

Foreign Direct Investment and the Japanese Economy

- Key to Japan's Revitalization -

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Overview of Today's Report

1 . Why is This a Critical Problem?

**2 . FDI Can Be a Key to Japan's
Revitalization**

**3 . Barriers to Inward FDI , and Essential
Policies**

1 . Why is This a Critical Problem?

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Globalization and Japan's Crisis: Hollowing Out

Result of Globalization and IT: Via direct investment flows, capital and management resources (technology, management knowhow) have become mobile and fluid across borders

Up until the 1980s: Japan and its people could grow their income by using the high savings rate for capital formation and building management resources through R&D

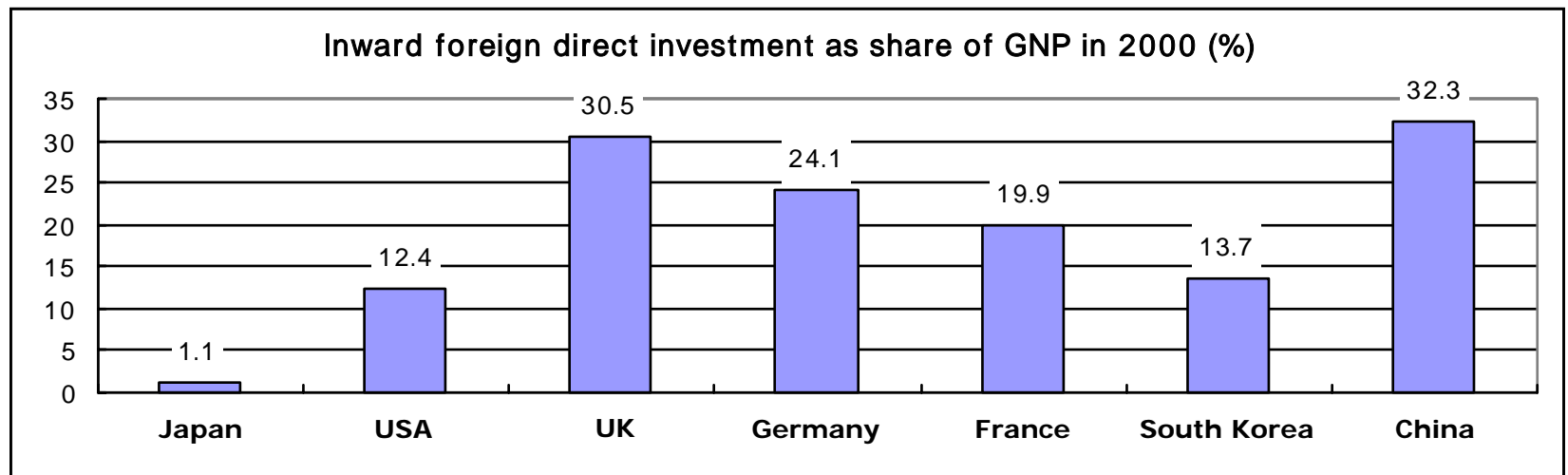
Today: The income of the Japanese people depends upon Japan's ability to attract global companies, including Japanese companies

• • • • • **The world's economy is shifting towards competition between different economic regions vying to attract global companies**

The fact that the Japan's FDI outflows greatly surpass its FDI inflows indicates that it is **losing the global race to attract corporate investment**

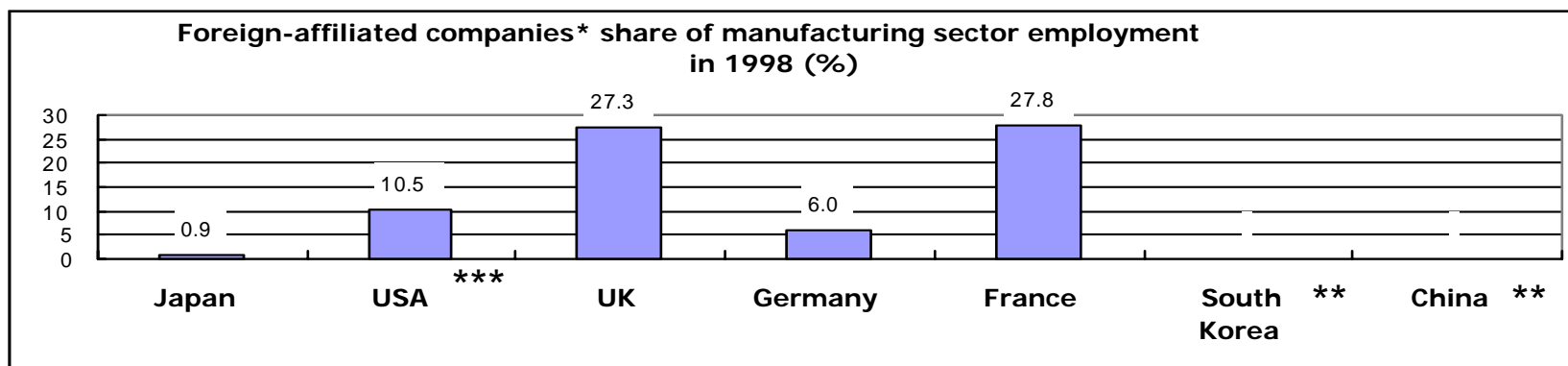
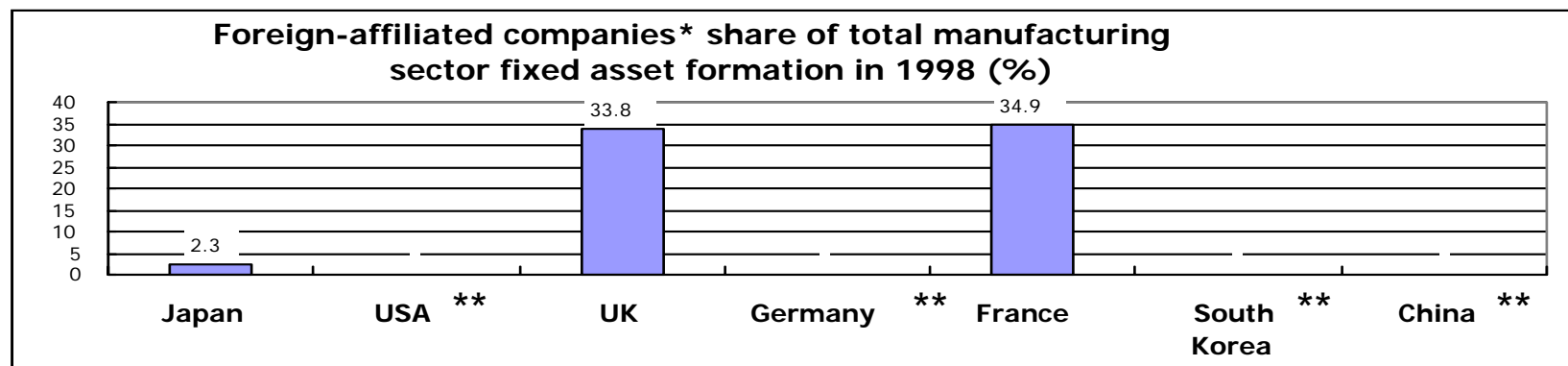
Compared to Other Countries, Japan's FDI Inflows Are Extremely Low

- As a % of GDP, only 1/11 of the U.S. and 1/22 of Germany
- Even compared to China, Korea: *orders of magnitude* lower



Source: UNCTAD *World Investment Report 2002*.

In Other Countries, Foreign Firms Make Significant Contributions to Employment and Fixed Capital Investment



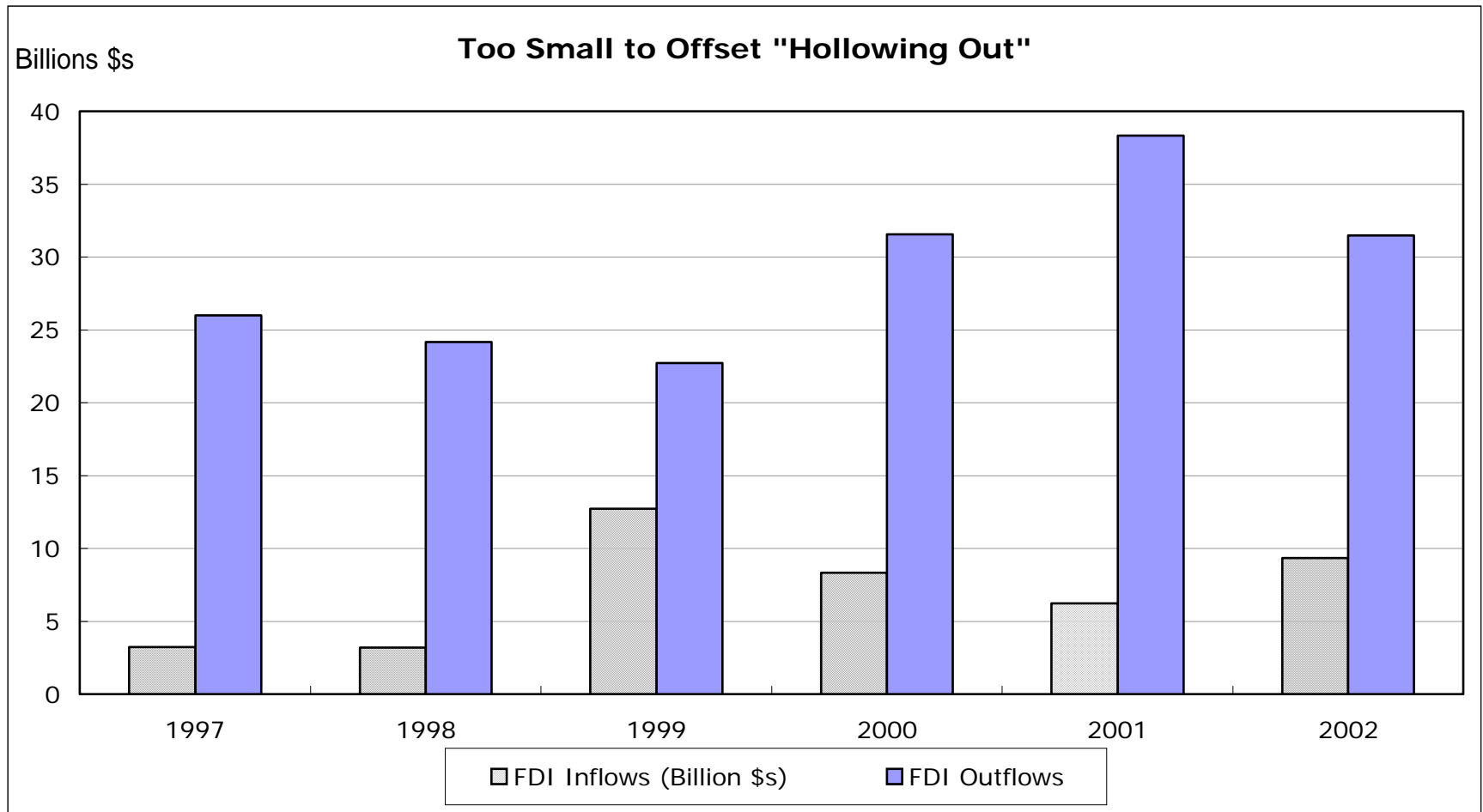
Sources: UNCTAD *World Investment Report 2002*, OECD *Measuring Globalization 2002*

* Here, "foreign-affiliated companies" refers to companies more than half foreign owned, as a rule.

** Data were unavailable for these countries.

*** For the USA, 1992 employment data (based on Itoh and Fukao, 2003)

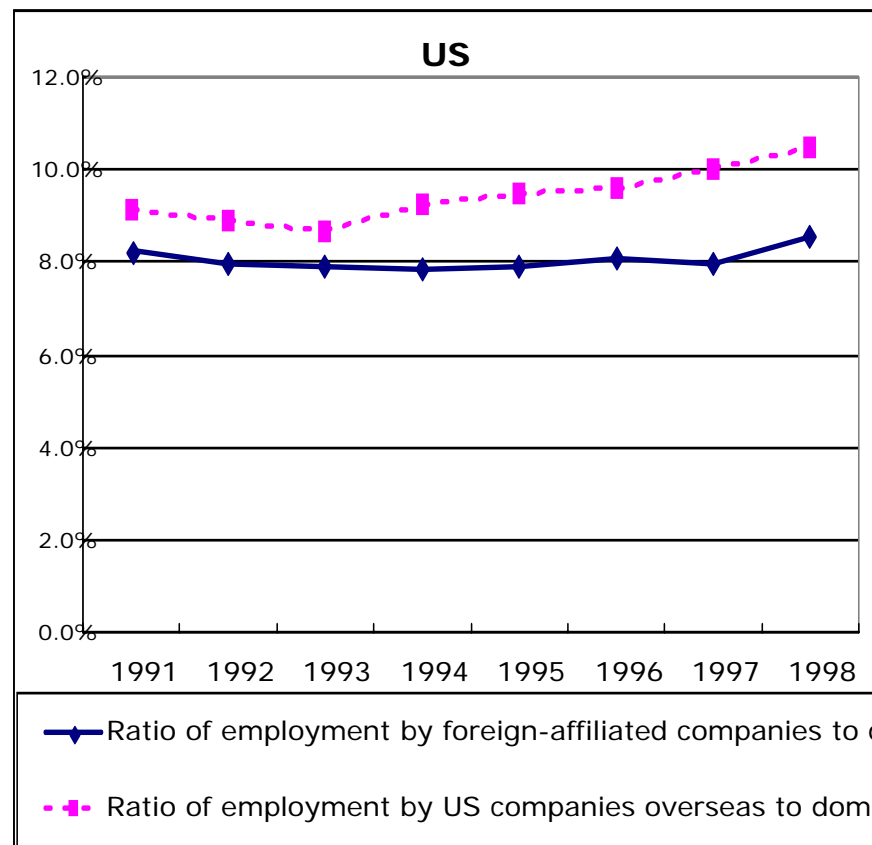
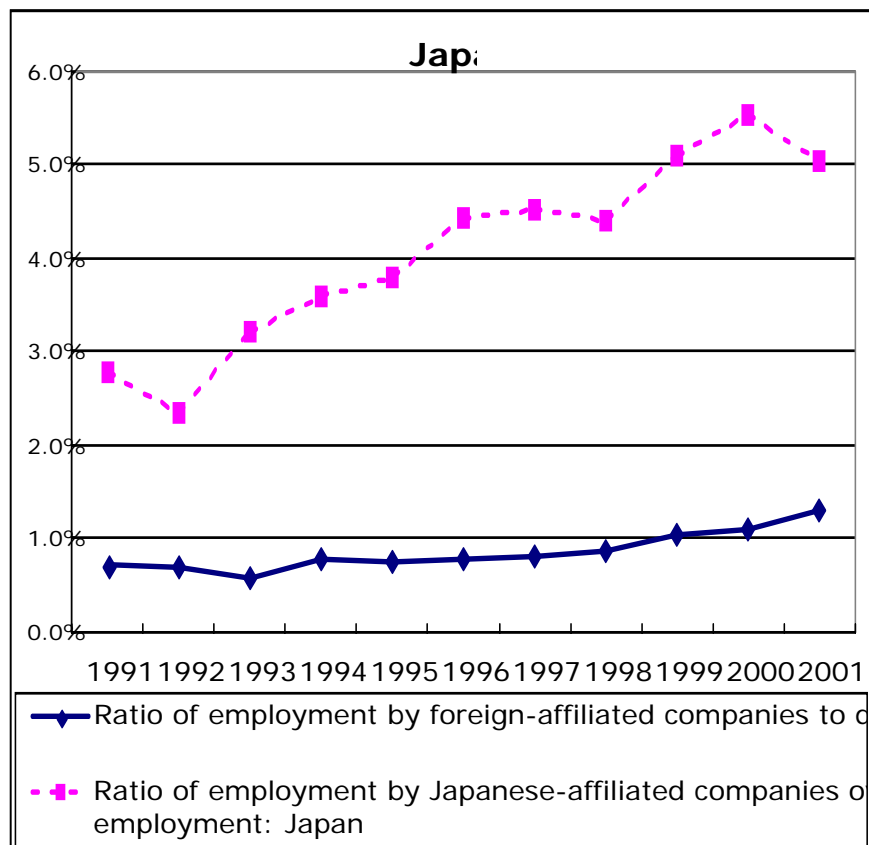
Low FDI Inflows Cannot Offset “Hollowing Out” by FDI Outflows (*Investment*)



Source: UNCTAD, *World Investment Directory 2003*

Low FDI Inflows Cannot Offset “Hollowing Out” by FDI Outflows (*Employment*)

Inward and outward foreign direct investment and domestic



The sources of the data on employment by foreign-affiliated companies in Japan and by Japanese companies abroad are as in Tak
 The data on employment by foreign-affiliated companies in the USA and by US companies abroad are from OECD, Measuring Glo

The *Latent* Potential to Expand FDI is High

- Analysis of factors affecting investment location choices by global companies shows that size of the local market is one of the most important. Japan is the world's second largest economy and is close to East Asia, home of world's most dynamic and fast-growing economies.
- Japan's comparatively advanced economic systems, highly competitive manufacturing base and sophisticated corporate service infrastructure are assets that Japan can leverage in order to serve as the region's epicenter and attract more global investment.
- From a different perspective, Japan's currently low FDI "stock" implies that there is huge potential "upside" for increased investment.
- What is important for Japan to do is abolish impediments to FDI inflows and proactively participate in the competition to attract global corporate investment.

2 . FDI Can Be a Key to Japan's Revitalization

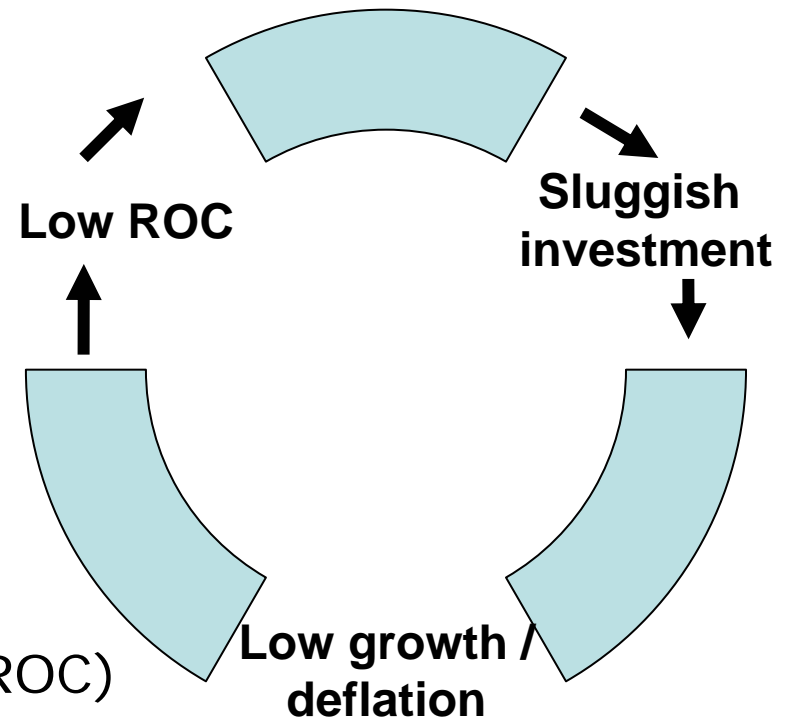
2. Increasing FDI is Key to Revitalizing the Japanese Economy

The Japanese economy has fallen into a vicious circle:

- Low rate of return on capital
- ↓
- Sluggish capital expenditure, investment

- ↓
- Low growth / deflation

- ↓
- Low rate of return on capital (ROC)



Private Investment is Decreasing

- 1 9 7 0 : 35% of GDP

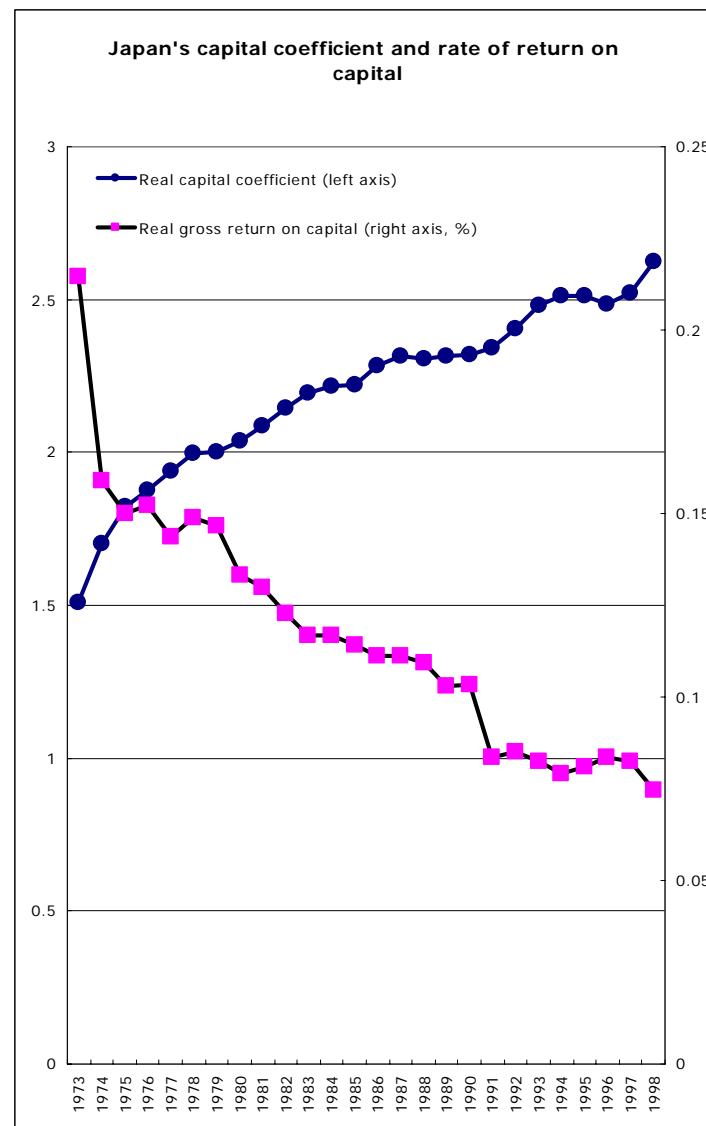


- 1 9 9 9 : 20% of GDP

- Today, the private saving surplus funds government deficits

Structural Low Profitability – Part 1:

- *Management that disregards profitability*
- *Economic growth strategy dependent on capital accumulation*



The numerator in calculating the real rate of return on capital is operating surplus divided by the real GDP deflator (1990 = 100). The real capital coefficient is the real capital stock at 1990 prices divided by real GDP at 1991 prices.
Data source: JIP Database (Fukao, Miyagawa, Kawai, Inui, et al.), 2003.

Structural Low Profitability - Part 2:

Stagnating Productivity Growth

Benefits of Foreign Direct Investment - Part 1

High Productivity of Foreign Firms

- According to our economic analysis conducted with a large sample of corporate data, foreign companies have 10% higher productivity
- Productivity at acquired Japanese companies shows improvement after merger/acquisition
- From 1994-1998 the production of foreign firms in the manufacturing sector grew to 9 trillion yen, primarily a result of foreign M&A
- Foreign firms usually have higher profitability than their Japanese counterparts, and greater (more active) capital investment
- Therefore, FDI does not cause the **loss** of “management resources” from Japan, but rather their **accumulation**

Benefits of Foreign Direct Investment - Part 2

Macroeconomic Stimulus (Model)

- Assuming that participation in the Japanese economy by foreign companies increases from its current share of 1% to 11% or more within a specific period...
- ...that is, assuming a larger scale of inward FDI investment than targeted by the Japanese government - in essence, a level of inward investment comparable other advanced economies....
-our projections using a macroeconomic model show that this investment would result in new accumulated private investment of 18.8 trillion yen and a perpetual increase in GDP of 7.5 trillion yen.

3 . Barriers to Inward FDI, and Essential Policies

3. Impediments to FDI, and Prerequisites for Expansion

What is obstructing FDI inflows?

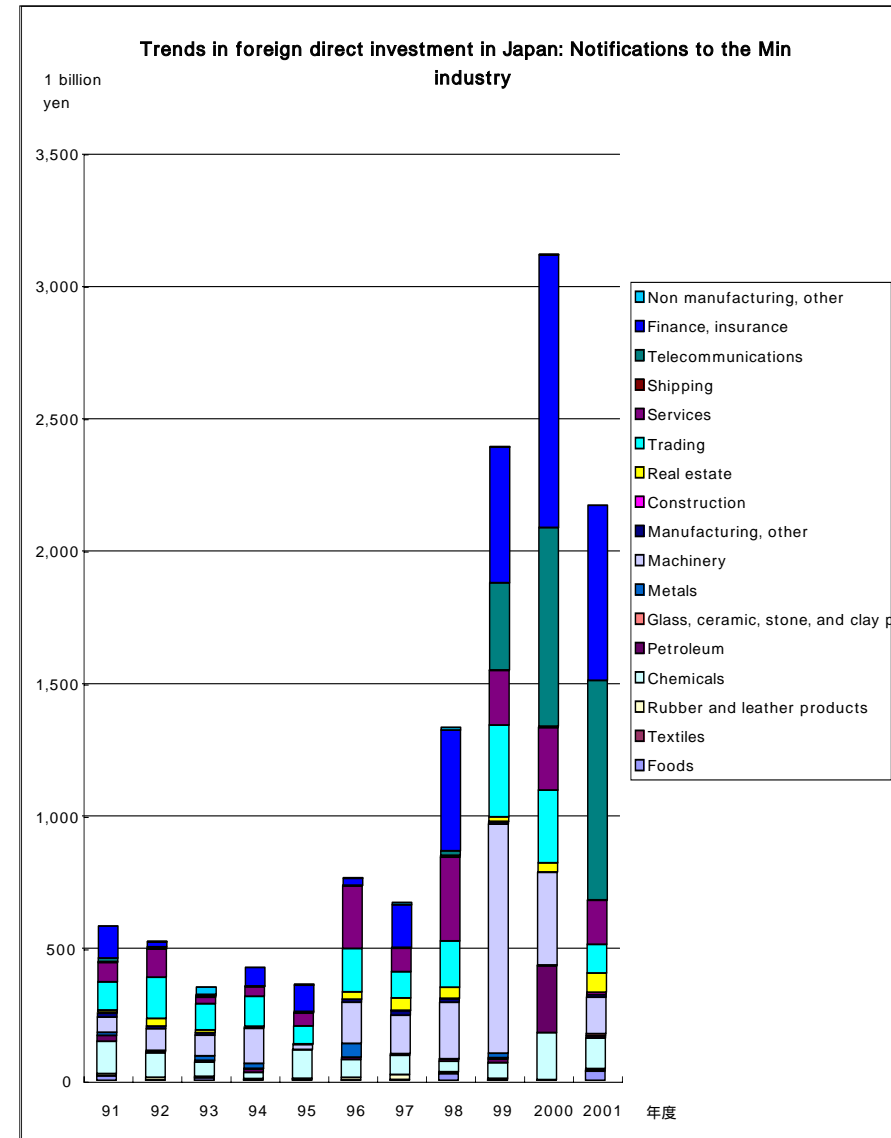
- General policy since Meiji era: usage of foreign technicians, licensing agreements, import of capital equipment
- Selective approach to liberalization since joining OECD (1967-1980)
- Cross-shareholdings (an effective bar to M&A)
- Impediments in non-manufacturing sectors that created “sanctuaries”: not specifically prejudicial to foreign firms, but significant barriers to entry
- Existence of government-held companies
- Misconception that “Japan doesn’t need FDI”

The Right Goal, but Implementation Strategies Still Lacking

- Prime Minister Koizumi should be praised for setting the goal to double the nation's FDI stock.
- However, not all ministries and government agencies have been quick to act to achieve this goal.
- Quantitative evaluation of pre and post policy implementation has yet to occur.

Chances of Attaining the PM's Goal are Slim

- Superficial policy measures such as PR will not be enough to achieve the stated goal
- Downturn in the global M&A boom and the diminishing effect of the first phase of deregulation, now over
- FDI in the balance-of-payments statistics: a 42% year-on-year decrease over the most recent 6-mth period
- Inward FDI over the last 1 year period (July 02 to Jun 03) was 0.83 trillion yen. Extrapolating over the next 5 years at the same level only adds 4.15 trillion yen ($0.83/\text{year} \times 5$ yrs), which is a far cry (less than half) of the 9.4 trillion increase needed to “double” the FDI stock



Required Policies

- Eradicating barriers to entry and implementing privatization on a large scale in healthcare services, education and the public sector (government companies)
- Creating a nondiscriminatory M&A environment for domestic and foreign companies
- *Accord deferred tax treatment in the case of M&A by foreign companies using the stock for stock exchange method*
- Correct “misconceptions” that Japan does not need FDI
- ***Misconception 1:*** “Capital inflows are not necessary, due to Japan’s excess savings”
- ***Misconception 2:*** “Inward FDI leads to technology leakage”
- ***Misconception 3:*** “Most inward FDI comes via ‘vulture funds’ “(In terms of the number of cases, M&A transactions by private equity funds only comprise 5% of all inward FDI)
- ***Misconception 4:*** “Inward FDI does not benefit regions outside of the major urban centers” More than half of all foreign employment falls outside of Tokyo and Kanagawa

Conclusions

- 1) Japan is losing the global race to attract corporate investment.
- 2) FDI brings with it increased productivity, profitability, and capital investment.
- 3) Japan has a huge potential to increase its investment inflows and Prime Minister Koizumi should be praised for establishing the goal to double Japan's FDI stock.
- 4) However, under current conditions, Japan is in danger of not realizing the Prime Minister's goal.

Inward FDI is Key to Revitalizing the Japanese Economy