FDI Flows into Japan: Changing Trends and Patterns

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Introduction

The rising prominence of inflows of foreign direct investment (FDI) into Japan, which has traditionally been one of the top regional and global outward investors, is a significant element of several overall changes taking place in international capital flows.

At one level, the increasing dominance of foreign direct investment (FDI) in international capital flows since the mid-1980s and its trade-linkages have led to substantial policy changes and harmonisation efforts across the globe at the national, regional and multilateral levels, aimed at capturing the expected benefits of these trends. In turn, such deregulation and liberalisation initiatives are serving to establish and reinforce the dominance of FDI across an expanding range of countries and in an increasing number of sectors and industries.

It is also widely acknowledged that one of the dominant changes in the global structure of FDI flows has been the increasing role of brown-field investment compared to green-field investment, particularly among FDI flows between developed countries. Among other factors, this increasing dominance of cross-border mergers and acquisitions (M&As) has been an outcome of the worldwide reorganisation and consolidation taking place across various highly competitive and increasingly deregulated technology-intensive manufacturing and service sector industries. In general, manufacturing sector M&As have been dominated by electronics & IT equipment, automobiles and pharmaceuticals, while those in the service sector have been dominated by finance and telecommunications. While Japanese corporations have indeed been part of the above process through their outward investment activities particularly since the late-1980s, the ownership changes signified by the rising FDI inflows into Japan since the late 1990s, is leading to a far greater integration of Japanese domestic firms into this world-wide restructuring process.

Increased foreign penetration of the Japanese economy is being driven by the emergence of cross-border M&As as a significant channel for market-led financial and corporate sector restructuring since the late 1990s, which has traditionally been effectively closed to foreign participation in most sectors, particularly in finance, due to the prevalence of cross shareholdings. The weakening of Japanese corporate control signified by these rising FDI inflows can be seen to have come about as a consequence of the dilution of the traditional intermediation role of the Japanese financial sector *vis-a-vis* the corporate sector, following the financial liberalisation agenda since the mid-1980s. Meanwhile, the ongoing economic restructuring, which has accelerated since the late 1990s, is transforming the Japanese economic system to closely resemble the increasingly discredited Anglo-Saxon corporate and financial systems of governance.

Given the import of such changes for Japan as well as for the regional economies, this paper attempts to examine the trends underlying this remarkable increase in FDI inflows into Japan, the factors driving these trends and their implications for Japan's own foreign direct investment in Asia.

The Overall Picture of Rising FDI Inflows into Japan

Foreign direct investment into Japan, which began increasing in the second half of the 1990s, has gained in momentum considerably in the recent years, as evident from the following trends.

While FDI outflows[1] from Japan had reached a historical peak (7352 billion yen) in 1990, FDI inflows into Japan had recorded only about 262 billion yen. At this point, (net) inward investment into Japan was some 28 times lower than outward investment by Japan. However, the surge in inflows in 1992 and their subsequent linear growth during 1996-99 led to a drop in this gap to as low as 1.8 times in 1999. This was also aided by the massive drop in outflows from 1991 onwards.[2] Although the gap between net inflows and outflows increased again to 3.5 times in 2002,[3] inward FDI into Japan grew at about 53% in 2002 and marked the second highest value on record. This rising trend in FDI inflows into Japan is all the more significant, when considered against the fact that following the historical boom during 1999-2000, global FDI flows fell sharply in 2001 and 2002 -- the largest decline in at least three decades.[4]

Thus, Japan's share in global FDI inflows, which was an average of only 0.5% during 1990-95, increased to 1.2% in 1999.[5] When compared to the share of the US, which accounted for about 26% of global FDI inflows in 1999,[6] Japan's share does look miniscule. However, for a country which began courting inward FDI only recently, Japan's share is comparable to that of the EU countries of France, Germany and the UK, with their shares in global FDI inflows at 4.3%, 5% and 8% respectively in that year.[7] Further, among these major global outward investors, a comparison of the gaps between their respective shares in global outward FDI and inward FDI between 1990-95 and 1999 clearly reveals that for both France and the UK, this gap had actually increased reflecting the fact that inflows into these countries were growing less faster than outflows from them. It is only for the US that has become a net FDI recipient and for Germany that this gap declined, mirroring a faster growth in inflows relative to outflows. On the other hand, since the early nineties, on an average inflows have grown much faster than outflows for Japan, except for the two years 2000 and 2001 (See Figure 1 and Table 1).

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[1] On balance of payments basis, or actual net flows. There are two sets of statistical data available on Japan's FDI. The FDI data in the BoP statistics compiled by the Bank of Japan shows actual net transactions (that relate to a lasting interest held by a direct investor) that took place in the amount of 5 million yen or more and cover not only new investments (equity and loans) but also additional working capital and expenses incurred to existing close and/or contract operations. Acquisitions of real estate are also included in this data. Further, dividends from affiliated companies are recorded as reinvested earnings. While the BOJ data cover through to small investments (up to five million yen), it is on a net basis (inclusive of withdrawals, repayment of loans, and profit repatriations in a particular year). The other set of FDI statistics is compiled by the Ministry of Finance on an approval/notification basis. See Footnote 15 below.

[2] On BOP basis, actual inward FDI reached a record high of 1,451.4 billion yen in fiscal 1999.

[3] This was because net FDI inflows had dropped during 2000-01 before rising again to 1158.6 billion yen in 2002. On the other hand, although outward FDI had dropped in 2002, it had risen faster during 2000-01.

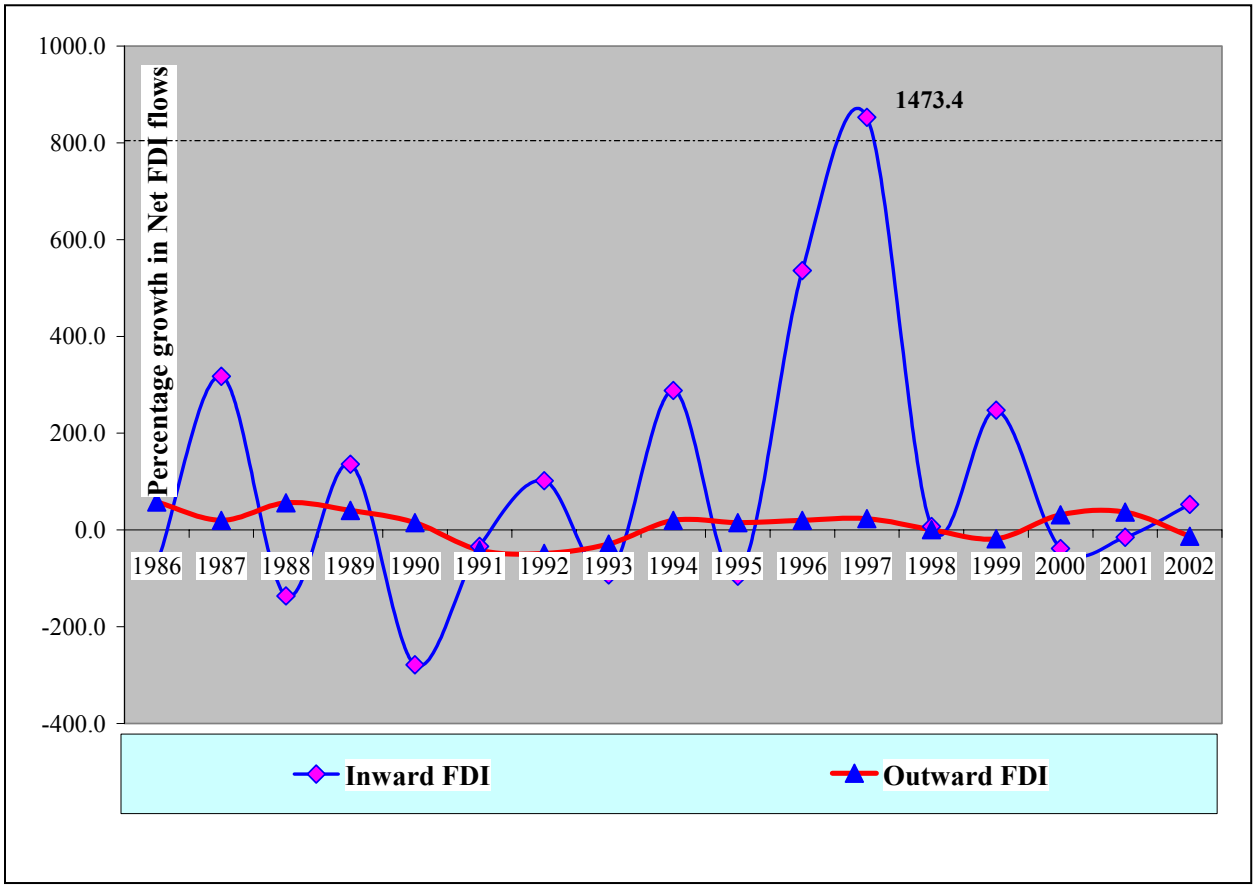
[4] See UNCTAD 2003, Prospects for global and regional FDI flows: UNCTAD's worldwide survey of investment promotion agencies', UNCTAD Research Note, May 14.

[5] Subsequent to the drop in inflows to Japan during 2000-01, this declined to 0.8% in 2001.

[6] This fell to 17% in 2001.

[7] It must be noted that this comparison should be made after weighing in the role of the EU integration process in the case of the latter group of countries.

Figure 1. Growth Trends in Japan's Net FDI flows, 1985-2002.



Source: Based on data from the Bank of Japan.

Table 1: Growth Trends and Share of Capital Components in Japan's Net FDI Flows, 1985-2002.

	Net Inward investment					Net Outward investment				
Year	Total Inflow (M.yen)	**Growth in Total Inflows**	Share of Equity	Share of Reinvested earnings	Share of Other capital	Total Outflow (M.yen)	**Growth in Total Outflows**	Share of Equity	Share of Reinvested earnings	Share of Other capital
1985-90	52880	**-6.8**	n.a.	n.a.	n.a.	4721680	**37.9**	n.a.	n.a.	n.a.
1991-93	181800	**-8.5**	63.5	0	36.6	2666867	**-40**	98.7	0	1.3
1994-97	127425	**550.4**	148.5	81.5	-129.7	2418500	**19.4**	89.4	7.5	3.2
1998-99	934650	**127.2**	85.4	-7.2	21.7	2876150	**-8.8**	75.5	7.4	17.1
2000-01	827800	**-26.8**	85.6	11.8	2.6	4029650	**34.1**	84.4	6.3	9.3
2002	1158600	**52.7**	-62.6	16.3	146.3	4047600	**-13.1**	73.7	25.5	0.8
2003(1-4)	481600	**-**	100.2	9.4	-9.6	928200	**-**	85.9	15.4	-1.4

Source: Bank of Japan data from the UNCTAD Japan FDI Profile for 1985-95 and www.boj.go.jp BOP statistics for 1996-2003 data.

Indeed, the growth in FDI inflows into Japan takes on additional significance when considered against the fact that Japan's share in global FDI outflows is on a declining trend. Even while

developed countries' share in global FDI outflows increased consistently from about 87% during 1990-95 to about 92% in 2001, Japan's share declined sharply from 10% to just higher than 2%. Although this share increased again to 6% in 2001,[8] the trend has been one of decrease, as outflows from Japan declined again in 2002. Thus, at the end of 2002, Japan's inward FDI stock was only about 4 times lower than the value of outward FDI stock, as compared to more than 7 times at end-1995. Thus, in terms of both flows and stock, the gap between FDI inflows and outflows of Japan has declined, suggesting that increasingly Japan is becoming a destination for M&A-based consolidation.

Further, ***gross*** FDI inflows into Japan have been much higher than that provided by the BoP data. According to the Ministry of Finance (MOF) data on gross annual FDI inflows,[9] the second half of the 1990s witnessed a massive expansion of foreign involvement in the Japanese economy, with gross FDI inflows growing at an average rate of more than 60% per annum and peaking at 3125 billion yen in 2000.[10]

Meanwhile, the ratio of (net) FDI inflows to gross fixed capital formation (GFCF), which was a minuscule 0.1% for Japan and continued to be the same throughout 1981-1995, is seen to have surpassed one percent in 1999. But, the latter ratio does not necessarily capture the greater participation in Japan's corporate sector by foreign firms. In 2000, for example, foreign affiliates' capital investment accounted for 2.4% of the capital investment by all incorporated enterprises in Japan.[11] This was an increase of 0.4 percentage points from the previous year and much higher than the ratio of FDI to GFCF for that year. The ratio of foreign affiliates' investment in the manufacturing sector was higher at 4.4%, continuing with the gradual upward tendency since the late 1990s. By industry, transportation machinery and tool manufacturing was the highest, followed by the petroleum & coal product manufacturing and the chemical industries.

Further, assets held by foreign affiliates in 1999 were 4 times as large as inward FDI stocks, because a good part of them were financed locally as well as by funds raised in third markets. In 2000, the ratio of borrowings by foreign affiliates to their total funds was seen to have risen 4.2 points from the previous year to 28.1%. Although this was lower than the ratio of borrowings to total funds for all incorporated enterprises in Japan (37%), foreign affiliates' fund raising by borrowings has clearly been rising. All these mean that the production capacity and the role played by foreign affiliates in Japan are larger than that implied by its FDI stocks.

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[8] In 2001, outward FDI from Japan was the highest ever recorded since 1990.

[9] MOF's FDI data is on the basis of ex post facto report or prior notice basis. This FDI statistics count only new acquisitions of stocks/shares and new loans (and new investments for the establishment or extension of branch offices) notified that exceed, in principle, 100 million yen, but may include transactions that are in fact not executed. Thus, the MOF data gives the picture relating to large investments. In this data, dividends from foreign affiliates are not recorded unless the proceeds are transferred. Data on FDI stock are also based on the cumulated 'approved' (ex post facto report or prior notice basis) values of projects submitted to the Ministry of Finance. From December 1980 to March 1992, FDI transactions were recorded on a prior notice basis, reflecting "liberalization in principle". A further revision took place, effective 1 April 1992, in which FDI transactions are to be reported on ex post facto basis in principle; yet, for certain cases, prior notices are still required. But, the MOF's FDI data switched from prior to ex post facto notification as of FY1998. Thus, (since the pre-1998 data would have included investment which did not eventually materialise), the actual growth registered post-1998 would in fact be more drastic than the present time series reveals, as the pot-1998 data is ex post facto basis.

[10] Based on MOF data, Japan's FDI inflows grew strongly in 1991, 1994 and 1996. Subsequently, except for the 12% decline in 1997, FDI increased continuously for the three years during 1998-2000, before declining in 2001 and the first half of 2002. Annual data for 2002 is not yet available.

[11] Based on METI, 2002, The 35th Survey of Trends in Business Activities of Foreign Affiliates (gist), July 31st, 2002. (Regarding movements of foreign affiliates in FY 2000).

Again, the Survey on Planned Capital Spending for Fiscal Years 2002 and 2003 by the Development Bank of Japan shows that while estimated actual capital spending for FY 2002 for all industries was down by 3.8% in 2002 and planned capital spending for all industries is likely to decline in 2003 for the third consecutive year as a whole,[12] domestic capital spending by foreign-affiliated firms[13] is slated to increase in 2003 for the first time in three years, as double-digit growth is expected in manufacturing, again led by transport equipment, chemicals, petroleum and electrical machinery. Non-manufacturing spending is also expected to rise as foreign firms in telecommunications & information and wholesale & retail expect increases in capital spending. Foreign-affiliated firms account for 5.6% of total capital spending in Japan in FY 2003. Thus, it is clear that the importance of foreign direct investors in Japan is expanding rapidly.

This rapid rise in inward FDI into Japan since 1996 can be linked to the following two phenomena occurring simultaneously. First has been the ongoing corporate and financial restructuring in Japan as a result of the deregulation and liberalisation undertaken by the country, following the prolonged recession since the early 1990s. The second has been the increased competition and industrial reorganization occurring at the global level across many industries. While Japanese outward investment activities have indeed been part of the latter process, the increasing inward FDI into Japan is leading to greater integration of domestic firms into this global restructuring process. While there are both domestic and external factors at work in this process, since it is beyond the scope of this paper to examine the role of external elements, this paper shall focus on the domestic factors driving the rise of foreign direct investment into Japan.

Some Background to the Role of FDI in Japanese Industrial Development

While Japan had experienced one of the fastest rates of structural change worldwide in the post-World War II period, it never was the case that inward FDI was the dominant strategy for its export-led growth, for either technology transfer or capital accumulation. Historically, Japan discouraged inward FDI as part of its strategy for developing domestic industries.

However, as Japan's economy developed, outward FDI by Japanese enterprises came to play a crucial historical role in Japan's industrial restructuring. With large current account surpluses and facing protectionism in its export markets since the mid-1960s, Japan emerged as a significant outward investor as a strategy to fend off trade friction with other developed countries and to thwart the loss of competitiveness in successive industries caused by rising labour, land and environmental regulatory costs, and later on, the loss of competitiveness triggered by the 1985 yen appreciation. Thus, guided by a nationalistic technocratic state, outward FDI came to play a decisive role in the transformation of Japan's domestic production structure from labour-intensive light manufacturing towards capital-intensive heavy industries in the 1970s and towards technology-intensive industries and service industries by the late 1980s.

In this process, Japanese FDI also came to play a decisive role in the catching-up industrialisation strategy adopted by the first- and second-tier East Asian late developing countries. Outward

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[12] The expected upturn (1.1%) in manufacturing is projected to be more than offset by the continuing decline in non-manufacturing. See Development Bank of Japan, 2003, Survey on Planned Capital Spending for Fiscal Years 2002 and 2003, Economic and Industrial Research Department, Research Report No. 40, May 2003. This survey defines 'capital spending' as domestic investment in tangible fixed assets of one's own corporation, such as buildings, structures and equipment, and purchase and development of land. It covers all private firms in Japan's major industries capitalized at one billion yen or more, but excludes agriculture, forestry, finance & insurance and medicine. There were 2915 firms (80% of the total targeted firms) with valid responses.

[13] 119 firms with more than one-third foreign ownership.

investment by Japanese companies looking for lower-cost production sites for export back to Japan as well as to regional and developed country markets expanded massively in the 1980s, changing the division of labour in East Asia. Multiplying year-by-year through the second half of the 1980s, outward FDI reached a peak in 1989, and thus Japan replaced the US from 1986 and the UK from 1989, and became the largest source country of global FDI flows, accounting for 23% of total worldwide outflows in that year.[14]

By contrast, inward FDI did not play any major role in the process of Japanese structural change until the 1970s, by which time Japan had long reconstructed itself into an economy with a strong industrial base. Throughout the earlier decades, Japan's reliance on FDI was limited to a few industries. In many industries, indigenous firms accumulated their own managerial resources through trial and error, using domestic capital and relying on imported machines, equipment, and materials. While foreign multinationals were involved through contractual agreements (mostly licensing agreements and subcontracting) to obtain new or advanced technologies, there was hardly any technology transfer through inward FDI. New technology was introduced through investment in kind or joint ventures with the foreign firms (i.e., FDI) only if foreign suppliers of technology insisted.[15]

Thus, between 1949 and 1967, FDI accounted for only 6% of total foreign capital inflow due to the fact that only minority ownership was allowed and most vital industries were totally banned for foreign participation. There was some relaxation in policy over time, but it was a very gradual process. The first phase of liberalisation in 1967 "automatically" allowing a maximum of 50% foreign ownership in 33 industries (Category I) still involved only those industries in which Japanese firms were already well established (e.g. household appliances, sheet glass, cameras, pharmaceuticals, etc.). Further, the approval process was also hardly automatic given that it was based on several conditions about management participation by Japanese as well as other restrictions. The 17 Category II industries in which 100% foreign ownership was allowed were industries where the Japanese firms were even more securely established (ordinary steel, motorcycles, beer, cement, etc.). And importantly, in both categories, brown-field FDI was not allowed. In the second phase of liberalisation in 1969, the government deliberately included a number of attractive industries in order to diffuse foreign criticism, but they were still mostly unattractive to foreigners.[16]

The next important landmark is 1980 when the Foreign Exchange and Foreign Trade Control Law was revised aimed at general liberalization, affecting a shift from the 'authorization' system to a 'notification' system. From December 1980 to March 1992, FDI transactions were thus recorded on *a prior* notice basis, reflecting "liberalization in principle". However, despite gradual liberalisation of FDI at the formal level, the highly restrictive policy stance continued to be maintained in these periods. Some strategic industries (esp., distribution, petrochemicals, and automobiles) were never considered as possible candidates for FDI liberalisation. Also, like in Germany and many other European countries, FDI was further constrained by the existence of informal defence mechanisms against hostile takeover, especially the cross-shareholding arrangements that lock up 60-70% of the shares in friendly hands (such as major lending banks and related enterprises).[17] Consequently, Japan was arguably the least FDI-friendly among

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[14] During this surge of 1986-1990, machinery and transport equipment alone accounted for a half of the total value of Japanese outward manufacturing FDI.

[15] See Yamazawa, opcit., p. 35, and WIR, 1995.

[16] Based on Ha-Joon Chang, 2003, "Foreign Investment Regulation in Historical Perspective- Lessons for the Proposed WTO Agreement on Investment" at <www.twnside.org.sg>

[17] Ibid.

developed countries. Even in the 1980s, when there was a dramatic increase in global FDI with significant increases in inflows to the US and Europe, FDI inflows to Japan were much smaller, in spite of the fact that Japan has been one of the world's largest economies. [18]

In effect, substantial liberalisation of the inward FDI regime took place only in the early nineties subsequent to the collapse of the bubble economy and as the Japanese economy slipped into a recession. It was in view of the Structural Impediments Initiative (SII) Report that the Japanese government stated in June 1990 that it would promote open policies concerning international investment. The most important of these deregulations of FDI policies came into effect during 1992-94. The following four measures were implemented. First, introducing transparency and openness, the Foreign Exchange Law was revised in January 1992 and '*prior* notification' was replaced with '*ex-post facto* notification' for all sectors other than the 7 sectors classified as "related to national security" and those that are reserved under an international code.[19] Second, the Import and Inward Investment Promotion Law was enacted in 1992 under which tax incentives and credit guarantees are provided for foreign companies that meet certain requirements (that is, for "designated inward investors").[20] Third, low-interest loan programs provided by Development Bank of Japan (DBJ) [21] and other development finance institutions, and the information and advisory services of JETRO were enhanced. Fourth, the Foreign Investment in Japan Development Corporation (FIND) was established in 1993, to support both foreign companies working to make an entry into the Japanese market and foreign-capital corporations already in Japan.

In order to further promote investment in Japan, a series of measures were undertaken in the following years.

- The Japan Investment Council, which consists of relevant ministers and is chaired by the prime minister, was established on July 1994.
- In 1995, the Import and Inward Investment Promotion Law was extended for ten more years to 2006. Tax incentives and credit guarantees under this law were enhanced, in addition to the upgrading of low-interest loan programs provided by JDB, etc. Some service industries were

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[18] Thus, the ratio of FDI flows to gross fixed capital formation in Japan, which was historically a minuscule 0.1 %, continued to be the same even during the periods 1981-1990 and 1991-1993. The developed country average for the 15-year period before the late-1990s' merger boom (that is, for 1981-95) was 3.5%. Source: Data from UNCTAD's WIR, various years.

[19] Industries that are restricted as important to national security, public order and safety, etc. are airplanes, weapons, nuclear energy, space development, and explosive manufacturing, electricity, gas, heat supply, water, railways, passenger transportation, communication, and broadcasting, manufacturing of biological chemicals and security, etc. Exceptional industries that are reserved by Japan under Article 2 of the OECD Code are agriculture, forestry, fisheries, mining, petroleum, and leather/leather products, marine and air transportation. (These are exempt from deregulation of inward FDI among OECD member states).

[20] The incentive system includes a preferential tax system that permits carrying over for ten years, losses that occur within the first five fiscal years after start-up and loan guarantees from the Industrial Structure Improvement Fund (ISIF) for up to 95% of the company's funds during the first eight years after start-up. Funds eligible for ISIF guarantee include capital funds as well as operating funds. ISIF also offers debt guarantees for the operating funds required for importing specified products approved by METI such as machine tools and semiconductor manufacturing equipments (including parts and accessories). Further, ISIF provides financial support (in the form of equity participation) for businesses which assist foreign direct investment in Japan by carrying out tasks such as conducting market surveys, providing information on hiring employees. Source: The 'Law on Extraordinary Measures for the Promotion of Imports and the Facilitation of FDI in Japan' at <http://www.isif.go.jp>

[21] Loans from the DBJ aim at promoting imports and inward direct investment from foreign countries, which applies to foreign companies and companies with foreign capital ratios exceeding 50% of the total. Loans up to 50% of the total cost provide funds at lower interest rates and for longer periods than those of private financial institutions.

added to the scope of designated inward investors to enhance the inward investment promotion system.

- In 1997, the loan program by the Japan Development Bank to promote foreign direct investment in Japan was extended to companies whose capital ratio exceeds 1/3 of the total capital from capital ratio exceeds 50%. In the same year, following "Emergency Economic Policy Package Reforming Japan for the 21st century", the programs for special low-interest loans by the Japan Development Bank was improved and were made available to all the first full scale direct investments in Japan.
- In 1998, FIND issued a report on concrete measures for improvement of the climate for promotion of mergers and acquisitions (M&As) including improvement in the provision of information and improvement of administrative/legal procedures, in addition to the support actions for deregulation of the M&A market in Japan. In the same year, the Japan Regional Development Corporation (JRDC) with the Japan Industrial Location Center established began providing information on industrial sites in Japan.
- Many local governments also have begun to offer incentives for companies locating in their territories (regardless of whether they are domestic or foreign-affiliated companies), such as exemptions and reductions in prefectural and municipal taxes under various regional development laws, and independent prefectural and municipal subsidy programs (including subsidies, loans, interest supplementation, and other incentives).

In response to the deregulation of inward FDI policies and the decline in land and real estate prices following the burst of the asset bubble, there was a certain surge in FDI inflows into Japan in the early nineties[22]. However, they did not translate into a consistent growth in inflows until the late nineties. This can be related to the presence of a wide range of regulations and practices that have been integral to the Japanese corporate and financial systems, which created significant barriers to entry and operations of foreign investors, despite the formal liberalisation of inward FDI regulations.

A range of Japanese welfare-oriented regulations and business practices have been cited as leading to higher initial investment costs for foreign investors in Japan when compared with western developed countries.[23] For example, in Japan, a “certificate of seal registration” is required in registering a new company, in contrast to the western countries, where signatures are used in registering companies and signing residential leases and nothing comparable to the requirements imposed in Japan exists. The stringent rules for land development approval under multi-layered land use regulations in Japan, which have been guided by the limited land availability in the country, have also been pointed out to significantly increase costs for foreign corporations. It is also often pointed out that foreign corporations find it difficult to hire capable middle managers due to practices rooted in the life-time employment system in Japan, which has led to an immobile labor supply. Again, for foreign companies lacking in collateral assets and having no history of business in Japan, unless the parent company offers guarantees, it has been pointed out that fund procurement through a bank loan is difficult due to the requirement of a ‘personnel guarantor’ for loans from local financial institutions.

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[22] While growth in gross inflows was strong in 1991, that of net inflows was negative in that year. Net inflows registered a growth rate of about 102% in 1992. The only other year of positive growth in FDI inflows (both gross and net) in the first half of the nineties was 1994.

[23] Based on JETRO, 2000, The Survey on Actual Conditions Regarding Access to Japan: Inward Foreign Direct Investment, June 2000 and JETRO 2001, The Survey on Actual Conditions Regarding Access to Japan: Direct Investment to Japan-Business Activity Support Services, June 2001.

Apart from these regulations and practices, a wide range of regulations in Japan's corporate (Commercial Code and other related laws) and financial laws, erected effective barriers to foreign direct investors wanting to set up business in Japan. However, the protracted recession of more than a decade made Japan's economic system undergo drastic transformations, the most dramatic of which began occurring from the late nineties. Thus, in order to understand the reason behind the remarkable surge in FDI inflows in the second half of the nineties, it is important to understand how these historical changes in Japan's corporate laws has made FDI policy liberalisation effective in terms of facilitating ownership changes.

The Historic Rewriting of Japan's Corporate Laws

As the Japanese economy entered into a prolonged recession from 1991 onwards, the government tried a wide range of schemes to reinvigorate the economy over the course of the last decade. None of the government attempts to boost private consumption or liquidity, however, was seen to have a lasting effect on the national economy. But, even as the debate goes on whether Japan's problems are structural[24] or simply due to a persisting deflationary downward spiral linked to the burst of the asset bubble that was built up subsequent to financial sector liberalisation of the 1980s,[25] it has been widely recognised that corporate restructuring was the key to the economy's recovery process and long-term viability of their corporations, as the economy has been confronted with large-scale financial and corporate distress with the continuing recession.

However, early resort to corporate restructuring and prompt revival of distressed firms was not forthcoming as smoothly or fast as was required for a faster resolution to the Japanese financial sector's bad loan problems. This was because of the large and ever-expanding scale of the problem amid a deteriorating economic environment and also due to the fact that the viability of the financial sector too continued to get affected given their widespread cross-holdings. While the revival mechanism for liquidation of corporations with excessive debt was functioning effectively until the early 1990s, (as continuous economic growth ensured that it was within banks' earning capacity and financial conditions to absorb disposal costs), it became a victim of the continuous recessionary conditions in the economy. Thus, since the second half of the 1990s, the number of corporate failures, especially that of listed companies, has been on the increase,[26] which has led to further deterioration in banks' financial position due to their increased commitments.

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[24] For example, a closer examination of the proximate sources of change in total GDP growth for OECD countries after 1995 shows that Japan is the only country having faced a deceleration in both productivity and labour resource utilisation. See OECD (World Economic Outlook, 2003). On the other hand, Shinada (2003) has shown that in terms of changes in total factor productivity (TFP), while manufacturing industries suffered stagnant growth after the collapse of the bubble economy, they succeeded in maintaining overall positive growth only due to expansion in electrical machinery and other IT-related industries. On the other hand, there was a broad decline in productivity in non-manufacturing industries due to the scaling back of corporate activities and prolonged decline in demand and personal consumption during the recession in the 1990s. See Shinada, Naoki, 2003, Decline in Productivity in Japan and Disparities Between Firms in the 1990s: An Empirical Approach Based on Data Envelopment Analysis, Development Bank of Japan Economic and Industrial Research Department, Research Report No. 38. On the other hand, it is clear that the continuous deflaitonary trend, by leading to a decline in investible surplus, would have itself contributed to this decline in productivity.

[25] For a detailed discussion of the financial sector deregulation and liberalisation that led to the stock market and real estate booms of the late 1980s, which in turn led to the accumulation of NPAs in the system, see Chandrasekhar, C.P. and Jayati Ghosh, 2002, "Explaining Japan's Decline", available at <www.macroscan.com>

[26] There were 32 cases (of legal liquidations) in the 1970s, 16 cases in the 1980s, 12 cases in the first half of the 1990s, 40 cases in the second half of the 1990s, and 55 cases in the last three years alone. Source: Early Business Revival Study Group Report, February 2003 available at <www.meti.go.jp>

It is clear that since the bank-based financial intermediary system in Japan had been able to support distressed corporate firms through earlier downturns and recovery phases until the burst of the bubble, the problem with the corporate revival mechanism in the 1990s must have to do with the dilution of this traditional intermediation role of the financial sector *vis-a-vis* the corporate sector, following the financial liberalisation of the 1980s. This dilution had come about through increased investment by banks into market-driven sectors. If the economy has not been in such a prolonged state of deflationary conditions, it might have been still possible for the same system to continue, since any rise in asset prices held as collateral by the banking and non-banking lenders would have helped them again to cover the costs of corporate failures.

It became clear that the economy has become unable to absorb the costs of rising business failures. At the same time, following the contemporary views on financial sector liberalisation, it was also no longer possible for the economy to revert to the earlier system wherein the financial system was less exposed to the fortunes of the asset markets. Thus, the government has been made to undertake drastic transformations in its long-standing Commercial Code laws on corporate reorganisation as well as in a host of related areas, in order to pave the way for market-led corporate restructuring, mainly driven by secondary market operations like mergers and acquisitions (M&As). This has received ample encouragement from the neo-classical school of thought, and from various foreign players who could, until recently, not achieve 'market-driven' liberalization of the Japanese corporate system.

Concurrently, the same pressures have led to a growing convergence within Japan's policymakers and private sector to the belief that only inward FDI can bring about the necessary economic restructuring required in the Japanese economy and revive production growth, and that only M&As can increase the low levels of inward FDI into Japan within a finite time, given the depressed conditions.[27] In April 1996, the Japan Investment Council's statement on M&A espoused a new willingness on the part of Japanese corporate sector to embrace M&As as part of the market-oriented approach to corporate restructuring. Much hope has since been pinned on a comprehensive reform effort dubbed the "Big Bang", encompassing reforms in banking, capital markets, insurance, and accounting standards. Together, these reforms are slated to mark a historic shift away from the main characteristics of the traditional Japanese corporate environment such as bank-centered financial intermediation, *keiretsu*-controlled stock ownership patterns, administrative guidance, insider-dominated board of directors, etc. [28]

One of the legal hurdles with respect to M&As in Japan was that there had been a ban on pure holding companies, fearing that such a structure would lead to anticompetitive business practices. In an effort to provide Japanese corporations with organizational flexibility, on October 1, 1997, the Japanese government amended the Commercial Code to simplify and rationalize the

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[27] This gets reflected in the fact that every major domestic interest group (inclusive of METI which has been under pressure to 'show' corporate sector revival and the Keidanren, the association of Japanese corporations, as their dependence on external capital increases the need for shift to international practices) have been supportive of liberalization of rules that restricted corporate restructuring earlier.

[28] Announced in 1997 by then Prime Minister, the "Big Bang" program takes its name from the British financial reform package of 1986, which proved moderately successful in stimulating the British economy. See Mark Poe, Kay Shimizu, Jeannie Simpson, 2002, "Revising the Japanese Commercial Code: A summary and evaluation of the reform effort", Stanford Journal of East Asian Affairs, Spring 2002, Vol. 2, p. 71-95, and Hashimoto, Motomi, 2002, "Commercial Code Revisions: Promoting the Evolution of Japanese Companies", Nomura Research Institute Papers, No. 48, May 1, 2002 for detailed discussions on the various revisions of the Commercial code. Many details in the ensuing discussion are based on the first source, while other sources like Hashimoto (2003), "Commercial Code Revisions in Japan" by the Ministry of Justice and Progress of "Program for financial Revival" at <www.fsa.go.jp> of the Ministry of Finance have also been used.

procedural rules for mergers.[29] This made it easier for corporate parents to reorganize and trade their business units. The Anti-Monopoly Law was also amended effective January 1, 1999, to increase the size of M&A that must be reported to the Japan Fair Trade Commission (JFTC).[30] The old threshold that basically prohibited mergers resulting in a market share of 25 percent or more was also cancelled.

For a few years following the sanctioning of holding companies, however, major impediments to business reorganization still remained. First of all, while the collapse of the bubble economy had left many Japanese companies with huge floats in outstanding shares and inefficient or marginally profitable assets, they faced strict limitations on the repurchase and retirement of outstanding shares.[31] It was only from 1994 onwards that the government had begun gradually relaxing these stringent restrictions, and subsequently, a broad range of companies had gradually used these channels. However, since cross holding of shares is a common phenomenon, relatively few shares were available for trading in the market. Moreover, resistance to M&A has been strong as almost all Japanese directors are promoted internally from the ranks of the companies where they are employed. However, in 1999, the Diet passed a bill that allowed for compulsory share exchange if endorsed by a two-thirds majority of the shareholders.[32] Meanwhile, the ban on repurchase and retirement of stocks, without restrictions on the purposes behind the transactions, was finally lifted in the spring of 2001.

Secondly, previously, Japanese corporate law was full of restrictions that prevented companies from changing their corporate structure. For example, an important impediment was that previously Japan's corporate law had lacked provisions regarding corporate spin-offs, which allow a corporation to divide itself into separate companies. The absence of spin-off provisions became a pressing issue as the economy continued to stagnate, and corporations increasingly needed to streamline themselves by divesting unprofitable divisions. Thus, the company splitting system was implemented in 2000.

Such corporate restructuring is being rapidly facilitated in the recent years by the start of a movement towards the dissolution of cross-holding relationship, driven by the following regulatory changes. Firstly, from reporting periods after April 1999, corporate accounts have been reported principally on a consolidated basis. Companies are no longer able to "cover up" losses, non-performing assets, and debt-ridden subsidiaries by excluding them from the consolidated assets statement. As a result, there is pressure to create value at the corporate group— not just parent company level— and to restructure via divestment of sub-performing assets and companies. Secondly, the Financial Services Agency (FSA) has attempted to encourage banks

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[29] Prior to this amendment, a company was required to notify all the creditors individually of its merger plans and give them the right to raise objections. Now, a company has only to put a notice in a daily newspaper. Previously, a company also had to hold a shareholders' meeting both before and after a merger. Now, it has to hold a meeting only before a merger. In addition, small mergers have been totally excluded from these requirements.

[30] Now, reporting is required only when a company whose total assets are over Yen 10 billion merges with or acquires a company whose assets are over Yen 1 billion. With the average corporate size being only slightly above one billion yen (1013 million yen in 2003 1st quarter), it is clear that there will be massive underreporting of M&As in official sources.

[31] In the later half of the 1980s, listed Japanese corporations had heavily increased the amount of direct financing, through the issuance of stocks and corporate bonds. After the collapse of the bubble, however, for several years from April 1990, equity financing operations were actually suspended and companies turned to bonds for which the limitations on issue amounts had been abolished. However, government restrictions imposed from the point of view of creditor protection, remained.

[32] Whereas earlier, in the absence of a share exchange system, a single hold-out shareholder could prevent a firm from purchasing another as a wholly owned subsidiary. Information based on Poe, Shimizu and Simpson, 2002.

more directly to sell their cross-held shares. In June 2001, the agency proposed that a bank's shareholdings be less than the value of its capital holdings in a company, and requires banks to divest of all excess shares over a three year period, which is estimated to be more than 10 trillion yen.[33] Thirdly, beginning in March 2002, new corporate accounting rules require that cross-held shares be assessed at their market value rather than their book value. Because the market value is much more volatile than the book value, banks and corporations are expected to have further incentive to divest of their cross-holdings. Thus, market value accounting has also added impetus to reducing cross-shareholdings and cross-shareholding rates have been gradually falling in recent years.[34]

However, even after Commercial Code revisions allowed corporate restructuring, the risks of considerable tax burdens arising from corporate spin-offs left the reforms unenticing. This was because tax rules regarding reorganization previously treated mergers favorably but spin-offs unfavorably. Prior tax rules regarding parent-subsidiary taxation also encouraged integration. Further, it was not possible to include profit and loss of the company being purchased when the holding company calculates its taxable income. Since this reduced the incentive to acquire companies and meant that there was little value in making use of the holding company system (which has been permitted since 1997), this was one of the factors that failed to promote greater M&A activity in Japan, until the consolidated tax payment system was introduced in 2002. It allows companies to defer recognition of gain arising from asset transfers and, thus, to defer the tax. As a result of all these changes, firms are said to be increasingly splitting businesses along product lines or geographical areas and spinning off unprofitable divisions.

In effect, disincentives in the Tax Code, not simply the Commercial Code, previously constrained firms from pursuing corporate restructuring. While the corporate reorganization reforms have already made it easier for firms to spin off unprofitable divisions, the holding company structure has become a viable option upon the introduction of the consolidated taxation system. At the same time, the corporate tax system has also undergone major changes in the recent years. The main reforms in Corporation Tax Law since April 1999 were a reduction in the enterprise tax rate and the corporation tax rate such that the effective tax rate has been lowered from over 50% to around 41%.

Along with the above changes, the Japanese bankruptcy system has also seen changes from around 1998, with legislative reforms in the bankruptcy laws taking place in 2000. There are two key points to the new Bankruptcy Code: companies can apply for court protection before their liabilities surpass their assets, and this move needs the approval of half a company's creditors, down from the previous requirement of three-fourths. The new bankruptcy law is intended in part to facilitate the transfer of operations of a failed company to its buyer. This is said to have opened the way for a new restructuring method that combines filing for court protection and revival through M&As.

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[33] It is estimated that through 1999 and the first half of 2000, major banks sold cross-held shares of a total value of more than 4 trillion yen. See Poe, Shimizu and Simpson, 2002.

[34] According to a report from the NLI Research Institute quoted in Poe, Shimizu and Simpson (2002), at the end of fiscal year 1999, the cross-holding ratio stood at 10.5% in value (2.7% decline from the previous year), and 11.2% in share count (1.2% decline). These ratios marked new lows since the survey's inception, and indicate that cross-holdings continue to unwind at a rapid pace. Similarly, the long-term holding ratio — a broadly defined crossholding ratio which includes not only the confirmed cross-holdings but one-sided shareholdings by financial institutions, and one-sided shareholdings of financial stocks by other companies — also reached new lows of 37.9% in value (2% decline) and 34.7% in share count (2.2% decline).

Facilitated by all these important policy changes in answer to the recession, M&As in general have emerged as a significant channel for corporate restructuring in Japan since the late 1990s. These regulatory changes, along with the reversal of the yen's appreciation, which made business operations in Japan relatively inexpensive for foreign corporations,[35] also saw a continuous rise in cross-border M&As in Japan (See Table below). Consequently, the ratio of cross-border M&A sales by Japanese corporations in the country's gross FDI inflows rose from 24% in 1996 to 55% in 1997. After a slight drop in its share in 1998, the share of cross-border M&As in Japan's gross FDI inflows was just below 80% in 1999. By 2001, M&A accounted for as much as 85% of gross inward FDI. While M&As involving strategic technology tie-ups have been important, the recent surge has been motivated by the desire of foreign companies to "acquire a base"[36] in a corporate sector long protected under a conglomerate holdings structure. It is therefore clear that this large increase in the share of cross-border M&As in Japan's inward FDI, which was a result of the direct impact of the changes in corporate laws that facilitate the legal environment for M&A activities, has been the major factor behind the large surge in FDI inflows since the late 1990s.

Table 2: Contribution of Cross-border M&As to Japan's FDI Inflows, 1996-2001.

	1995	1996	1997	1998	1999	2000	2001
1. Cross-border M&A sales by Japan*	541	1719	3083	4022	16431	15541	15183
2. Growth rate in cross-border M&A sales by Japan		217.7	79.3	30.5	308.5	-5.4	-2.3
3. FDI Inflows **	3930	7084	5605	10240	21062	28998	17921
4. Cross-border M&A sales as % of FDI inflows	**13.8**	**24.3**	**55.0**	**39.3**	**78.0**	**53.6**	**84.7**

Notes: *Based on WIR, 2002, UNCTAD and FDI data form the Japan Ministry of Finance.

In the following section, we examine the structural composition of FDI inflows and its changes, to analyse the factors underlying the recent surge.

Changing Sectoral Composition in FDI flows

In terms of the number of foreign investments in Japan, non-manufacturing sector has always dominated FDI into Japan and their prominence has increased significantly over time. The share of manufacturing sector which had constituted an annual average of about 35% of total *number* of foreign investments during the late eighties (1989-90) decreased to as low as 13% in 2001. On the other hand, while the annual average shares of manufacturing (48%) and non-manufacturing sectors (52%) in total FDI inflows in terms of value were roughly the same in the late eighties, by 2001, service sector came to account for as much as 85% of total FDI inflows.[37] This was principally owing to the drastic increases in the *number* of service sector investments. Even though service sector investments also increased in average size steadily, manufacturing sector showed a much higher increase in terms of the average size of investment all throughout the nineties.

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[35] After the continuous appreciation of the yen against the US dollar after the Plaza Accord of 1985, the yen depreciated continuously over the two years from May 1995 through May 1997. During 1997-99, it appreciated again, before starting to depreciate subsequently over 2000-01/02. The yen is appreciating currently against the dollar. From an average of 125.4 to the US$1 in 2002, the yen has climbed to 118.9 on April 2nd 2003. However, the Bank of Japan seems to resisting the pressures on yen for further appreciation, and the yen is currently hovering around 120 to the dollar.

[36] See Nicholas Benes, 2002, "Increasing FDI Without Adding to Overcapacity", JTP Corporation Presentation to the 18th Expert Committee Meeting of the Japan Investment Council, November 21, 2002.

[37] However, in 1999, the share of the service sector had shown a heavy drop to below 60% of the total, due to some very large investments in the manufacturing sector.

Table 3: Industrial Distribution of Inward Direct Investment into Japan

Sector / Industry	**Value of Investments** (% share)			
FY	**1989-90**	**1991-97**	**1998-2000**	**2001**
Mfg. Total (Share in Total)	**48.4**	**42.8**	**29.8**	**15.1**
Food	1.7	2.6	2.8	10.7
Textile	0.6	0.6	0.5	0.9
Rubber & Leather	1.3	3.5	0.8	2.1
Chemical	22.5	37.3	13.8	35.3
Metal	6.6	6.1	0.9	0.0
Machinery	60.0	41.1	67.0	42.2
Petroleum	1.3	4.1	12.0	2.7
Glass & Ceramics	0.5	-	-	2.9
Others	5.6	4.5	2.0	3.2
Non-Mfg. (Share in Total)	**51.6**	**57.2**	**70.2**	**84.9**
Telecomunication	1.5	1.8	19.0	44.8
Construction	0.6	0.2	0.1	0.5
Trading	46.1	39.7	17.8	5.9
Finance & Insurance	9.6	23.4	41.5	35.7
Service	14.9	25.7	18.5	9.0
Transportation	1.9	0.8	0.3	0.1
Real Estate	20.7	5.4	2.2	4.0
Others	4.6	2.9	0.4	0.0
TOTAL	**3952**	**5329**	**22882**	**21779**

Source: Based on gross FDI inflow data from the Ministry of Finance.

Within the manufacturing sector, machinery and chemical industries were the only significant recipients of FDI inflows in the late eighties. By 2001, chemical industry had increased its share significantly to account for more than one third of total manufacturing sector inflows. However, the machinery industry remained the most dominant recipient within manufacturing. Inflows into food, petroleum, glass & ceramics etc. also have also risen in relative significance. The boom period of 1998-2000 was signified by large inflows into the machinery, chemical and petroleum industries.

Within service sector, trading had accounted for nearly half of all FDI inflows during the late 1980s. Real estate and services had attracted the remaining FDI inflows into the service sector in this period. By 2001, the shares of all these service sub-sectors were down to less than 10%. Meanwhile, the share of finance and insurance sector, which began increasing during 1991-97, increased to about an average 42% of all service sector FDI during the 1998-2000 boom period of inflows. On the other hand, in 2001, the telecommunications sector became the single most significant recipient (accounting for 45% of all service sector FDI inflows).

Given the dramatic increase in the value of inflows during 1998-2000 as compared to the late 1980s when the manufacturing and service sectors had accounted for roughly similar shares in total inward FDI into Japan (See Table 3), the implications of the huge ownership changes in the latter period, particularly in the Japanese financial sector, cannot be overemphasised.

This sectoral composition of FDI inflows, combined with the dominance of M&As as channel clearly indicate that the changes in the corporate laws related to M&As have been particularly mirrored in the case of the large inward investments in industries such as automobiles (included in the machinery sector), telecommunications, finance, insurance and petrochemicals. While large M&As were dominated by banking and telecommunications in 2000, deals in a number of new

sectors such as smaller telecom, insurance, pharmaceuticals, and vehicle parts became significant in 2001.[38] This has also been facilitated by the deregulation undertaken in those industries.

Parallel to the revisions in the laws relating to corporate sector reorganisation and governance, deregulatory measures were also seen in sectors which accounted for large FDI inflows.

For example, the finance and insurance sector has seen the most significant deregulation in the late 1990s. In April 1996, a new Insurance Business Law was implemented while in 1998, the Foreign Exchange and Foreign Trade Control Law was revised. This was followed by the implementation of the Financial System Reform Law in December 1998. A series of deregulations, such as the shift from the licensing system to the registration system for securities companies, has given foreign financial institutions an opportunity to step up operations in Japan. Subsequently, a number of foreign-owned financial institutions, which had pulled out of the Japanese market and reduced the scale of their operations during the post-bubble phase, once again began making active inroads into Japan's financial sector in the late 1990s. This can be attributed to the growth in the personal asset management market prompted by the progress in financial liberalization and to expectations of a rise in stock prices on the back of an economic recovery. Another group of foreign financial institutions have also been active in acquiring failed and financially depressed Japanese financial institutions. On the whole, it can been clearly seen that Japan's traditionally closed financial system has been undergoing ownership changes involving significant foreign penetration.

In the telecommunications industry also, which was a sector characterized by strong government protection and strict regulations for security purposes with only limited deregulation from the mid 1980s, liberalisation gained momentum from the second half of the 1990s. Under the revised Telecommunications Business Law, connections to international circuits and domestic public telephone networks were deregulated in December 1997. In February 1998, restrictions on foreign capital participation in Type One telecommunication companies (which own the lines) were abolished. As a result of this, numerous foreign international telecommunications companies entered and undertook operations in Japan. While in general, the targets for foreign M&As in Japan have been financially distressed companies, in the case of telecommunications, foreign corporations have been quoted to be competing with Japanese corporations for the acquisition of companies with sound financial statements. Thus, cross-border M&As in the Japanese telecom sector is also part of the consolidation going on in the global telecommunications industry.

Further, in manufacturing industries where international corporate restructuring is taking place, foreign corporations are aggressively acquiring operational bases in Japan as part of their worldwide reorganization effort. For example, the large growth in investment in machinery resulted mainly from massive investments in the automobile industry, in which corporate realignment gained momentum in the late 1990s all over the world. Foreign corporations are finding the location and accumulated technical capabilities of Japanese automakers attractive as operational bases to the Japanese and Asian markets. Japanese corporations, too, now view partnerships with foreign corporations as a promising option for reinforcing their financial and technical strengths amid the ongoing downturn in the Japanese economy. [39]

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[38] See JETRO White Paper on FDI, 2000 and 2001.

[39] For example, Ford Motor of the U.S. acquired a stake in Mazda (33.4% stake) in April 1996 while Renault of France purchased a stake in Nissan (36.8% stake) in March 1999. In both cases, the foreign companies dispatched management personnel to the Japanese automakers, thereby speeding up the review of their management structure.

Major Source Countries of Japan's Inward Investment

Thus, as expected, industry-wise regional distribution of Japanese FDI inflows shows that developed countries dominated inflows into both manufacturing and tertiary sectors. Geographically, the share of North America (dominated by the United States), which was the most dominant investing region in Japan in the late eighties, declined from an average 44% during 1989-90 to 32% of total FDI inflows by 2001. On the other hand, the average share of Europe in total FDI inflows, which has been stable around 35% since the late eighties and throughout the nineties, registered a quantum rise to 50% in 2001. While the average size of investments from both North America and Europe have steadily increased, the average size of European investments has become almost twice as large as those from the former. Within Europe, Netherlands followed by Germany and Switzerland were the most important investors in the late eighties. However, by 2001, Netherlands, UK and France became the most prominent investors.

While North American investments have always been concentrated in the non-manufacturing sector, its share has increased to above 90% of total North American inward FDI into Japan over the 1990s. Proportionately, the share of manufacturing sector has shown a steady decline from an average of about 32% during 1989-90 to less than 10% by 2001. Within manufacturing, machinery followed by chemical and metal industries used to account for the bulk of inflows from North America. However, the share of machinery industries has increased significantly since the inward FDI boom of the late nineties. Within the non-manufacturing sector, trading followed by real estate and service industries constituted the majority of inflows in the late 1980s's economic bubble period. While the share of all these have dropped subsequently, the most conspicuous increase in North American corporate presence in Japan has come in the finance & insurance sector. North American inflows into the finance and insurance sectors reached historical peak levels during 1998-2000.

The industrial composition of European FDI inflows to Japan shows the reverse of that of the US. Except for a decline in the early nineties,[40] European FDI into the manufacturing sector has always been higher than that into the non-manufacturing sector and accounted for as high as 71% of the total inward FDI from Europe into Japan in 2000. But, in 2001, it collapsed to just 14% due to some very large non-manufacturing sector investments. Within the manufacturing sector, machinery followed by chemical industry dominated European FDI inflows into Japan, with the average size of machinery investments registering a quantum jump during 1998-2000, related to the M&A that occurred in the automobile industry in this period. Within the non-manufacturing sector, European investments into finance & insurance and service industries also began increasing substantially from the mid-1990s. However, in 1999 and 2001, European investments were dominated by just 5 and 16 exceptionally large-scale M&As in the telecommunications sector.[41] Thus, the uncommon domination of the non-manufacturing sector in 2001 in European investments was almost entirely due to these large-scale investments in the telecommunication sector.

In terms of other investing regions, inflows from Asia and Latin America, which used to constitute roughly about 4% of total inward investment in the late eighties, increased in the nineties. Latin American inflows were also dominated by non-manufacturing industries such as trading, services

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[40] In the late 1980s, the manufacturing sector had accounted for an average 62% of European FDI inflows to Japan.

[41] For example, in 2001, Vodafone Group, the biggest mobile phone service operator in Britain, acquired Japan Telecom by buying British Telecom's stake in the company. Vodafone has also obtained a controlling stake in J-Phone Co., a cell phone subsidiary of Japan Telecom Holdings Co.

and finance & insurance. The latter flows were largely linked to international tax havens like Cayman Islands, where Japanese investors also had high stakes. On the other hand, after increasing in the pre-crisis period, the relative share of Asia (mainly South, East and Southeast Asia) in the value of total FDI inflows dropped drastically during the late nineties subsequent to the financial and economic crisis. Clearly caused by the absence of investible funds from either corporate profits or loans in the aftermath of the crisis, there was a drop in the number and average size of Asian investments into Japan in this period. Meanwhile, Asian investments in Japan, which were dominated by Hong Kong and Singapore in the late eighties, have come to be dominated by Singapore and Taiwan during 2000-01. These are mostly related to those in finance & insurance, trading as well as electrical machinery.

Significantly, investments by foreign-owned or affiliated companies already operating in Japan have constituted a significant share of the total FDI inflows into Japan. Their share increased from 11% during 1989-90 to some 19% during 1998-2000. This is a clear testimony to the increased buoyancy in FDI inflows, which is associated with the ongoing process of corporate ownership changes occurring in Japan's domestic economy on all fronts, including expansionary activities. Given that FDI inflows into Japan have been dominated by those into the non-manufacturing sector, overall investment by established foreign affiliates are also dominated by this sector, particularly by trading and service industry firms. During 1991-97, however, there were significant investment undertaken by established foreign affiliates in all the four key manufacturing sector FDI recipients namely, machinery, chemical, metal and petroleum industries. However, during the boom period 1998-2000, investment by non-manufacturing corporations increased in share again dominated by foreign corporations in the telecommunications and finance & insurance sub-sectors. It is clear that with the large number of new foreign enterprises that have set up operations since the late 1990s, the investment share of established foreign enterprises in Japan is likely to rise again.

Future Prospects

It is clear that the increase in FDI inflows into Japan since 1997, against the backdrop of the ongoing economy-wide corporate and financial sector restructuring, portends significant ownership changes in important sectors of its economy. By leading to the dismantling of the traditional Japanese corporate structure, the recession seems to have come as a blessing in disguise for some of the foreign investors who have since long been frustrated by Japan's characteristic corporate practices that protected its market for investment.[42] This is particularly so in sectors such as finance & insurance, telecommunications, transport equipment, chemical industries and electrical machinery. As various inter-related reforms in the financial markets, corporate governance and accounting systems accelerate the deregulation of Japan's capital markets and change traditional corporate financing practices, foreign involvement in the economy is set to increase further. All these will lead to change in business strategy of Japanese corporations to counter increasing competition on their domestic turf and would also influence global positioning of Japanese outward investors.

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[42] In fact, it has been pointed out that the American Chamber of Commerce in Japan (ACCJ) has been the most active foreign influence on the direction of corporate reform in Japan. The ACCJ's interest in corporate reform seems to be motivated by the desire to increase the similarity between Japanese and American corporate law (so that foreign businesses and investors will be better able to predict the outcomes of their activities, apart from money for their shareholders (by getting Japanese managers to share their primay objective of maximisation of shareholder value). In fact, nearly all the proposals suggested by ACCJ are reportedly direct transplants from American corporate law. See Poe, Shimizu and Simpson (2002).

As the shift to cash flow management focusing on business profitability and establishment of disclosure practice become more widespread, enterprises are expected to receive signals for early implementation of business revival from 'outsiders', such as financial institutions and rating agencies.[43] This will inevitably put increasing pressure on Japanese enterprises to be competitive or adopt various types of restructuring to dispose off less profitable divisions or enterprises earlier and faster than before. Caught between survival and the need for competitiveness, more and more Japanese enterprises are likely to be prodded into restructuring and business reorganization by accepting foreign capital. Meanwhile, increased securitization makes it possible for banks to divide their loan assets into small lots and sell them to many investors. In fact, the government has recently announced that foreign firms will have equal and fair access to the processes and the investment opportunities that will be created by the Industrial Revitalization Corporation of Japan (IRC) as it disposes off bad loans.

M&As as part of the market-oriented approach to corporate restructuring will also likely increase, as new types of investors come to be actively involved in Japanese corporate sector financing[44] such as corporate rehabilitation funds,[45] take-over funds,[46] foreign pension funds, and other foreign investors.[47] Large MBOs or management-buy-outs have also recently emerged.[48] All these investment entities are expected to undertake investment by judging the potential of businesses and, as shareholders, supervise the management of invested companies. This will place stronger emphasis on cash flow management rather than on enhancement of growth potential and stability considered from a long-term perspective, which have been traditionally the major factors in investment decisions by Japanese investors. This also implies a shift in the nature of inflows that will be recorded as FDI in Japan. The regulatory changes related to business reorganization and the change in corporate financing implies that increasingly foreign investors could also be those with short- to medium-term investment plans rather than long-term.[49] Further, while Japanese investors plagued by recessionary conditions are loosening their relationship in both financial and

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[43] It has been pointed out that financial institutions are beginning to offer restrictive financial covenant-attached financing and disclosing internal rating information. A restrictive financial covenant is one of the clauses in a financing contract, which requires borrowers to maintain a specific financial indicator (for example, the ratio of interest payments to cash flow) above a certain numerical value and disclose the index reading on a regular basis (for eg. every quarter or every six months). If the figure falls below a certain numerical value, the covenant requires revising the loan terms. This is expected to make it possible for a lender to prod the corporate borrower to embark on business improvement at an earlier stage. See Early Business Revival Study Group Report, February 2003 .

[44] Following deregulation, fund raising from the capital market has recently increased to about 30 percent of the total fund raising of Japanese corporate firms.

[45] These funds invest in promising businesses of corporations under reconstruction and business corporations engaged in strategic M&As.

[46] A takeover fund is an investment fund, which raises funds from more than one investor, for the purpose of acquiring the right of management of a business. They acquire a target company, raises its value by measures as the replacement of management or restructuring, and sell it later for a capital gain (within 3 to 5 years). During and after 2000, many takeover funds for the purpose of acquiring Japanese companies have been established. In addition to those established by foreign investors such as US securities companies and independent investment managers, Japanese financial institutions and major trading companies are entering into this field. Source: Invest Japan site.

[47] As part of the financial sector reforms, funds are moving from being controlled by the MOF to private funds that are open to management by foreign asset managers. The liberalization of investment restrictions in Japan has conferred economic power on western pension funds, which are having liquid investible funds.. See Poe, Shimizu and Simpson, 2002.

[48] A type of M&A in which a manager of a subsidiary or a business segment acquires the right of management of that subsidiary and becomes independent. In these M&As, powerful venture capitals in Western countries tie-up with Japanese city banks to supply funds. In such cases, a company which takes over a business is established, and loans by venture capitals or city banks are usually extended to it when it takes over a business. Ibid.

[49] From April 2003, the requirement that foreign companies conducting continuous business activities in Japan must set up a branch office in Japan has also been abolished.

real sectors, western companies are consolidating them by means of the cross-border M&A activities through hybrid financial intermediaries and instruments.[50]

Implications for Asia

The increasing flows of foreign investment into the Japanese economy which underlines the integration of Japan into the ongoing processes of worldwide financial and corporate consolidation has implications for Japan's developing country hosts in East Asia.

During 1991-97, Asia was the largest recipient of Japanese outward FDI in terms of number of investments (an average 44%), with its share in the value of Japanese FDI reaching a peak of 25% in 1996. Although there was a drop in investments in Asia in terms of both number and value during the crisis period 1998-2000, Asia recovered its share (around 20%) in Japan's falling outflows by 2001. At the same time as Japan's investments into Asia has remained rather stable in terms of relative share, there is a clear realignment favouring Europe. Europe has become the largest host region for Japanese investment since 1998 and North America's share has declined.

Meanwhile, the industrial distribution of outward investment, which has been and still is predominantly oriented towards the non-manufacturing sector (dominated by finance, trading and services), has increasingly shifted towards the manufacturing sector. Japanese FDI in North America has come to be dominated by the manufacturing sector (electrical machinery, transport equipment and chemical industries), while in Europe it is still concentrated in the service sector (particularly, in finance & insurance and trade). However, in Europe too, the share of manufacturing sector in Japanese FDI has been steadily increasing (dominated by the same three industries). In Asia, on the other hand, the service sector domination of Japan's FDI during the late eighties' bubble period, has since dropped steadily and by 2001, Japan's FDI in Asia was dominated by manufacturing sector to the extent of some 65%. Of this, the electrical machinery industry continues to be the single largest recipient industry in Asia, followed by chemical and transport equipment and metal industries. Japan's non-manufacturing sector FDI in Asia is concentrated in finance & insurance, services and trade.

While Japanese outflows suggest an increasing focus on the manufacturing sector, the strategic papers of the government suggest increasing role for domestic demand-oriented growth and frontier technology-driven inward investments. The latter is confirmed by the industrial distribution of inward FDI into Japan since the late nineties (as we saw in detail in an earlier section). Amid increasing informatization, Japan's manufacturing industry is attempting to create a new advantage by exploiting its inherent strengths through the creation of "third-ware", a fusion

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[50] The 260 billion yen ($2.2 billion) buyout of Vodafone's fixed-line business in Japan Telecom by the US investment fund Ripplewood holdings this month, which is being heralded as the coming-of-age of the M&A market in Japan by the financial media, is the most suitable example of the emerging scenario of unconventional corporate M&As. First, British Telecom had bought into Japan Telecom in 1999 following the second-phase deregulation of the Japanese telecom sector. In 2001, the Vodafone Group, the world's largest mobile phone operator, acquired a two-thirds stake in Japan Telecom by buying British Telecom's stake in the company. Vodafone had also obtained a controlling stake in J-Phone Co., a cell phone subsidiary of Japan Telecom Holdings Co., as mentioned earlier. Having come to see Japan Telecom's fixed-line business as non-core operations and wanting to focus solely on the profitable J-Phone operations, Vodafone entered into talks to sell off this unit of the Japan Telecom in 2003. Last week, Ripplewood Holdings, the US investment Fund with funds from the Citi Group etc. bought Vodafone's fixed line business from Japan Telecom by using loans from JP Morgan, Citibank, Mizuho, Sumitomo Mitsui and Bank of Tokyo-Mitsubishi, etc., which funded about 80 per cent of the acquisition cost. This is the largest leveraged buy-out in Japan. Interestingly, Ripplewood Holdings was the first foreign investor to buy a Japanese bank, when it took over the failed Long Term Credit Bank in March 2000 and relaunched it as Shinsei Bank.

of hardware and software, and by opening up new frontiers.[51] It has also been recognised that in light of the growing weight of the service industry and the transformation of services into tradables, Japan will also need to boost the productivity of the service industry. In fact, JETRO has projected ICT (with the second largest wired population and rapidly expanding broadband capabilities), biotechnology, medical care, and environmental business as potential fast-growth areas for inward investment[52] and METI has identified prefectures with significant agglomeration economies in related technologies for FDI promotion into these advanced areas.

Thus, as Japan undergoes a major transformation in its own corporate ownership and industrial structure, which more than ever before in its modern history, has become foreign-penetrated and knowledge-based, Japanese companies are expected to undertake major renovations in order to prevent deindustrialization and decline in international competitiveness against the backdrop of increasing borderlessness of economic activities and the emergence of mega competition. Telecommunications, pharmaceuticals, cutting-edge electronics, medical devices and equipment, and service sectors will be the sectors where Japan will focus its energies on, while more mature technologies will be phased out. However, relocation of manufacturing industries is unlikely to see the kind of surges in outward FDI as in the past. Rather, the trends in outward investment suggest increased activities undertaken by host country affiliates on a more independent basis.

This is evident from the Survey of Overseas Business Activities produced by the Ministry of Economy, Trade and Industry (METI), according to which, the overseas production ratio, which was only 3% in 1985 when the prolonged appreciation of the yen started subsequent to the Plaza Accord, has gradually increased to 14% in 2001. Given the declining trend in FDI outflows, this rise in overseas production ratio clearly points to increased financing by Japanese corporations on their own. In fact, a report from the Development Bank of Japan (2002) has shown that in financial terms, the plant & equipment investment made by overseas subsidiaries is largely covered by funds procured locally- overseas subsidiaries' own funds and external funds procured locally.[53] Building up on the base of the large-scale investment undertaken by Japanese firms in the late eighties and mid-nineties, overseas development thus seems to be becoming more selective and focused. This is also reflected in the fact that even as there is a decrease in the number of newly established overseas affiliates and increase in the number of overseas affiliates withdrawing[54] due to restructuring and consolidation of overseas offices, overseas affiliates are experiencing an increase in revenue and profits.[55]

While they attempt to actively court inward FDI for facilitating another round of economic restructuring, the increased integration of western and Japanese financial sectors and other fast moving ICT-related sectors (both in the manufacturing as well as the service sectors) will inevitably increase the vulnerability of the region towards the business cycles and policy changes in the American and major European economies, manifold. Combined with the fact that the East Asian crisis already led to significant penetration of the crisis-hit countries' financial sectors by foreign investors following outright liberalisation and convergence in bankruptcy laws toward the

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[51] See METI, 2000 <www.meti.go.jp>

[52] See <www.jetro.go.jp>

[53] See Development Bank of Japan, 20002, Recent Trends in the Japanese Economy: Globalization and the Japanese Economy, Research Report No. 30, p. 22.

[54] This was true for both 2000 and 2001. Withdrawal as defined to include "liquidation (includes dissolution and insolvency)" and "decline in equity position (the equity position of Japan became within 0% to below 10%)". See Summary of the 31st Survey of Overseas Business Activitites, Ministry of Economy, Trade and Industry, May 17, 2002.

[55] Ibid.

Anglo-Saxon models, the implications of yet another financial crisis for the region appear more complicated than before (in terms of Japan's weakening grip on investment decisions in the region). Surely, once its economy continues to grow again, import demand from Japan will enable the regional economies' exports to grow faster. However, with its own vulnerability to global slowdowns heightened and with increased vulnerability to financial crisis due to the shorter commitments of foreign investors coming in even through the FDI channel, Japan's ability to drive economic recovery in the region may get adversely affected.

In his January 2003 policy address, the prime minister has declared the country's commitment to doubling the cumulative foreign investment in five years. Thus, the trend in increasing FDI inflows into Japan will likely continue. Meanwhile, recognizing that growth bottlenecks for Asia will also be bottlenecks for Japan, Japan continues its calls for greater liberalization of regional trade and investment, the harmonization of intra-regional systems, and the development of the various necessary economic systems. Increasingly, Japan would provide growth prospects for flexible systems operating in dynamic technological arenas. What Asia can gain from this round of economic restructuring in Japan would depend on the strength of individual countries' initiatives to find their own niche through specialized areas, and increasingly their ability to collaborate with Japanese firms (as well as those from other developed countries), rather than on technology catching-up as in the past.