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Introduction

The world is moving ever faster toward a truly globalized economy. International trade in goods and services is expanding at exponential rates, financial markets are becoming ever more integrated, and multinational companies with operations around the globe are ubiquitous. Few corners of the world have been left unaffected by these trends, and how nations respond to the opportunities and challenges posed by globalization is a key determinant of their future economic prosperity.

Although globalization has been greeted with a mixture of excitement and apprehension in most places, few developed countries appear as ambiguous toward it as Japan. On the one hand, the island nation has greatly benefited from the opportunities provided by access to world markets. Exports played a significant role in the country's stellar economic rise during the postwar period and external demand propped up the economy when domestic demand collapsed during the 1990s. In addition, Japanese firms have actively invested overseas, purchasing real estate and movie studios in the United States and setting up production facilities in the United States, Europe, and the rest of Asia. Yet, throughout most of its history, Japan has been wary of granting access to its own domestic market. During the early postwar period, government policies placed tight controls on imports and inward investment, and even after many regulations were lifted during the 1960s and 1970s, exports to and investment in Japan continued to face various informal obstacles that severely limited the presence of foreign firms in the Japanese market.

However, as a result of government reforms and structural change triggered by the prolonged recession, many of the informal obstacles to foreign direct investment (FDI) have also recently weakened or vanished. Important service sectors such as finance and telecommunication have been deregulated and measures to facilitate mergers and corporate restructuring introduced; the bank-centered horizontal *keiretsu* (business groups) have all but disappeared as extensive cross-shareholdings were unwound; mergers and acquisitions (M&A), previously almost unheard of in Japan, have become almost commonplace; and the lifetime employment system, another pillar of "Japan Inc.," has been seriously undermined by mass layoffs.

At the same time as these and other fundamental changes in the Japanese economy were gathering pace during the second half of the 1990s, the world was swept by a boom in M&A activity, which saw a series of megamergers in a number of sectors. In the car industry, for example, Germany's Daimler-Benz acquired American Chrysler Corp. in a deal worth US$40 billion, while in the telecommunications industry, Britain's Vodafone bought Airtouch Communications from the United States for about US$60 billion and Mannesmann from Germany for about US$200 billion. With investment barriers vanishing, some of this global M&A boom also reached the shores of Japan, resulting in a large surge in inward FDI. Cross-border mergers and acquisitions with major Japanese firms as the target were headline-grabbing stuff around the turn of the millennium. Prominent cases include the acquisition of a controlling stake in Nissan by French carmaker Renault, the acquisition of Japan Telecom first by British Telecom and AT&T and then Vodafone, and the sale of failed Long Term Credit Bank to foreign investors. Thanks to these megadeals, as well as many smaller ones, FDI flows into Japan during 1999 and 2000 combined outstripped the cumulative total of the entire three preceding decades.

Although FDI inflows have leveled off somewhat since those heady days and remain much lower than in many other countries, these developments and the way they have been received in Japan represent an important break with the past. Both the government and the public at large are increasingly aware that if the country is to achieve sustainable growth in the future, it needs to embrace globalization – and foreign investment – more fully. Foreign multinationals can contribute to Japan's economy in multitudinous ways: through the introduction of managerial expertise and advanced technologies that have been tested in the global market place; by adding a healthy dose of competition in areas that often have seen little so far; and by offering consumers a wider range of products and services to choose from. Yet, whether the country will be able to attract more FDI in the future greatly depends on whether the deregulation and structural change initiated in the 1990s will continue in the years to come.

The purpose of this book is to assess the issues surrounding the recent increase in FDI in Japan in detail. Of interest in particular are the forces underlying the surge in inward FDI and the impact that the growing presence of foreign multinationals is having on the Japanese economy. Specifically, the aim is to examine questions such as: Why was inward FDI in the past so low and why did it increase when it did? How can foreign firms contribute to productivity and growth? How does the entry of foreign multinationals affect the industries in Japan in which they operate? What are the future prospects for FDI in Japan, and what could or should the government do to achieve its ambitious goal of raising the inward FDI stock to 5 percent of gross domestic product (GDP) by 2010?

By looking at the actual impact of inward FDI on the Japanese economy, this book moves beyond much of the existing literature on the topic. Given that, until recently, FDI in Japan has been miniscule, it is not surprising to find that, at least up to the beginning of this decade, most research has concentrated on trying to explain why this is so. There is a long list of studies with titles such as "Why is FDI in Japan so small?" (Wakasugi, 1994); "Japan's low levels of inward direct investment: Causes, consequences and remedies" (Mason, 1995), and "Japan's low levels of inward investment: The role of inhibitions on acquisitions" (Lawrence, 1994). Even the booklength study edited by Yoshitomi and Graham (1996), with a title similar to the present volume and containing contributions by leading scholars and business practitioners, deals almost exclusively with the issue of access to Japan, discussing topics such as "How can theories of foreign direct investment shed light on the small size of FDI into Japan?" "How do Japan's distinctive business practices and trade structure affect FDI into Japan" and "What are the actual experiences of foreign multinational companies in Japan?" with the latter again concentrating on the difficulties faced by foreign firms in the country.[1]

It is only since the beginning of this decade that scholars have started to examine the role of foreign multinationals in the Japanese economy. Much of that research has concentrated on comparing the productivity and profitability of foreign- and domestically-owned firms in Japan.[2] Although FDI may have an impact in various other areas, such as employment or the

[1] The list continues. Other studies with indicative titles include "On the causes of low levels of FDI in Japan" (Wakasugi, 1995) and "Tainichi chokusetsu toshi wa naze ka sukanai ka? Keiretsu, kisei ga mondai ka? [Why is FDI in Japan so small? Is it because of the *keiretsu* or because of regulations?]" (Nakamura, Fukao, and Shibuya (1997). The level of and/or barriers to FDI in Japan are also a major concern in Encarnation (1992), Mason (1992), Eaton and Tamura (1994), Weinstein (1996, 1997), Kawai and Urata (1997), and Feenstra (1998).

[2] See, e.g., Fukao and Murakami (2005), Fukao, Ito, and Kwon (2005), and Kimura and Kiyota (2007).

current account balance, the direction and magnitude of that impact are difficult to determine once one attempts to take into account the reverberations in the rest of the economy – such as potential reductions in employment at domestic firms in response to competition from foreign multinationals. For this reason, probably the most important benefit of inward FDI is the contribution it can make to productivity growth as a result of the inflow of managerial resources. Empirical studies along these lines indicate that foreign firms indeed tend to be more productive and profitable than domestic firms.[3] These are important results that suggest FDI can make a potentially significant contribution to overall growth at a time when Japan, despite recovering from stagnation, continues to face serious economic challenges.

Research along these lines represents an important step forward from the focus on the level of and barriers to FDI. However, most of these studies are rather specialized, focus on a single, narrowly defined topic, and often tend to be technical. In addition, some of this research as well as many other materials are available only in Japanese. Against this background, the aim of this book is to provide an overview and synthesis of recent research results, put these results in the wider context of FDI in Japan, and take this as the point of departure for new original research. The next section provides an outline of each of the chapters and the topics they address.

Outline

Following this outline, the remainder of this introductory chapter provides a definition of foreign direct investment and a description of the data sources on FDI in Japan. In the Japanese context, the first challenge facing the researcher is the quest to obtain consistent, reliable, and internationally comparable figures on FDI. Reflecting the country's ambiguous attitude toward inward FDI until the recent past and also partly explaining researchers' concern with FDI *levels*, such data are difficult to come by. What are available instead are a host of different statistical sources of varying usefulness and it is therefore helpful to discuss their characteristics before embarking on the analysis of FDI in Japan.

With these caveats in mind, Chapter 2 begins the analysis by looking at various measures of inward FDI in Japan. Internationally comparable figures, such as the United Nations Conference on Trade and Development's (UNCTAD's) data on inward FDI flows and stocks, for example, indicate that

[3] Again, see, e.g., Fukao and Murakami (2005), Fukao, Ito and Kwon (2005), and Kimura and Kiyota (2007).

foreign investment in Japan is indeed substantially lower than in other advanced and many developing economies. This assessment is further supported by statistics of the Organisation for Economic Co-operation and Development (OECD) statistics comparing the share of industrial production or employment accounted for by foreign firms across member countries. However, in conducting such a comparison, the OECD has to rely on national statistics, which in Japan are based on a survey that suffers from a low response ratio and does not include foreign affiliates in the real estate and financial sectors.

To address these shortcomings and to provide a comparison of the extent of FDI penetration in Japan, Chapter 2 presents an alternative measure, the employment share accounted for by foreign affiliates in Japan, using a survey that is compulsory and covers all enterprises in Japan. Comparing these shares with figures for the United States suggests that the employment accounted for by foreign affiliates in Japan in 2001 was about half of the equivalent level in the United States in 1997, suggesting that although FDI penetration in Japan remains much lower than in the United States, the gap may not be as large as is typically assumed.

The second major topic addressed in Chapter 2 is why FDI in Japan is so low. Although geography can partly account for this, there is little doubt that government policy is a main factor. In fact, keeping foreign influences at bay has a long tradition in Japan and this chapter provides an historical overview of government policy toward foreign business. The overview shows that even though there were periods during which foreign investment was welcomed, these tended to be short-lived and for the most part investment inflows were restricted. Even when FDI "liberalization" began in the 1960s, the process was only gradual and, during the 1970s and 1980s, formal restrictions were replaced by informal barriers. It is against this historical background that the surge in FDI in Japan since the mid-1990s and the changes that have made it possible must be viewed.

Yet, as Chapter 2 also shows, although inward FDI has been restricted throughout most of Japanese history, this does not mean that foreign firms have played no part in the country's economic development. On the contrary, during the brief period when the investment regime was relatively liberal during the first three decades of the twentieth century, foreign capital and technology were instrumental in the establishment of some of Japan's most successful industries. This episode thus provides a vivid illustration of the transformative potential of FDI, although, because of the size and level of development of Japan's economy today, any impact is likely to be much less dramatic.

The surge in inward FDI in Japan over the past decade and its underlying causes are the subject of Chapter 3. The analysis suggests that the 1990s were a period of substantial political and economic change in Japan that has significantly reshaped the environment for FDI in the country. Seeking to overcome the economic stagnation that followed the burst of the bubble economy, the government enacted various reforms to deregulate the economy and attract foreign investment. For example, the Large Retail Store Law was revised twice; the telecommunications industry was deregulated and foreign investment allowed for the first time; financial sector reform was implemented; and changes in accounting rules and measures to facilitate mergers and corporate restructuring were introduced.

In addition, structural changes brought about by economic stagnation significantly reduced or even removed many of the informal barriers that had hampered inward FDI. The unwinding of cross-shareholdings, together with the measures to facilitate M&A as well as the rising number of distressed companies, for the first time, made the acquisition of Japanese firms by foreign multinationals a viable proposition. Changes in the labor market, in particular the erosion of the lifetime employment system, made it easier – and cheaper – for foreign firms to hire qualified Japanese staff, and falling property prices and office rents lowered the costs of doing business in the country. Finally, long-term economic stagnation contributed to a change in attitudes toward foreign direct investment among policy makers, the Japanese business community, and society in general.

At the same time, however, the surge in FDI in Japan from 1997 to 2000 coincided with a global boom in M&A activity, and on closer inspection, there is a conspicuous overlap between leading inward FDI sectors in Japan and industries at the forefront of the global FDI boom during that period. This suggests that, rather than the changes in Japan acting as a trigger for an autonomous rise in FDI inflows, they largely opened the gates for the wave of global FDI to lap onto Japanese shores. What is more, following the surge around the turn of the millennium, net inward FDI has been on a downward trend since its peak in 1999. This trend suggests that without significant further deregulation it will be difficult to achieve the government's target of an inward FDI stock equivalent to 5 percent of GDP by 2010.

Leaving trends in FDI inflows behind, Chapters 4 to 6 turn to consider the impact foreign firms have on the Japanese economy. Chapter 4 begins the analysis by examining Japan's recent growth performance. Although the prolonged economic stagnation during the 1990s and early 2000s to a certain extent was a cyclical phenomenon triggered by the collapse of the bubble economy, more fundamental structural factors are at work that play a crucial role in explaining the disappointing growth record. These structural factors include the unfavorable demographic trends and the declining productivity of capital in Japan. Against this background, a key role falls to total factor productivity (TFP) – the efficiency with which factors of production are used – which reflects technological progress in the broadest sense and depends on the rate of innovation, the accumulation of intangible assets, and the degree of competition in the economy. The chapter shows how TFP growth, too, has declined in recent years, highlights some of the reasons, and argues that it is in this area, which is key to achieving sustained economic growth in Japan, that foreign firms can make an important contribution.

Chapter 5 delves deeper into the analysis of the potential growth contribution FDI could make by presenting empirical evidence on the relative TFP level of foreign and domestic firms in Japan. Comparing foreign and domestic firms, it becomes evident that the former tend to show both higher TFP levels and higher TFP growth and, moreover, are ahead of domestic firms in terms of a range of other indicators, such as return on capital, wages, and research and development (R&D) investment per worker. However, most FDI cases in Japan consist of M&As, and on closer inspection, it turns out that foreign firms' superior performance partly owes to the fact that they acquire Japanese firms that already perform better than the average local firm. Nevertheless, further investigation reveals that out–in M&As (i.e., M&As where a domestic firm is acquired by a foreign one) do improve target firms' TFP level and current profit/sales ratio. In other words, the evidence suggests that FDI is indeed helping to raise productivity and thereby contributing to the growth of the Japanese economy.

The second part of Chapter 5 then attempts to quantify the macroeconomic impact of inward FDI in Japan. Because comprehensive and reasonably up-to-date statistical data for a rigorous empirical investigation are unavailable, the analysis instead simulates the impact of FDI by using the results on the improvement in TFP experienced by firms acquired by foreigners and combining these with various assumptions regarding the level of future inward FDI flows. The purpose of the simulation is not so much to provide accurate estimates of the macroeconomic impact of FDI, but to gain an overall impression of the magnitude of the effects under various assumptions. The results suggest that the impact on Japan's GDP ranges from rather modest under a relatively conservative scenario, which probably underestimates the true effect of foreign acquisitions on TFP, to quite substantial under a more optimistic scenario that assumes a fairly large, although unlikely, increase in FDI. The simulation thus supports the view that there is considerable scope for Japan to more fully benefit from inward FDI.

Whereas Chapter 5 attempts to quantitatively assess the impact of FDI on the Japanese economy, Chapter 6 takes a closer look at more qualitative evidence through a series of detailed sectoral case studies. This qualitative approach complements and extends the quantitative analysis in that the case studies provide concrete illustrations of the intangible assets – management skills, business models, the knowledge and technology embodied in products – that foreign firms introduce into the Japanese market and show how their presence shapes the competitive parameters and the degree of competition in their respective industries. In fact, in some of the industries that will be examined, the presence of foreign firms has reached sufficient critical mass to contribute to substantial structural change (although the overall number of such industries is small).

In the automobile sector, for example, foreign acquisitions of Japanese firms, and in particular that of Nissan by Renault, have led to an increased focus on profitability throughout the industry and a reconfiguration of supplier networks in parts of it. In the pharmaceutical and the insurance sectors, foreign multinationals have gained significant market share and are leading the way in overhauling distribution channels and introducing new products hitherto unavailable in Japan, thus increasing consumer choice and forcing domestic firms to raise their game. And in the wholesale and retail sector, by circumventing the traditional multilayered distribution system and introducing new retail business concepts, foreign multinationals have compelled domestic competitors to streamline their own purchasing operations, which, in turn, has resulted in consolidation in the wholesale sector.

However, there are also sectors where, despite substantial FDI inflows, foreign firms have failed to make a tangible and/or lasting impact. Prime examples are retail banking and especially telecommunications. The telecommunications industry played a central role in the increase in FDI around the turn of the millennium; yet, today, only a few years later, no foreign firms are left in Japan that offer telecommunications services to the wider public. Although the specific reasons why foreign multinationals have failed to make an impact differ in these two industries, it appears that certain features they have in common (such as the importance of local knowledge, firm size and concentration, etc.) and possibly regulation continue to form barriers to foreign firms.

What is more, the industries chosen for the case studies represent sectors that have received significant amounts of foreign investment, but large sections of the economy remain that have received hardly any FDI at all – partly as a result of industry structure, partly as a result of regulations that discriminate not necessarily against foreign firms in particular, but against new entrants in general. Yet, as the case studies show, even at the current low levels of FDI penetration, foreign firms can play an important role in reshaping and revitalizing the Japanese economy.

Obviously, though, FDI would have a much more substantial impact if there was more of it, and Chapter 7 sets out to examine the prospects for future investment flows into Japan. To do so, the chapter considers the determinants of FDI in Japan, highlighting that the central motive underlying the majority of foreign investments is to gain access to the Japanese market. Profitability and market growth therefore are likely to be key determinants of Japan's attractiveness as an investment destination. Using data on U.S. multinationals, the available evidence suggests that the profitability of foreign affiliates in Japan has improved in recent years and now is more or less on par with that in other advanced economies such as Germany, France, and the United Kingdom. At the same time, however, both the number and size of FDI withdrawals from Japan have jumped in recent years, suggesting that profits are not guaranteed and many firms have been unable to fulfill their ambitions. The outlook for market growth is also rather mixed. On the positive side, Japan has finally managed to pull out of its decade-long recession and, if all goes well, may continue to enjoy sustainable growth at rates that are more or less on par with those of Western European countries facing similar population dynamics. Yet, Japan's growth prospects pale in comparison with those of most of the rest of the region and it seems unlikely that FDI in Japan is going to benefit much from these regional growth dynamics.

Other aspects considered are political, social, and cultural factors that shape the investment climate in Japan. Compared with only a decade earlier, attitudes toward FDI have certainly changed considerably. Politicians, ministries, and business organizations are much more aware of the potential benefits of FDI and, in principle, have become much more supportive of measures to facilitate greater inflows. Society as a whole is also generally favorably inclined toward foreign multinationals. Surveys indicate, for example, that a majority of Japanese believe that foreign companies had a positive effect on the economy and especially many younger Japanese would be happy to work for one. On the other hand, Japanese society remains much less internationalized than that of most Western countries, meaning that it still remains difficult for foreign multinationals to recruit employees with the right skills, attitudes, and experience, including an international outlook. Moreover, as the economy is regaining strength and confidence in business circles is rising once again, there are also signs of a revival of earlier patterns, such as a renewed increase of cross-shareholdings as a defense against takeovers. Finally, although the government has declared its desire to attract more FDI to Japan, few concrete policy steps have been taken to achieve this goal.

Yet, it seems unlikely that FDI inflows will increase significantly without further government measures. To a large extent, the surge in inward investment in the late 1990s represents the response to deregulation and structural change during that period, which has now largely run its course. But numerous areas remain that the government could address to improve the business environment for foreign multinationals and thus increase FDI inflows. These areas include the policy framework for mergers and acquisitions, where the government needs to ensure that the triangular merger scheme introduced in May 2007 can play its intended role and thereby make it easier for foreign companies to acquire Japanese firms. Also, there remain numerous industries in which regulations hamper FDI not by banning foreign firms but by restricting market access and competition more generally. Creating a level playing field would allow foreign firms to compete and exploit their strengths in such industries and would therefore help to raise Japan's inward FDI potential and benefit the economy as a whole.

The main findings of the study are summarized in Chapter 8 and put into the context of Japan's globalization more generally. It is argued that, despite the recent increase in inward FDI, the country's integration into the world economy remains severely unbalanced. Whereas Japanese firms are pressing ahead with "outer globalization," taking advantage of opportunities overseas, "inner globalization" continues to lag significantly behind. Japan therefore faces a real danger of failing to benefit from the fruits of globalization.

As the country's own experience illustrates, inflows of foreign knowledge and technology have played a historically important role in its economic development. But whereas in the past it may have been sufficient to rely on knowledge and technology that is easily separable from managerial resources – technology that can be obtained through licensing, for example – this is no longer the case. Today, the areas in which Japan would most benefit from foreign knowledge and technology are those that are embodied in people, organizational structures, business processes, and products and come as a "package," that is, in the form of FDI. While this is true for the manufacturing sector, it is especially true for services, which will have to generate most of Japan's future economic growth, but in which the country has produced few internationally competitive companies and productivity lags considerably behind that of other advanced economies. However, for Japan to be able to take advantage of such types of knowledge, it will have to