Chapter 2
Japan and Foreign Direct Investment

Abstract This chapter covers the historical economic developments of Japan and discusses recent FDI investment flows. It will be shown that Japan has a relatively low inward, but a high outward FDI. Furthermore, some data from World Investment Report about M&A will be presented. Finally, trade agreements are shortly discussed.

2.1 Introduction

The Japanese government, like any other government considers the export of products and services as a very helpful tool as it brings a money inflow into the country. In accordance to governmental initiatives, export supports an increased economic growth of a country and leads to an increase in productivity. In addition, there is a higher diversification and export supports the pace of innovation, which leads to an improved survival prospect of firms. Furthermore, employment opportunities and salaries of the employees may increase.

Recently, the Japanese government pays also increased attention; not only to exports but also to higher inward foreign direct investment (inward FDI). All country governments in the world highly appreciate potential economic benefits through inward FDI. The reason for this is that inward FDI leads to many positive economic effects for local firms as well as to consumers. Consumers enjoy lower prices and inward FDI leads to more job-creation in the local economy (Fleming and Johnson 2008). Also, Japanese officials highly appreciate foreign direct investment coming to Japan; therefore, the Japanese government has launched a number of political measures to promote inward FDI. Former Prime Minister Junichiro Koizumi promised several years ago in his general policy speech to the Diet in 2003 to double the cumulative amount of inward FDI until 2008 (Paprzycki and Fukao 2005). Even if the program failed in absolute terms, an increase of FDI to Japan was visible. The largest part of this increase in inward FDI has been realized through M&As (Schaede 2008, p. 117). However, the inward FDI to Japan by total numbers is still low. Japan had only 5 % inward FDI stock compared to the USA in 2012 and a relatively low inward FDI compared to other leading world economies (Table 2.1).

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Table 2.1 Inward FDI into Japan. (Source: JETRO (2014)

Year	Amount ($ mil.)	Year	Amount ($ mil.)
1983	416	1999	12,308
1984	−10	2000	8226
1985	642	2001	6191
1986	226	2002	9089
1987	1165	2003	6238
1988	−485	2004	7808
1989	−1054	2005	3223
1990	1753	2006	−6789
1991	1368	2007	22,181
1992	2728	2008	24,550
1993	86	2009	11,839
1994	888	2010	−1359
1995	40	2011	−1702
1996	208	2012	1761
1997	3199	2013	2358
1998	3269		

This led the Ministry of Economy, Trade and Industry (METI) to propose amendments back in the year 2007 and several changes were implemented. For example, Japanese regulations were harmonized with other leading countries in order to improve inward FDI to Japan. In spite of relatively small Japanese inward FDI figures, recently the number of inbound M&A transactions in Japan has increased.

The first part of this chapter shows the history of inward FDI in Japan, examining how attractive the country was (and still is) in receiving FDI. The second part discusses the outflow of Japanese FDI in contrast to other countries. The third part discusses trade agreements and then the groundwork for M&A is to be laid out.

2.2 History of Inward FDI to Japan

Records indicate that Chinese immigrants from an area called Qin introduced a wide variety of new techniques to the Japanese archipelago such as weaving and rice cultivation at a time between 221–207 B.C. (Qin dynasty) and 206 B.C.–220 A.D. (Han dynasty) (Burns 2000). These Chinese cultural influences were naturally filtered through Korea. Between the fifth and tenth centuries A.D., the Sino–Japanese relationship are said to have blossomed. Economic ties expanded, bringing Chinese influence to a broad spectrum of spheres, naturally also economic ones (Burns 2000).

Sui dynasty (581–618 A.D.) and Tang dynasty (618–907 A.D.) served as models for Japan. Most significant among these were the introduction of Buddhism and Confucianism. The adaptation of the Chinese writing system, and the proliferation of Chinese arts and crafts implemented Chinese influence. Under Japan's Yamato period (300–710 A.D.), Prince Shotoku (574–622 A.D.) propagated Buddhism, while another important Japanese figure at that time, Nakatomi-no-Kamatari (614–669 A.D.), instituted the Taika Reforms. In this, Chinese political institutions and policies were adopted, as well as tax and land policies, including nationalization and equalization of landholdings. Most significantly, China's example inspired Japan to establish a fixed capital city, first at Nara in 710 A.D., and later at Kyoto in 794 A.D (Bruns 2000). In that, the streets of both cities, Nara and Kyoto were built in a chess board style based on the previous ancient capital city of Xian in China (Matsubara 1987). Evidence is also found that already at these times neighboring Asian countries had connected their businesses of ceramics and silk production with the Japanese archipelago (Matsubara 1987).

Years later in early 1600s, the Ieyasu Shogunate managed to establish trade agreements with the Korean Peninsula as well as to other Asian countries; although an agreement with China could not be fixed. This enabled Portuguese firms to control the entire Japanese silk trade with China. Therefore, if a Japanese firm wanted to buy silk from a Chinese firm, they would need to go through a Portuguese intermediary in Macao. Because Japanese firms were not allowed to directly trade with China at that time, intermediary traders made a high profits (Matsubara 1987).

Operations of foreign businesses of the western world in Japan dates back to the sixteenth century, when traders from the Netherlands, Portugal and England established connection points for their East Asian trading network (Boxer 1968; Weinstein 1996). These trade connections were abolished by the Ieyasu Shogunate in the early seventeenth century. Japanese traders with close contacts and shipments to most Asian countries reported to the Shogunate what was happening, for example to the natives at Macao. First, Portuguese catholic "patres" converted the natives at Macao to their belief system by teaching them Christianity, but then as a second wave the Portuguese military came to conquer Macao to establish a Portuguese colony (Matsubara 1987). As a result, at the beginning of the seventeenth century the military leaders of Japan, the Shogunate, decided to close the country off from the foreign world. All Christian padres were banished from the Japanese archipelago and even the converted Japanese believers were persecuted by the Japanese Shogunate. For the next 250 years, no foreigners were able to access the Japanese islands, nor were Japanese permitted to stay abroad. Those going abroad had to repatriate themselves to Japan within 2 years, those who failed to return within 2 years were punished by death. Only a small settlement of Dutch traders was allowed to conduct trade with Japan. This settlement called "Dejima" was placed on a manmade island in front of Nagasaki, on the southern Island of Kyushu (Matsubara 1987).

The arrival of Commodore Perry in 1854 with his "black ships" ("kuro fune") brought the subsequent economic re-opening of trade with Japan. Western foreign firms established bases at by then open ports for foreigners e.g. at Nagasaki, Kobe, Yokohama, Hakodate. In this, countries showed different preferences for their port of entry. Chinese firms predominantly entered Japan through Nagasaki on the southern island of Kyushu. Russian firms arrived in the northern island of Hokkaido, at the port of Hakodate. US and European firms arrived mainly at the two remaining open ports. While US firms mainly entered Japan at the eastern part of the peninsula at the port of Yokohama, close to Tokyo, European firms arrived at Kobe port, which is located in the Kansai region. In the heart of Kobe, in the “old settlement”, Western firms undertook business. Even today, the city of Kobe is still European flavored with many European style coffee houses and bakeries.

It is to mention that in the years around the eighteenth century every Asian country dealing with the West was forced to accept Western treaties. For Example, Japanese firms dealing with foreign firms were forced to apply European or US country laws in a case of a dispute, giving Japanese firms disadvantages. That led to the so called “unequal treaties” (“ansei keiyaku”). Potential business related problems with foreigners were dealt with using foreign law, instead of applying Japanese law (Auslin 2004). Furthermore, an advantage given to one foreign firm was—upon request—transferable to any other country`s firm. Firms also received a standard low tariff rate of 5 % for all imported goods, whereas Japanese firms had to pay much higher tariffs when exporting their products to Western countries (Matsubara 1987). This situation continued until the end of the nineteenth century, when Japanese firms finally regained full control of their trade activities with the outside world (Westney 2009).

Before the opening of Japan in 1854, some Japanese families had already managed to form strong ties and build their own business empires, resulting in only a few firms ruling entire industries (Morikawa 1992). These conglomerates, known as Zaibatsu, became a famous buzzword (Morikawa 1992). These family controlled businesses were known as financial clique firms. Zaibatsu were not common to the Western world until World War I, even though they existed in Japan from the nineteenth century. By definition, Zaibatsu are large family controlled firms, vertical in structure. These Zaibatsu covered all major industries such as mining, steel, trade and banking. Just a handful of these Zaibatsu controlled large parts of the whole country.

The “big four Zaibatsu” consisted of Mitsui (the biggest), Sumitomo, Mitsubishi and Yasuda. These four Zaibatsu controlled more than half of the whole Japanese industry at that time. In the aftermath of the Second World War, Western occupational forces destroyed the Zaibatsu structure by dividing them into separate firms in order to prevent the reemergence of a strong Japanese war industry. The biggest Zaibatsu Mitsui, for example was split in more than 100 independent firms (Westney 2009).

Despite the dominance of Zaibatsu firms, foreign firms managed to exist in Japan. There is evidence that in the prewar era, 59 foreign affiliated firms were located and successfully operated their business in Japan. Out of them, 13 firms were wholly owned and managed by foreigners and 36 were run as a joint venture managed by Japanese (Yamamura 1986; Westney 2009).

After eliminating the unequal treaties, Japanese authorities set heavy FDI inward controls on foreign firms dealing with Japan. One of the few ways for foreign firms to enter Japan before the 1960s was to set up a “yen” company, which was not allowed to repatriate their profits out of the country (Westney 2009).

The 1960 GATT negotiations let to a removal of these investment restrictions set by the Japanese government. The easier access to the Japanese market through not only FDI, but also by acquisitions was appreciated by western firms. In contrast, several Japanese firms saw this as a threat and joined into cross-shareholdings, in which firms would interchangeably hold each other's shares. This was seen as the beginning of protection against takeovers and interestingly, happened to become the so called "first Japanese merger wave", where firms like Nippon Steel were created (Muramatsu 2007).

In the years after World War II, the Japanese economy grew at a high rate. In these economic boom years, Japan was known as a strong exporting country. It was also the time where Japan catapulted into the second biggest economy. Other countries were interested to learn from the Japanese miracle, e.g. about the concept of lifetime employment, or the closely knit groups, called keiretsu. Japan became economically so dominant that other countries, especially the US, worried about the health of their own firms. 1985 under the Plaza Agreement, the strong dollar was balanced through intervention by advanced industrialized nations. This led to a strengthened yen what made Japanese exports more difficult. Put different, the Plaza Agreement led to a sharp appreciation of the yen to the US dollar. From Sept. 1985 to 1988, the value of the yen jumped from 260 to 125 yen per dollar (Adams and Gangnes 1996). This enormous price disadvantage caused difficulties for Japanese firms to export their products not only to the US but also to any other foreign country as the exchange currency was always handled in US dollars. Japanese firms experienced a high pressure what challenged once more life time employment (Moriguchi and Ono 2006). However, the Japanese economy bottomed up by the end of 1986 and saw a quick recovery (to the surprise not only of Japanese citizens). This economic recovery was stabilized by a low interest rate policy of the Bank of Japan to stabilize the economy. These low interest rates led firms to aggressively invest in land and in the stock markets. This development was encouraged by the appreciation of land and of stock prices. This upward spiral ended in 1989 with the so-called bubble economy (Noguchi 1994).

Outsiders saw the Japanese industry as a highly connected establishment. The term "keiretsu," which means to have interconnected firms, became a famous catchphrase. One of the ways that these firms connected themselves was (and still is today) the so called "shacho kai" in which the leaders of all connected firms meet once a month to discuss relevant issues and ideas. Keiretsu structures of Japanese firms were the study object of many researchers worldwide in the late 80s. Toyota for example was and still is famous for having a vertical Keiretsu structure, meaning there were only a few direct suppliers. These suppliers have other suppliers (2nd rank suppliers for Toyota), which again get supplied by 3rd rank suppliers. Even today this gives Japanese automobile firms advantages against US and European makers because the 2nd and 3rd tier suppliers do not belong to any union. That is to say, Japanese unions are not industry unions, but merely company unions which have different roles than their Western counterparts. Unions try to work out the best for the firm but also for the regular employees as well. Union members often work closely together with the top management, many of them even share the same office (with the top managers). Also a common way for young and promising talents to become a top manager at the firm is to start their career at the (company) unions. Even though unions are not independent of managers, they actively support their employee's interests. Employees at supplier firms, in particular at the 3rd rank have worse income conditions. Under this structure Japanese car makers can better adjust to a changing market because of a higher flexibility in times of crisis, or at economic recessions. As a result, Toyota for example saves money and is more flexible in its strategic movements to successfully compete on a worldwide competitive automobile market.

The difficulty of entering the Japanese market was pronounced repeatedly by foreign firms even at an early stage. In the 1980s, Japan lowered its formal restrictions on FDI inflow to boost new investments to the country. Nevertheless, only a very limited number of firms found its way to Japan. Since then, Japanese argue widely that the lowering of formal barriers to inward FDI as well as formal restrictions on imports and inward investment were more favorable to foreign investment (than in the past). Some examples of successful Japan-based foreign firms already existed in the 1980s. IBM-Japan for example, historically with strong local networks was always a financially successful operating subsidiary. Some other Japan-based foreign affiliates were considered to be the most profitable firms in Japan at that time, especially after the yen appreciation of the mid 1980s (Christopher 1986).

In spite of the lowering of formal restrictions, very few foreign firms came to Japan to set up a business. The list for complains was (and still today is) long. One of these complaints was that foreign firms perceived a successful entry into Japan as very difficult, not because of formal restrictions by law, but, because of informal hindrances caused by other Japanese firms, differences in thought, and even because of the behavior of Japanese people themselves. For example, even though a foreign firm may offer more advanced technology, they still may not be able to compete with a Japanese firm. The reason is that a Japanese firm may have more confidence in another Japanese firm. In other words, even if foreign firms outperform Japanese ones in the technical level, Japanese firms can count on advantages in service, to be close to the customer. That means foreign firms in Japan have to adjust to the Japanese market to be successful in doing business (Bebenroth et al. 2014; Mason 1992).

2.3 Competition for FDI

The modern economy is built on the transfer and exchange of ideas at unprecedented speed. FDI can facilitate this process. Positive effects of FDI are often articulated and it is unquestionable that the market for FDI is competitive worldwide. This also includes inward FDI. Every nation attempts to attract advanced foreign technologies to transfer them to their own firms. FDI in terms of technology diffusion can lead to direct or indirect positive spillover effects. A direct effect for example, could be that foreign firms transfer to Japan and simply absorb (Japanese) employees to work at their affiliates. This would in turn cause more foreigners to come to Japan and spend their incomes in Japan. This, however, is considered as rather of lower importance for many countries' governments. More importantly are the indirect effects of inward FDI (Aitken and Harrison 1999). In other words, the spillover effect may come in the form of higher qualified labor. Besides the direct effect that foreign firms hire Japanese employees, they can indirectly help them in getting a higher qualification in their job. Japanese employees may improve their technological knowledge and may even start their own business to connect foreign firms to Japan. That means, indirect effects can help to internationalize Japan's economy. Without an internationalized economy, there is worry that an increased number of employees need to get subsidized by social welfare, or on the job. Some countries are reported to subsidize their own employees in high tech area with more than US$ 250.000 per year (Blomstroem and Kokko 2003).

It should be noted however, that FDI can also have negative effects on domestic firms (Dunning 1994). For example, FDI could negatively influence domestic producers so that production calms down and operations shut down. It is also possible that the increased competition through a higher inward foreign FDI could crowd out domestic operations. In the worst-case scenario, international competition could completely eliminate the existence of domestic firms. Hence, FDI can also lead to a negative growth by taking out domestic competitors.

2.4 Inward FDI to Japan

FDI activities to Japan were tightly controlled until the 1970s. Since then, almost all Japanese industries were heavily deregulated to open up for an increased inward FDI. The Japanese government is trying to attract inward FDI by protecting property rights and giving investors' security that their technology will not be copied or stolen by domestic firms (Belderbos et al. 2006).

Table 2.1 depicts the inward FDI to Japan on a yearly basis. The amount of FDI to Japan (compared to the year before) was quite low in the years from 1983 until 1996. The only exceptional time period for a higher inward FDI was right after the Japanese bubble economy burst from 1990 to 1992. In these 3 years, a higher inward FDI was absorbed. There are many reasons that the selloff of foreign firms and equity led to a high inbound financial stream. It could be that foreign firms expected Japan to recover quickly and therefore wanted to participate in this development.

From the year of 1998, Japan received more inward FDI with a first peak in 1999 at about $ 12.3 billion. It is clearly visible that the inbound FDI to Japan was negative in 2006 but positive in 2007 and 2008 with US$ 22.1 Billion and US$ 24.5 Billion respectively. From 2007 onwards, Japan has received a steadily increasing amount of FDI until 2009 with a sharp decrease. In the last 2 years of observation, Japan receives $ 1.7 and US$ 2.3 billion respectively.

Table 2.2 depicts the stock of inward FDI coming to Japan. In the year 2012, inward FDI stock was worth only US$ 205 billion, only about 5 % of the level seen

Table 2.2 Inward FDI Stock for years of 1990, 2000 and 2012. (Source: World Investment Report 2013, Annex Table 2.3, (in billion US $ dollars))

FDI inward stocks			
Region/economy	1990	2000	2012
Japan	9	50	205
United States	539	2783	3931
Germany	111	271	716
France	97	390	1094
UK	203	438	1321

in the US. To compare FDI stock in time, there is an increase visible, however. The inward FDI to Japan increased almost fivefold from 1990 to 2000, jumping from about $ 9 billion to about $ 50 billion. Finally, in the year 2012, inward FDI in Japan was worth about US$ 205 billion. However, in contrast to Japan, other countries have a higher inward FDI Stock at all three time periods. In other words, compared to other European countries or to the U.S., Japan receives comparably low inward FDI. The U.S. and the UK receive the largest volumes of FDI.

When looking at yearly changes of inward FDI to Japan, it is visible that the highest inflow was in the 2 years before the Lehman shock, totaling roughly US $ 22 Billion in 2007 and US $ 24.5 Billion in 2008 (Fig. 2.1). As a side note, even though these were the highest volumes of investment ever received it was still far less than that received by the U.S. and the U.K at the same time.

After the financial crises in 2008, Japan experienced a sharp decrease in FDI inflow to the point of negative US$ 1.3 billion in 2010, but has since recovered.

When looking specifically where the investment comes from, it is clearly visible that in both 2007 and 2008, US investments made up the biggest part of FDI inflow to Japan. The sharp decrease in 2010 was caused by FDI from Central and South America. Finally, in the year 2012, European FDI inflow was negative while Asian FDI inflow was positive (Fig. 2.1).

It should be mentioned that one could interpret the information in different ways. Paprzycki and Fukao (2005) for example report that volume of investment differs by industry. According to their study, inbound FDI to Japan is in several areas on par with that of the USA. Applying their figures, inward FDI in the automobile and machinery industry, for example, is high while there is hardly any investment in other industries. Therefore, of a complete lack of investment at some industries, the FDI to Japan is on the whole rather low.

2.4.1 Attractiveness of Japan as An Investment Location

One way of looking at a country's FDI attractiveness is by means of its received investment. Figure 2.2 shows the top 20 countries, which received the highest FDI inflow. USA received the highest FDI investment followed by China and Brazil. In contrast to these countries, France, Indonesia and Sweden, for example, have received a much lower FDI. Japan doesn't even make the list of the top host economies for FDI in 2012 (World Investment Report 2013).

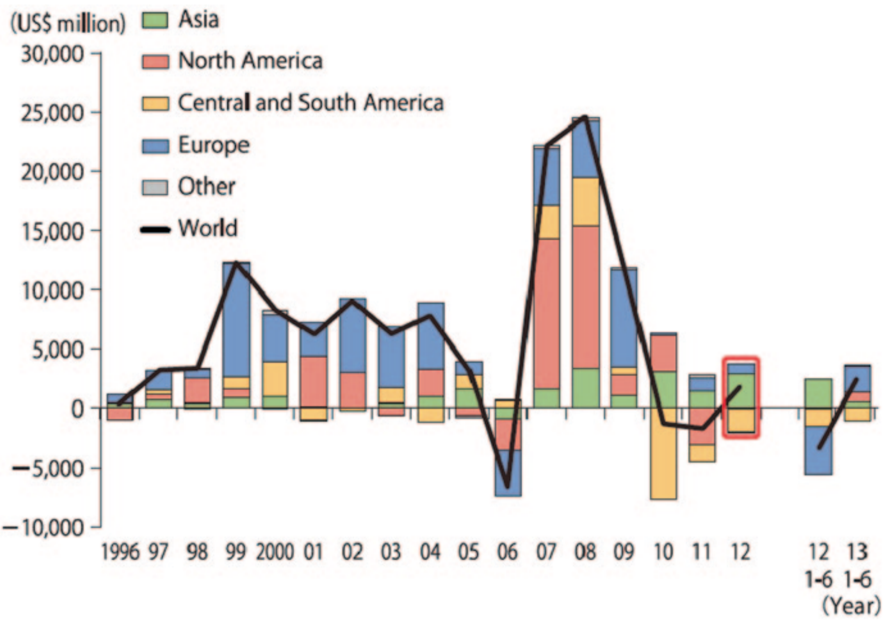

Fig. 2.1 Changes in Japan's Inward FDI by Region. Jetro (2013) Global Trade and Investment Report,. Revitalizing Japan through global business, p. 4. https://www.jetro.go.jp/en/reports/white_paper/trade_invest_2013.pdf, accessed on Febr. 24th 2014. (Note: The yen-based value is converted to dollars by quarter, using the average quarterly Bank of Japan interbank rate, and then the annual total is calculated. Source: Balance of payment statistics, Ministry of Finance, Bank of Japan)

Fig. 2.2 Top host economies for FDI in 2012 (billions of dollars). (Source: World Investment Report 2013, p. XIV)

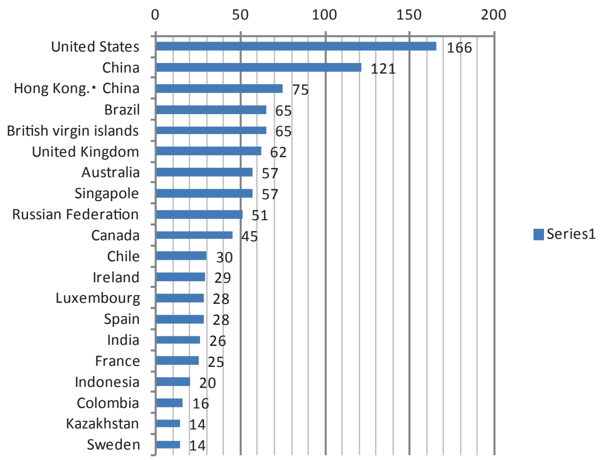

Table 2.3 Number of inward cross-border M&A, 2005–2011. (Source: World Investment Report 2013, p. 221 (in %))

	2005	2006	2007	2008	2009	2010	2011	2012
World	100	100	100	100	100	100	100	100
Developed Economies	76	75	74	72	69	67	45	84
European Union	42	41	39	38	32	33	28	40
France	4	4	3	3	2	3	2	4
Germany	7	7	6	5	4	3	3	2
United Kingdom	10	9	10	10	7	9	6	11
United States	19	18	18	17	17	16	11	21
Japan	1	1	2	2	2	2	1	1

2.4.2 Japanese Inward M&A

To compare several countries' cross border inward M&A, Japan receives rather low scores (World Investment Report 2013). For the years from 2005 till the end of 2012, Japanese inward cross border activities remain very scarce. According to UNCTAD data, Japan absorbed little over 100 acquisitions from the years starting in 2007. In contrast to Japan, the U.S. market absorbed about 1000 inward M&A a year until the beginning of the Lehman shock.

In the second year after the Lehman shock in 2010 (especially), the number of inward M&A to the US went down to around 700 to 900 cases a year, respectively. Even some European countries like France and Germany are absorbing more inward cross border M&As than Japan. In the fiscal year of 2012, both countries had a higher M&A inflow than Japan. France, for example, which has a much lower GDP, reported about 4% M&A cases and Germany was around 2% inward M&A cases.

To demonstrate the gap between Japan and other developed countries in percentage terms, Japan has an inward cross border activity of only 1 to 2%. The United States was around 16–19% until 2010 and again to a volume of about 21% for the year of 2012 (Table 2.3).

It is to state that also so called Greenfield investments exists. It happens when firms settle down their businesses at other countries without any help of locals that means to establish a business "on the green field". This kind of investment hardly exists in Japan, however (Fukutani and Dobashi 2008, pp. 61–62).

2.5 Outward FDI from Japan

In the year 2012, the worldwide outward FDI from all developed countries rose to a level of $ 1.5 trillion (World Investment Report 2013, p. 32). All three major developed-economies namely the European Union (EU), North America and Japan increased their FDI investments and, therefore, contributed to this stimulation. However, each economy had different driving factors. The United States was driven

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