“Foreign Direct Investment, Shareholder Power and Competition: Promoting a Virtuous Cycle”
RIETI, Tokyo
May 21, 2001

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The fact of how Koizumi came to power indicates that the process of “nemawashi” in Japan regarding reform is starting to take hold. It shows that the Japanese people are not satisfied, and this will also be clear in the elections in July. He is saying the right things but at the moment, it is unclear whether he will truly be able to implement reform.

Some reformers were disappointed, because they feel that nothing will really change until the LDP truly breaks up. Koizumi has the power to keep himself and the party in power, but not to implement reform, which will ultimately be a loss for reform.

Another concern is the clarity of the program. A cap on Japanese government bonds at ¥30 trillion, plus a bank cleanup, is going to be tough to implement. Perhaps ¥45 or even ¥90 trillion could be needed to solve the bad debt problem, and unemployment could be in the millions. If the debt is at 30% of GDP, which is the worst-case scenario, there will need to be unemployment insurance and capital injection, plus a personal tax cut. What Koizumi is currently suggesting could be a recipe for Hashimoto Take 2. Hashimoto gave reform a bad name with the consumption tax, and Koizumi could do the same. He needs to have an “extra emergency budget” of some kind, a political measure, to get around his ¥30 trillion-cap promise.

But he is saying the right things- this is positive. The obvious support for reform among the Japanese people, and in the LDP political machine, is a good sign, as is so-called “nai-gaiatsu”—pressure from internal reformers with support from outside. It was also good that the US raised the non-performing loans problem at the summit.

In the economic sphere, when METI says structural reform and FDI go together, it is correct, but how to do it? Internal competition is the key, and this should be the new mantra: "there is no competition without competition." It should not be a matter of Japanese versus foreign companies. (Slides 6, 7, 8) Industries most exposed to foreign competition are the most efficient. They have the greatest "internal competition," as shown in the slide from Porter and Takeuchi on market share fluctuations. Globalization and internal reform go together, as seen all over the world. (Slide 20) Even traditionally weaker industries, such as textiles, can do it. Toys R Us is now the largest toy retailer in Japan, but more importantly, toy prices have fallen 20% since it entered the Japanese market; a case of "good deflation." All toy retailers used to follow the manufacturer's suggested retail price, but now most of them do not. This benefits consumers: prices were lowered because of competition (slide 18). Price reductions on the supply side are desirable, as they increase consumer spending.

Taking as a given that globalization is the key to reform in Japan: Currently, imports as a percentage of GDP are lower than they were in 1955. Much (70% or so) of the import growth in the 1990's was due to what METI calls "reverse imports," or what I call "captive imports"; Matsushita televisions made in Malaysia (slide 29). This does not increase internal competition. New companies capturing leadership of markets increase productivity growth. Low imports also produce low exports, leading to economic hollowing: this is clear from looking at the economics.

In FDI, there has been more progress (slides 36, 37, 38). There has been a huge shift and it has been widespread, which is good. On a cumulative basis, however, it is still not up to international standards. At the current rate, it will be, in 5-10 years. But the rate should increase. METI knows, as outlined in its just-released White Paper, how far there is yet to go.

Why hasn't the rate increased? Mostly, FDI is acquisition. It used to be impossible to acquire a Japanese company. Foreign firm buyouts of Japanese firms have jumped, but the only companies that are for sale are the ones in trouble, possibly because foreign managers are thought to be able to make the tough decisions that Japanese managers can't, for political reasons. But it is still impossible to buy a “good” company, and this could put a ceiling on incoming FDI. New laws will now allow the selling of divisions of companies, which could lead to more M&A activity. Anything that will force corporate managers to pay attention to competition and shareholder influence would be a positive step. Bank holding of shares has not been a good system in the last 10 years, because no one is performing the duties of oversight. So-called “outside directors” are not really outside.

In finance: Foreigners now own 20% of one or both sections of the issues on the Tokyo Stock Exchange (slide 44). The foreign managed percentage of pension funds has also jumped sharply (slide 45). If 401K plans take off, there could be foreign management of a huge share of household assets, which could help to break down the system of cross-shareholding.

The three sectors to watch with regard to competition and FDI are:

- Retail: because it will introduce new competition.
- Finance: because the industry determines who gets money and who doesn’t—funds go to the efficient. Stock offerings and underwriting (slides 46 and 47) show that foreign firms have demonstrated leadership in the market. Less so in banking (slides 48 and 49), but this may also speak to the rise of capital markets over banking in this country.
- IT: because it reshapes labor, by eliminating back-office jobs and streamlining distribution. Japan needs more of this.

Are current measures enough? Are more needed? Measures currently under consideration will promote FDI and corporate restructuring; it looks good on paper. But, for instance, what is M&A used for, right now, in Japan? At the moment, it is making big companies bigger. In steel, in electronics, it is not a good trend and will produce a picture of market share that looks like slide 8 (uncompetitive industries). As Porter has pointed out, a company’s core competencies are very important: some Japanese companies make so many products that they don’t even know which are profitable, because they never had to worry about it before. Competition and shareholder control will produce a market for good corporate management. Reforms as outlined thus far are helpful, but will have a limited impact unless you look at things like the character of M&A. M&A should not be done because there are people who need to work, or because there is cashflow that needs to be utilized. Workers will move with labor mobility; cash should be returned to consumers in the form of dividends so that they can decide how to reinvest. When cross-shareholdings rose, dividends came down.

Tests of reform will be data that looks like slide 7 (on market share and internal competition), or slide 19 (less cross-shareholding means more shareholder power and income). The "Grand Nemawashi," is occurring right now, and parts of the FSA, the BOJ and METI are on the right track. Action may be a ways off yet, but things are much better than four years ago.

Question and Answer Session:

Q: Captive imports are creating competition, as in the case of Uniqlo.

Katz:

There are exceptions, and textiles could be one. But retailers did the initial outsourcing. And broadly: Japan is expensive, and firms go offshore. The effect on competition of Matsushita televisions imported for the Japanese market by Matsushita, compared to selling them next to Lucky Gold Star TVs from Korea is very different. There was a similar problem with exports, where they were being exported to overseas affiliates.

Q: What else can be done to strengthen corporate governance?

Katz:

Active enforcement of competition policy, including among industry associations, is necessary. Because they are private organizations, they do not fall under WTO rules, but they have in effect been given regulatory power because companies that are kept out are essentially kept out of the business. A strong Securities and Exchange Commission would help. How many auditors are there in Japan? (around 500) There are 15,000 in the US. "Product swaps" in certain sectors is old thinking. Even with economies of scale as an incentive, METI should (if not taking a hands-off policy) be advocating the opposite policy. And, of course, there is the fact that "outside directors" are not really outside. The threat of shareholder suits has been good: it kept IDC from being bought by NTT when C&W had a better offer, because IDC was afraid its shareholders would sue. When the cost of shareholder lawsuits went down, the Japanese seemed to shake off their cultural reluctance to sue. Being able to use stock to buy companies is also good. It is very common in the US. It has been a cross-border issue-- foreign companies cannot buy Japanese firms with stock, or vice versa. This will increase M&A in both directions. Instead of capital gains tax incentives, there should be a dividends tax incentive- anything that increases the householder share of stock ownership. It would allow consumers to decide where to spend or invest the payout.

Q: What is your opinion of the government stock-buying plan that was under discussion?

Katz:

I see no reason why consumers should be asked to bear the risk of banks' shareholdings. When securities companies guarantee investors against losses, it is illegal, and I don't see why the government should be able to make such a guarantee to banks at the taxpayer's expense.

Q: Household assets are still largely held under government plans, collectively known as FILP. What do you think about releasing those funds?

Yes, these funds should be freed. BOJ numbers on the deposits in all financial institutions shows that the amount going into government institutions is increasing. There are more government guarantees on loans, which is also a move in the wrong direction. All the disguised mechanisms of the "convoy economy" are disappearing because they are unsustainable. Everything is in the open now. This is good.

Q: On Chinese imports and safeguards for Japanese industry.

Katz:

There is no need for safeguards, and I can't understand the justification. In textiles and agriculture, and now there is even some discussion of electronics; a possible domino effect. There should be no safeguard, in principle, with some exceptions, and I can't think of any I would support. The reasoning seems to be that losing jobs to another Japanese firm is OK but losing jobs to imports is unacceptable. There should be a safety net for those affected (not to the extent of Europe, but some retraining, compensation, etc.). You cannot stop imports any more, and the debate on this topic is good.

Q: In the financial industry, M&A has taken place among big firms in response to global competition. Isn't that the right response, in some cases?

Katz:

It needs to be looked at on a case-by-case basis. When the global price doesn't impact the national market (as in Japanese steel), structural reform is needed. When the yen gap is closing, it's a good trend. Looking at purchasing power parity is helpful.

Q: It is easier to convince the public on FDI acquisitions when it brings in jobs. Why doesn't US investment bring investment that "counts toward the GDP"?

Katz:

The pattern worldwide is that FDI comes as acquisition, even among developed countries (for example between the US and Europe). The Japanese media reaction to FDI acquisition is much better than the US reaction was to Japanese acquisitions in the 1980's. It focused on the good in the "rescue operations" of the 1990's. But it's not just about the direct result of such acquisitions, it's about creating internal competition. For instance, Compaq dropping PC prices in 1992 sparked the price war between Fujitsu and NEC. In the case of Toys R Us, it brought jobs, yes, but the real impact is that toy prices fell. Yes, it's harder to explain those kinds of effects to the public, but it's still true. It doesn't matter whether or not it's a foreign firm that produces the situation in slide 7, but that's what needs to happen.

Question from Katz: Does METI actually say that the price gap must be reduced, and if so, what mechanisms are used?

A:

We say "elimination of high-cost structure," and this is what we mean by that. But there are no actual mechanisms; we cannot intervene. But in some sectors, deregulation is being pushed. Looking at purchasing power parity can function as a signal of what kind of policy measures are needed.

Q: What can or will Koizumi do before July?

Katz:

Nothing, except make symbolic statements and point to what he will do if elected. Both he and Foreign Minister Tanaka are popular. He will make enemies if he tries to act now. After July, I don't know.

There are a few scenarios I can imagine. As I mentioned before, he is strong enough to keep himself and the LDP in power. He could implement measures that look like reforms but aren't. A ¥14 trillion bad-loan write-off is not enough—it will only serve to maintain bad borrowers. Good firms will become marginal and marginal ones bad. In the meantime, ministries are saying that no capital injection is needed, and workers will need no safety net. The FSA will not admit that its numbers are wrong. This would be bad.

Another scenario is that he switches allies and reshuffles the Cabinet, with a split in Minshuto. This party is good on banking reforms, but bad on fiscal policy. That's why he needs an "emergency" category for public spending, and he needs to sequence policy well. This is a political art. He must crush the power of Keiseikai. Koizumi is sincere, but he needs to figure out the balance of power.

The US government welcomes Koizumi, but cautiously, because they got burned by Hosokawa. One debate in the US is: is reform possible with the LDP, is there a real reform leader? Many think it can't be done. Armitage, despite his pending government position with a Bush Administration and the surety that the LDP would still be in power, was very harsh on the LDP in his report. The US would like a more activist relationship on security. People wish FM Tanaka well. All new ministers have a steep learning curve, and they like the bureaucrat-bashing, and hope she gets settled soon.

Q: Economic reforms plus security issues needs strong political leadership. Can Japan do both? Which is more important?

Katz:

No such distinction is made in the US: the feeling is that an economically weak Japan cannot be a strong political ally. It was not Treasury, but National Security Adviser Condoleezza Rice who put the bad loan problem on the summit agenda.

The US is a little concerned about the remote possibility of US-China conflict over Taiwan. At this point, US tanks must obey red lights in Japan, and there is eagerness to discuss security issues.

Q: Question on Koizumi alliance with Minshuto.

Katz:

They have no idea what to do with Koizumi. They wanted Hashimoto. Their scenario was that Koizumi would come to them. The amazing thing was the rebellion within the LDP. The political process is so fluid, decision-makers do not know what will happen a few months from now.

Katz:

Many Japanese are worried about the US economy. I am optimistic, and predicting a soft to medium landing. There will be no recession; worst case would be a slowdown milder than 1990. I expect long-term growth at 3%, but real and lasting, similar to Fed predictions. Recovery may be slower than was hoped, but downturn will not be severe—even the most bearish on Wall Street do not see negative growth through the year. Japan's assessment is wrong- there will not be a harsh recession, or a protectionist trade policy, especially toward Japan. Steel is the exception, not the rule.

-The RIETI editorial department is responsible for this article.