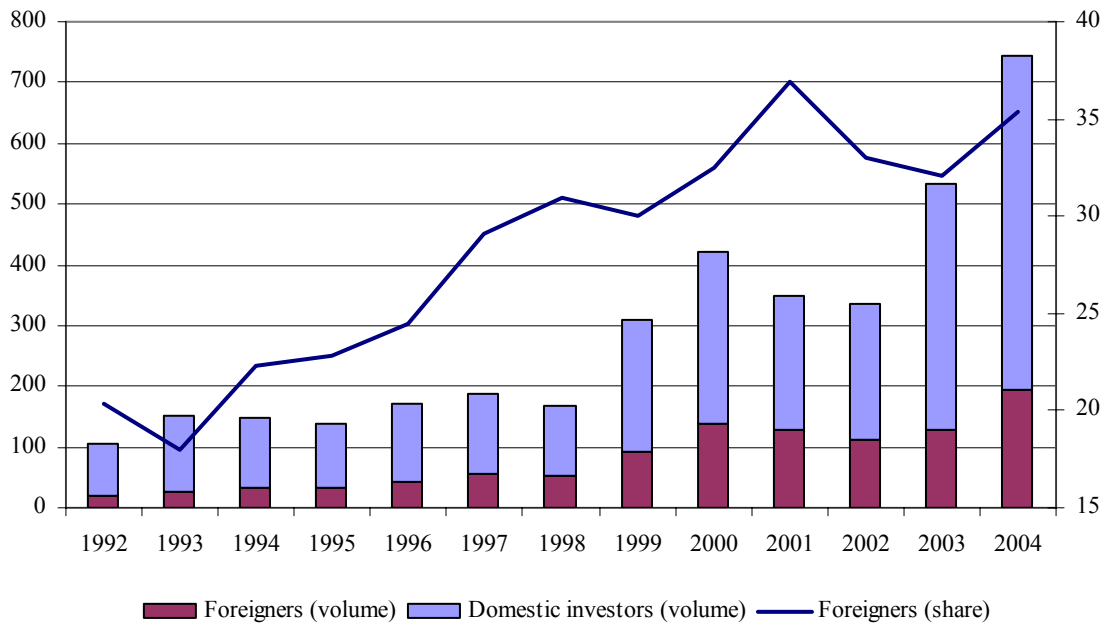
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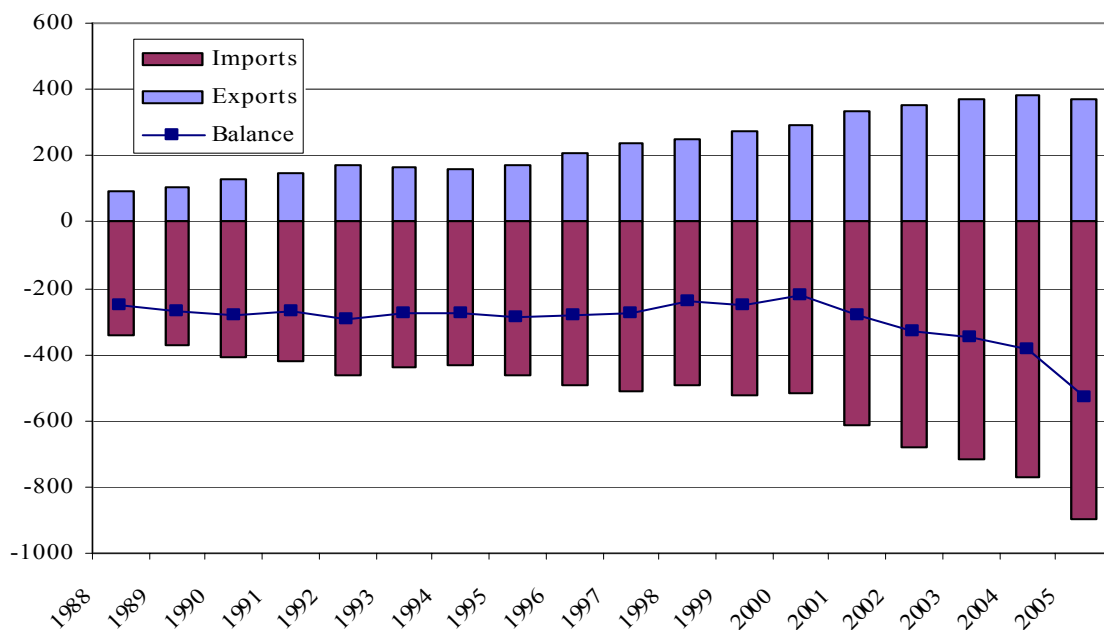
Figures and Tables

Figure 1: Trading value and proportion of trading value by type of investor on the 1st Section of the Tokyo Stock Exchange (trillion yen; percent)



Source: Japan Securities Dealers Association, *Fact Book 2005* and *Fact Book 2002*. Online: <http://www.jsda.or.jp/html/eigo/publi_i.html> (accessed 2 February 2006).

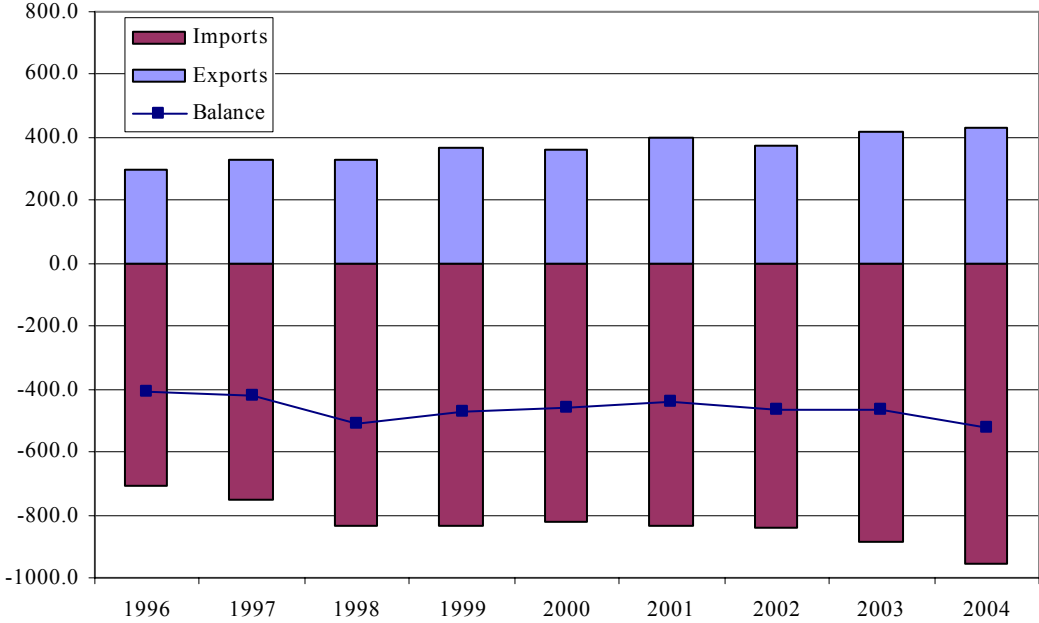
Figure 2: Japan's trade in pharmaceuticals (billion yen)



Note: Data for 2005 are the annualized values for the first ten months.

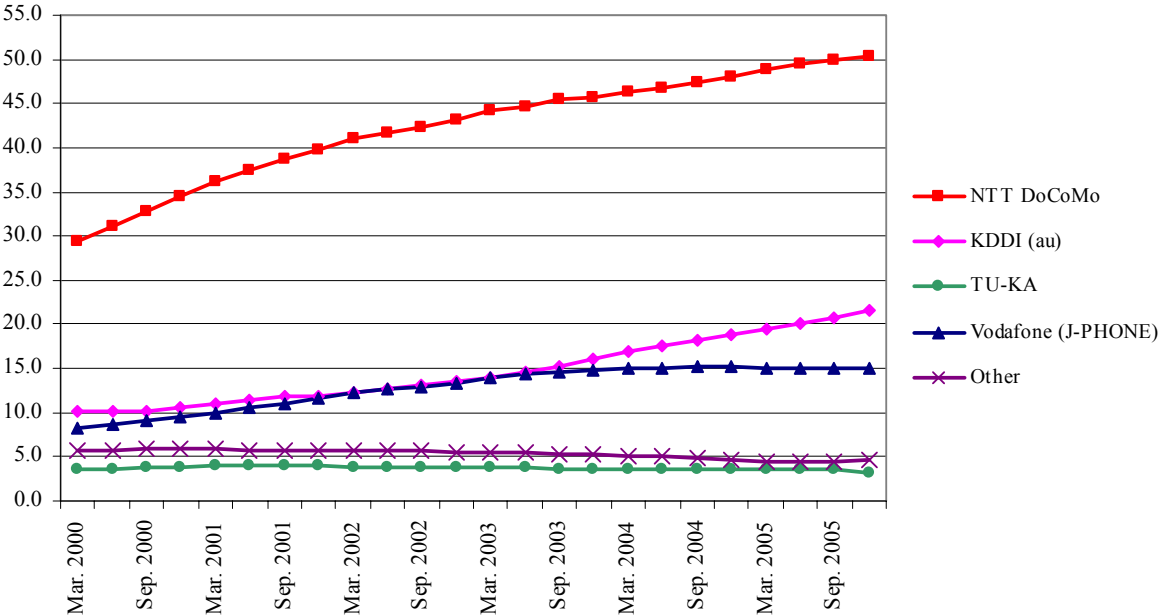
Source: Japan Customs, online database: <<http://www.customs.go.jp/toukei/srch/indexe.htm>>.

Figure 3: Japan's trade in medical devices (billion yen)



Source: Ministry of Health, Labour and Welfare, Yakuji Kogyo Seisan Dotai Tokei Chosa [Survey on Production Statistics of the Pharmaceutical Industry] (various years).

Figure 4: Mobile phone subscribers in Japan by carriers (million subscribers)



Source: Telecommunications Carriers Association.

Table 1: Employment in foreign affiliates as a share of total employment (in %)

Code	Industry	JAFF (33.4%) 1996	JAFF (33.4%) 2001	JAFF (20%, single owner) 2001	USAFF (10%, single owner) 1997
	Total all sectors	n.a.	1.15	2.75	5.61
	Manufacturing total	1.36	1.94	5.91	10.78
03	Food products	0.29	0.34	1.32	8.38
04	Textiles & apparel	0.15	0.17	0.93	5.83
05	Wood and paper products	0.06	0.16	0.83	4.95
06	Publishing & printing	0.13	0.22	0.38	7.83
07	Chemical products	3.61	3.27	13.50	21.80
08	Drugs & medicine	7.21	15.49	15.27	31.90
09	Petroleum and coal products	7.24	2.91	2.31	22.20
10	Plastic products	0.41	0.45	3.22	10.03
11	Rubber products	1.08	1.15	2.81	40.18
12	Ceramic, stone and clay	0.28	0.35	1.55	21.45
13	Iron & steel	0.01	0.13	0.27	19.35
14	Non-ferrous metals	1.61	0.44	7.72	15.73
15	Metal products	0.31	0.20	0.72	7.52
16	General machinery	1.68	1.78	6.82	12.75
17	Electrical machinery	2.46	2.48	12.51	13.78
18	Motor vehicles & parts	4.72	10.79	18.32	15.60
19	Miscellaneous transport equipment	0.7	0.62	12.71	4.23
20	Precision instruments	0.41	0.90	5.04	11.16
21	Miscellaneous manufacturing	0.47	0.72	1.71	6.62
	Services total	0.65	0.97	2.04	4.31
22	Construction & civil engineering	0.05	0.05	0.30	1.72
23	Electricity, gas, steam and water supply, etc.	0.00	0.00	0.04	1.96
24	Wholesale trade	2.31	2.57	4.24	7.89
25	Retail trade	0.29	0.49	0.77	4.50
26	Financial intermediary services	1.47	1.75	10.00	6.10
27	Insurance	1.67	6.69	12.57	6.40
28	Real estate	0.02	0.08	0.28	1.64
29	Transportation & postal service	0.50	0.27	3.52	4.82
30	Telecommunications & broadcasting	0.22	2.31	6.55	7.66
31	Education & research institutes	0.34	0.97	1.76	6.39
32	Medical services, health and hygiene	0.02	0.04	0.16	1.99
33	Computer programming & information services	1.83	2.55	4.33	3.88
34	Goods & equipment rental & leasing	0.88	1.20	0.49	3.66
35	Other business services	0.52	1.71	2.10	4.77
36	Eating & drinking places	1.58	2.36	3.89	2.48
37	Other personal services	0.12	0.39	0.38	4.23
38	Other services	0.01	0.00	0.00	n.a.

Sources: Compiled from micro-data of METI's *Establishment and Enterprise Census* for 1996 and 2001 and Bureau of Economic Analysis, *Foreign Direct Investment in the United States: Establishment Data for 1997*, online: <http://www.bea.gov/bea/ai/iidguide.htm#FDIUS>.

Notes: JAFF (33.4%): Japanese Affiliates of Foreign Firms (33.4% or more foreign-owned, one or more foreign companies); JAFF (20%): Japanese Affiliates of Foreign Firms (20% or more foreign-owned by a single foreign company); USAFF: U.S. Affiliates of Foreign Firms (10% or more foreign-owned by a single foreign company).

Table 2: Japanese car makers and their owners (owners and their ownership share in parentheses)

1995	2004
Toyota Hino (Toyota: 50.5%) Daihatsu (Toyota: 16.6%)	Toyota Hino (Toyota: 50.1%) Daihatsu (Toyota: 51.1%)
Honda	Honda
Nissan Nissan Diesel	Nissan (Renault: 44.3%) Nissan Diesel (Nissan: 23.8%; Renault: 17.8%)
Mitsubishi	Mitsubishi (Daimler: 18.8%) Mitsubishi Fuso (Daimler Chrysler: 85%; Mitsubishi group companies: 15%)
Suzuki (GM: 3.3%)	Suzuki (GM: 20.0%)
Fuji Heavy (Subaru) (Nissan: 4.2%)	Fuji Heavy (Subaru) (GM: 20.0%)
Isuzu (GM: 37.5%)	Isuzu (GM: 11.9%)
Mazda (Ford: 24.5%)	Mazda (Ford: 33.4%)

Source: Compiled by authors from *Kigyo Keiretsu Soran, Japan Company Handbook*, and company websites.

Table 3: Bankruptcies and acquisitions in the Japanese insurance industries

Company	Year collapsed	Buyer	Country of buyer	Year bought
Nissan Mutual ¹⁾	1997	Artemis	France	1999
Heiwa Life ²⁾	---	Aetna (ING) ⁴⁾	U.S.A. (Netherlands)	1999
Toho Mutual	1999	GE Capital ⁵⁾	U.S.A.	2000
Nihon Dantai Life ²⁾	---	AXA	France	2000
Nicos Life ²⁾	---	Winterthur Group	Switzerland	2000
Daihyaku Mutual	2000	Manulife	Canada	2001
Daiichi Mutual Fire & Marine ³⁾	2000	---	---	---
Orico Life ²⁾	---	Prudential	U.K.	2001
Taisho Life	2000	Yamato Life	Japan	2001
Chiyoda Mutual	2000	AIG	U.S.A.	2001
Kyoei Life	2000	Prudential Financial	U.S.A.	2001
Tokyo Mutual	2000	T&D Financial	Japan	2001
Taisei Fire and Marine	2001	Sompo Japan	Japan	2002

Sources: Various press reports.

Notes: 1) Following Nissan Mutual's collapse, the company's life insurance business was transferred to Aoba, which is the name of the entity that Artemis bought. Aoba was subsequently sold on in 2004 to Prudential.

2) Did not collapse.

3) No buyer was found.

4) Aetna, an American subsidiary of the Dutch financial services company ING, subsequently sold Heiwa Life to MassMutual of the United States.

5) GE Capital's Japanese life insurance business was subsequently bought by AIG in 2003.

Table 4: The top 20 pharmaceutical companies by sales in Japan

Rank	Company name	Nationality	Sales in US\$ billion	Market share in %	Global ranking
1	Takeda	Japan	3.6	6.3	15
2	Pfizer	U.S.A.	3.4	5.8	1
3	Roche	Switzerland	2.4	4.2	12
4	Otsuka	Japan	2.4	4.1	24
5	Sankyo	Japan	2.2	3.8	28
6	Novartis	Switzerland	2.1	3.7	7
7	Eisai	Japan	2.0	3.4	19
8	Daiichi	Japan	1.9	3.3	N.A.
9	Yamanouchi Seiyaku	Japan	1.6	2.8	23
10	Merck & Co.	U.S.A.	1.6	2.7	5
11	Mitsubishi Pharma	Japan	1.5	2.7	38
12	Shionogi Seiyaku	Japan	1.4	2.5	39
13	AstraZeneca	U.K.	1.3	2.3	6
14	GlaxoSmithKline	U.K.	1.3	2.3	2
15	Fujisawa	Japan	1.2	2.2	27
16	Tanabe Seiyaku	Japan	1.2	2.1	50
17	Sanofi-Aventis	France	1.2	2.1	3
18	Ono	Japan	1.2	2.1	48
19	Sumitomo	Japan	1.1	1.9	N.A.
20	Kowa Shinyaku	Japan	1.0	1.7	N.A.

Source: IMS Health, IMS MIDAS™, MAT Dec 2004, quoted in *Pharmaceutical Executive*, May 2005.

Table 5: Acquisitions of Japanese pharmaceutical firms by foreigners

Date	Companies involved
1996.03	BASF (Germany) acquired controlling stake in Hokuriku Seiyaku.
1999.04	Akzo Nobel (Netherlands) acquired the pharmaceutical division of Kanebo.
2000.01	UCB (Belgium) acquired the pharmaceutical division (prescription drugs) of Fujirebio
2000.01	Boehringer Ingelheim (Germany) announced a takeover bid for SS Pharmaceutical. SSP became a subsidiary in October 2001.
2001.01	Schering (Germany) acquisition of Mitsui Pharmaceutical Industrial.
2001.03	Abbott Laboratories (U.S.) acquired the pharmaceutical unit of BASF (Germany) and turned BASF-owned Hokuriku Seiyaku into a subsidiary.
2002.10	Nippon Roche merged with Chugai Pharmaceutical.

Source: JETRO, "Biotechnology", online: <<http://www.jetro.go.jp/en/market/attract/biotechnology/key.html>> (accessed 8 December, 2005), and press reports.

Table 6: Possibility of private corporate participation in medical services

		Japan	US	UK	Germany	France
Medical services	Core services (diagnosis and treatment)	Entry possible for non-profit operators only	Corporate participation allowed			
	Peripheral services	Corporate participation allowed				

Source: JETRO, *Japan Economic Monthly*, July 2005.