

THE ROLE OF FDI IN REVITALIZING JAPAN'S ECONOMY

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Abstract

After more than a decade-long economic decline that Japan has experienced (the so-called “lost decade”¹ episode), the national government has currently turned to looking at foreign direct investment (FDI) as a way to improve potential growth rate and productivity. Consequently, it has at present become incontestable what significant value the global capital and FDI can have for the performance of Japanese economy, being a catalyst for growth and reform.

The aim of the present paper is to analyze the trend of FDI inward flows in Japan before and during the economic international crisis, highlighting their role in sustaining and promoting economic growth.

Although, during the crisis, FDI flows have declined dramatically in all developed countries, showing a steadily drop-off both in Europe and United States, at that time, in Japan, the trend of FDI inflows has increased.

The analysis will focus on the main factors that have contributed to this tendency, pointing out the comparative advantages of Japan over the other developed countries (investment-friendly policies of the Japanese government, political stability, physical, financial and technological infrastructure, etc.). Besides, the article reviews the role of Japanese economy characteristics as determinants of foreign direct investment location patterns, underlying the internal macroeconomic factors that stimulate the flows of FDI and the linkage between FDI, trade, and other macroeconomic variables. Finally, the analysis will emphasize what policy actions the Japanese government may take with the view to increase foreign direct investments within the country.

Keywords: FDI flows, economic growth, comparative advantage, macroeconomic variables

1. Introduction

As in the recent years, there has been a significant growth in the observed levels of FDI inflows, a variety of views have been expressed concerning the importance of attracting FDI for the Japanese economy. Albeit it has been widely

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¹ “**Lost decade**” refers on the economic crisis following the Japanese asset price bubble during the 1990s.

recognized that Japan attracts a disproportionately low level of inward FDI relative to other leading advanced nations, there are essentially two arguments for why Japan should seek to increase its share of inward FDI. The first is based on the standard arguments that inward investment boosts employment, output and productivity (Driffield, 2001), while the second is more general, emphasizing the evidence that inward investment is an indicator of openness and the opening of an economy is beneficial for growth (Baldwin, 2003).

Accordingly, a substantial body of literature in the field suggests that foreign direct investment contributes to capital accumulation and technological progress, creating also a positive linkage between foreign and national firms, which, together with the capital financing it provides, can have a key role in modernizing a national economy and fostering economic development of the host country (Moran et al., 2005).

The location, distribution and volume of FDI across regions and countries depend on a variety of specific factors, among which the most important are: recipient country's openness to trade, national financial system, domestic infrastructure, investment in human capital, factor endowment and macroeconomic, political and social stability.

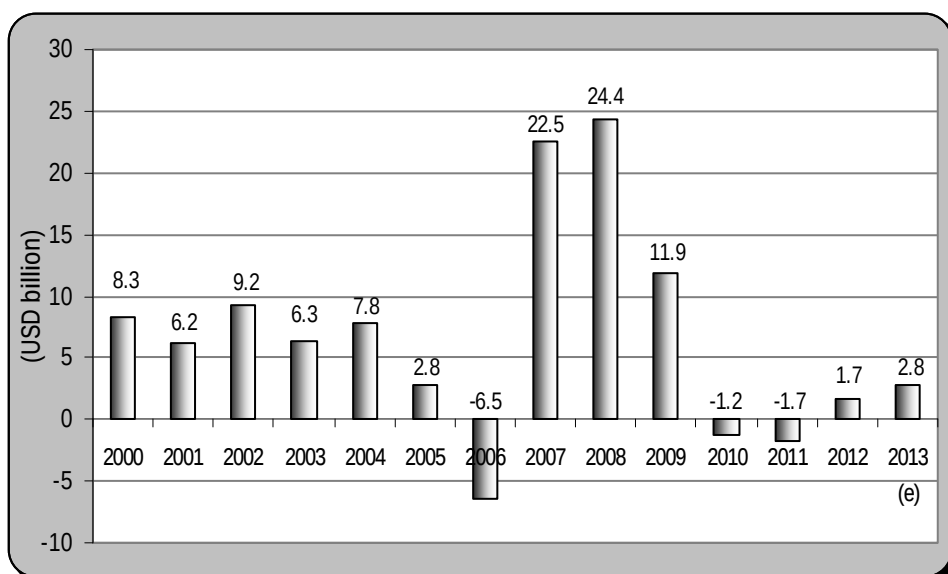
This paper focuses on the macroeconomic determinants of FDI in Japan and the linkage between FDI and other macroeconomic variables. Our analysis is based on the study of the factors behind the recent movements of FDI into the region in a quantitative manner, in the period before and after international economic crisis (during 2000-2013). Since inward FDI is a major indicator of an economy's openness and attractiveness, our research will focus on revealing the main determinants that have contributed towards this positive evolution of inward FDI, pointing out the comparative advantages of Japan over the other developed countries (national investment-friendly policies, political stability, technological infrastructure).

2. Global picture of FDI inflows in Japan before and after the Crisis

The rising prominence of inflows of foreign direct investment 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. Among these, at one level, the increasing dominance of foreign direct investment in international capital flows since the mid-1980s and its trade-linkages have led to substantial policy changes and harmonization 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 liberalization 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.

As it is widely recognized, historically Japan attracted an excessively low level of inward FDI comparing with other developed nations (Yoshitomi&Graham, 1996). FDI in Japan, which began expanding in the second half of 1990's (UNCTAD, 2013) has gain momentum after the ending of the “lost decade”², namely, at the beginning of the millennium and after a sharp decrement in 2006, it registered a double digit historical peak in 2007 and 2008, as evident from following trends.

Graph 1: FDI inflows in Japan during 2000 -2013 (USD billion)



Sources: UNCTAD (2013), UNCTAD (2014)

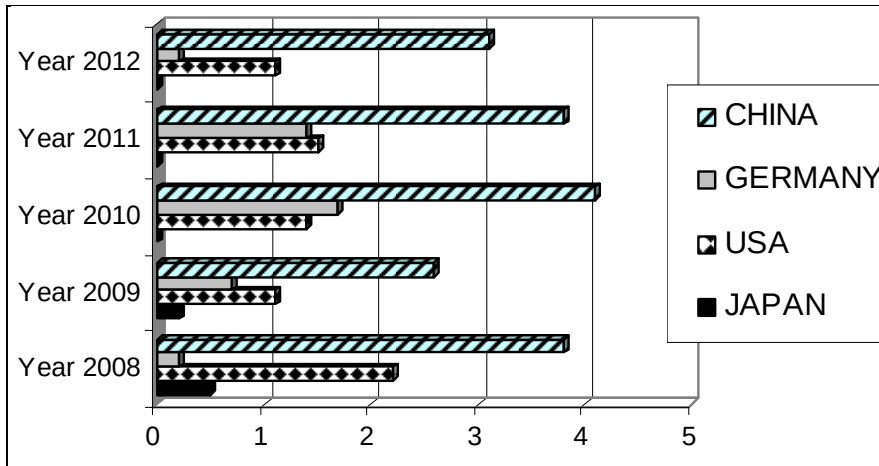
As shown in the Graph 1, the FDI inflows in Japan rose dramatically starting with 2007, than, after a sharp decline in 2009, due to the negative effects of financial crisis, for two other successive years it has recorded a net divestment. Beginning with 2012, the trend turned positive again, though the inflows were relatively small. According to preliminary estimations of UNCTAD (2014), in 2013, an upturn in M&A sales helped FDI inflows to Japan and they rose by almost 61% (according to the data presented in Table 1), reaching USD 2.8 billion. Albeit Japan's potential appeal is strong comparing with other developed countries, according to the illustrated figures, its performance in terms of FDI reception was very weak in the years following the economic financial crisis, endorsing the outcome that of late the

² The “lost decade” refers to the period 1991-2000 when Japanese economy has preformed lowest among the major industrialized countries in the world, despite significant efforts made by the national government in order to overpass the economic decline.

country didn't fully exploited its foreign investment potential for capital formation (UNCTAD 2012).

Even if they have increased during 2007-2009 (as shown in the Graph 1), Japan's inward FDI as percentage of GDP is still ranking the lowest position among other major developed countries (see Graph 2).

Graph 2: FDI inflows as percentage of GDP, during 2008-2012



Source: OECD, 2013

Thus, within traditional “triadic” - consisting of EU, USA and Japan – when compared with USA and EU (the main FDI world receptor), Japan share's in global inward FDI - that was on average 1% prior crisis - does look insignificant. Although the FDI to Japan increased in the last two years, its stake in world's FDI inflows declined even further.

Table 1: Comparative share of selected developed economies/region in total world FDI inflows during 2007-2013 and their growth rate in 2012-2013

(-%/+)

Region/ Country	2007	2008	2009	2010	2011	2012	2013	Growth rate 2012/2013
EU	42.9	30	29.5	26.9	26.7	19.1	19.6	38.1
USA	10.8	17	11.8	14	13.7	12.4	10.9	-4.8
Japan	1.1	1.3	0.9	... ¹	... ¹	0.1	0.2	60.7

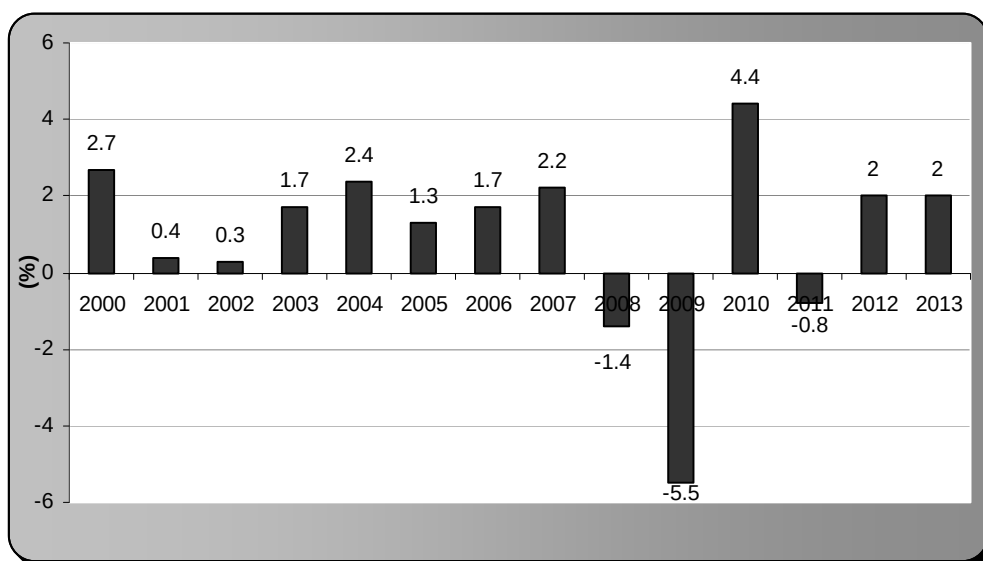
Source: Own calculations based on UNCTAD (2013), UNCTAD (2014) data.

¹Note: In 2010 and 2011, Japan experienced negative values of FDI inflows, indicating that the value of disinvestment by foreign investors was higher than the total capital newly invested in the country in the reported period.

As stated in the literature in the field (JETRO, 2013) the rapid rise noticed in inward FDI into Japan since 2000 until the negative effects of the global financial crisis hit the country 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 liberalization undertaken by the country, following the prolonged recession within the “lost decade”. *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.

In this regard, Japan should seek to increase its share of FDI inflows, considering not only the theories according to which inward investment helps to raise employment and productivity, but also taking into account the argument that the opening of an economy is a catalyst for growth (Baldwin, 2003) and with a view to Japan’s recent stagnation, generated by the economic financial crisis, but also by the natural disaster that hit the country in 2011- the earthquake and the devastating tsunami that followed (Graph 3).

Graph 3: Japan’s annual growth rate during 2000-2013 (%)



Source: UNCTAD database (2014).

3. The key determinants of inward FDI in Japan

As in terms of inward FDI, in the last years on the Japanese market it was noticed a net predominance of large developed countries (JETRO, 2013), the fact

may suggest that major motivation to invest there is market seeking, companies looking to develop their activities into markets similar to their own, or protect their domestic market from foreign competition.

Considering the dimension of the market and the presence of various multinational firms, in Japan there is a great availability of capital resources and intangible assets such as technological knowledge and marketing expertise that can be useful to establish foreign production to meet consumer demand in the host country. Thus, considering the positive relationship establishing between source country size and FDI inflows, as it is illustrated by the literature in the field (Kimino et al., 2007), Japan presents an enormous comparative advantage.

Also, considering the fact that presently Japan can provide highly educated labor force, since government policy has encouraged constantly education and R&D, this could be considered a different comparative advantage for multinationals that seek to develop high innovative business.

Friendly policy measures toward FDI have been developed recently in Japan consisting in reforms in the financial, communication and distribution sectors that have encouraged foreign investments in those industries. Therefore, in order to further promote investment in Japan, a series of measures were undertaken by the national government in the last years. Among all these, it is worthy to mention:

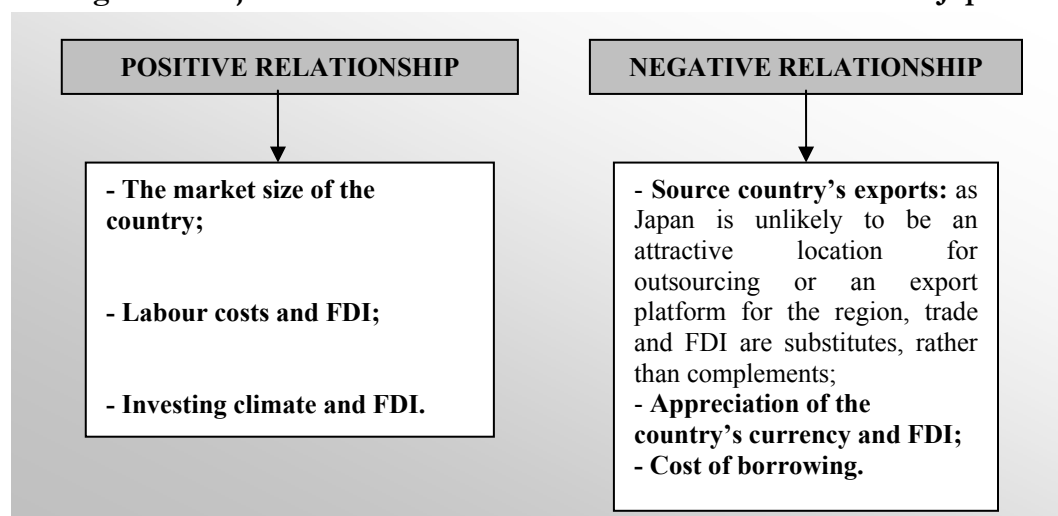
- The establishment (in 1994) of the Japan Investment Council, which consists of relevant ministers, being chaired by the prime minister;
- The repeatedly extension of Import and Inward Investment Promotion Law - tax incentives and credit guarantees under this law were enhanced, in addition to the upgrading of low-interest loan programs provided by Japan Development Bank (JDB) and some service industries were added to the scope of designated inward investors to enhance the inward investment promotion system;
- Also, there were some 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. Besides, 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).

Another input for FDI attraction is represented by the re-examination and simplification of Japan's Company Law, measure that have provided a better access for foreign investors. Also the cultural factor of traditional respect for engagements, has determined a high security of foreign investments since Japan has never been involved in any case of disagreements concerning FDI and, to the present, bilateral disagreement have given rise to no expropriation. However, supplementary measures may be undertaken by national authorities related to facility lease fee, equipment costs and promoted in form of subsidies for initial investment of global companies in Japan. The key incentives for direct investment in Japan could be represented by technology, brand & expertise existing on national labor market that could be fully exploited by companies investing in information communication technologies and other knowledge intensive industries.

Nevertheless, the international economic literature is consistent in terms of identifying the major determinants of FDI flows from source countries and how these determinants influence FDI into Japan. Based on the above-mentioned arguments, it is possible to develop six hypotheses concerning the determinants of FDI flows into Japan (as illustrated in Figure 1).

Figure 1: Major macro-economic determinants of FDI inward in Japan



Source: Synthesis of the authors, based on the international economic literature in the field.

4. Barriers related to FDI inflows in Japan

According to some recent studies (JETRO, 2013) it should be mentioned the fact that there are still some obstacles on the Japanese side, related to the penetration of FDI inflows into the national market. These include difficulties in recruiting capable staff, the opacity of various legal and administrative procedures and the exclusiveness of business practices, all of which require foreign-based transnational corporations (TNCs) to have a vast and detailed knowledge of the Japanese market and business practices. Thus, the first barrier reflects the rigidity of the labour market, the lifetime employment practice, the lack of foreign languages speakers and a certain labour shortage in Japan. The second and third obstacles often lead foreign affiliates to the belief that they are being discriminated against by the national Government and by the domestic firms. Therefore, in order to secure a more dynamic growth of FDI inflows and consequentially the Japanese economy, it is of a major importance to alleviate all these deficiencies.

Furthermore, as some analysts have shown (Assaf et al., 1999), through FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This fact provides them an informational advantage over "uninformed" domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high-productivity firms under their ownership and control and sell low-productivity firms to the uninformed savers. As with other adverse-selection problems of this kind, this process may lead to overinvestment by foreign direct investors. Excessive leverage can also limit the benefits of FDI. Typically, the domestic investment undertaken by FDI establishments is heavily leveraged owing to borrowing in the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by foreign-owned firms. Recent work has also cast the evidence on the stability of FDI in a new light. Though it is true that the machines are "bolted down" and, hence, difficult to move out of the host country on short notice, financial transactions can sometimes accomplish a reversal of FDI. For instance, the foreign subsidiary can borrow against its collateral domestically and then lend the money back to the parent company. Likewise, because a significant portion of FDI is inter-company debt, the parent company can quickly recall it. There are some other cases in which FDI might not be beneficial to the recipient country - for instance, when such investment is geared toward serving domestic

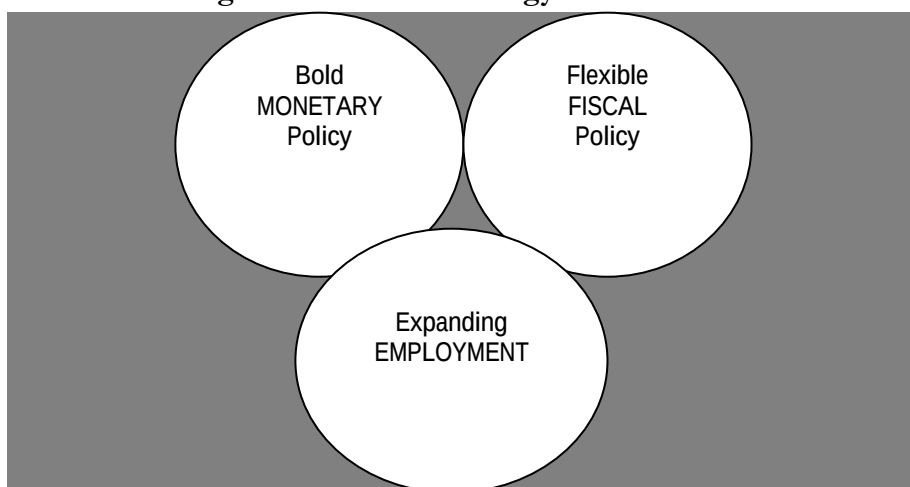
markets protected by high tariff or non-tariff barriers. Under these circumstances, FDI may strengthen lobbying efforts to perpetuate the existing misallocation of resources. There could also be a loss of domestic competition arising from foreign acquisitions leading to a consolidation of domestic producers, through either takeovers or corporate failures. Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on host countries. For Japan there are also some other potential risks: FDI can be reversed through financial transactions and a high share of FDI in total capital inflows may reflect its institutions' weakness rather than their strength.

5. National policy measures to promote FDI

Although Japan has eliminated most of the formal restrictions related to the FDI inflows that were put in place in the 1970s, investors continue to criticize the barriers that impede foreign penetration of the market. Restrictive market practices such as a closed distribution system, cartel-like behaviors and entrenched arrangements that make it difficult for new entrants to compete in terms of product, service and price, are frequently mentioned as impediments that are particular to Japan. In order to further encourage FDI in Japan, government could offer subsidies covering half of the expenses for small firms and a third of the expenses for the medium and large ones. Such measures would prevent the domination of very large multinational on the market, hence eliminating the risk of capital reversion. Current Abenomics³ Programm may also contribute on fostering FDI by three essential pillars: monetary policy, fiscal policy and measures to increase employment. Shinzo Abe announced his return with the memorable phrase: *“With the strength of my entire cabinet, I will **implement bold monetary policy, flexible fiscal policy, and a growth strategy that encourages private investment, and with these three policy pillars we will achieve positive results**”*. Thus began Abenomics.

In terms on monetary policy, measures proposed by the government should focus on government spending and a weaker yen, in order to compensate high costs of labor force and regulatory barriers. Moreover, Japan's government should encourage foreign investments by providing short-term fiscal stimulus necessary to make up for the fall in demand while broader structural reforms are still needed.

³ Shinzo Abe was first elected as prime minister in the 2006. His first stint was a short one, ending abruptly with his resignation in 2007. In September 2012 he was re-elected as the president of the Liberal Democratic Party (LDP). In December 2012 LDP aced the Lower House election, winning 294 seats out of 480.

Figure 2: National Strategy to boost FDI

Source: Own synthesis based on literature in the field.

6. Conclusions

Over much of postwar period, and even through the 1970s and 1980s, inward foreign investment was not a priority for Japan, but in the light of the negative effects generated by the economic and financial crisis, Japanese authorities had to reconsider the potential benefits of inward FDI to boost economic growth. As shown in our previous analysis, FDI can play a fundamental role in revitalizing economic growth. Like others economy in the region, Japan's economy depends on FDI for a crucial part of its net capital inflows. FDI positive impact is helping to create jobs, boost national and regional development and also can contribute decisively to fostering competitiveness. Presently, FDI in Japan is focused in the form of global alliances with capital tie-ups between companies in the same industry, to survive tough international competition. Traditionally, Japanese corporations have found such partners mainly among American and European firms, but recently there have been a growing number of partnerships with Asian firms. In particular, there has been increased investment from Chinese firms that recognize the value of the technologies, brands and expertise held by Japanese firms and is aiming to obtain these business resources. Nevertheless, since the total share of FDI inflows as percent of GDP is still low in Japan, compared with other "powerful economies" as USA, Germany and China, various policies and measures will be needed for encouraging foreign corporations to invest in Japan. There are some particular industries, as for example, low carbon industry that have an important potential in attracting FDI (according with national statistics, in 2010, the field of the green-industry was one of the most active fields in terms of entries made by foreign firms).

In order to further encourage such positive trend, Japanese government should implement more location-based subsidiary program to encourage industries with many revolutionary low-carbon technologies to locate their operation within Japan. Furthermore, since Japan's ICT infrastructure was rated the best among 24 major countries and regions, taking into consideration such factors of broadband usage fees and speed, more measures two support and encourage new FDI in the field are necessary. In our opinion, the Japanese government measures for promoting investment should focus on discounts in form of reduction of taxes, guarantees on loans and loans with reduced rates.

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