Japan’s prolonged recession over the last five years has provided the impetus for regulatory reform and industry restructuring. Historically, the flow of Foreign Direct Investment (FDI) into Japan has been small for an economy of its size. The high degree of vertical integration and relatively closed business networks that characterised the corporate system made it hard for newcomers to gain access, while the tradition of lifetime employment limited the ability of foreign firms to recruit quality staff. Dramatic declines in the price of Japanese equities and land since the collapse of the bubble economy of the early nineties has been accompanied by a sharp increase in foreign participation in the Japanese economy. Traditional business relationships are opening up, regulations are being dismantled or revised and increased foreign involvement is now accepted as inevitable, even through mergers and acquisitions (M&A). Potentially profitable openings created by restructuring and reform is likely to see the trend towards greater foreign investment in Japan maintained over the next decade, especially in non-manufacturing.

Introduction

The last five years have been a time of rapid change in Japan. As a result, foreign investment in Japan is not the same proposition as it was a few years ago and it is important for firms to reassess the prospects for establishing a presence there.

FDI into Japan is on the rise

Foreign Direct Investment (FDI)\(^1\) into Japan has recently shown impressive growth, in particular in relation to non-manufacturing sectors like financial services. While there has been rapid growth in FDI worldwide for a number of years, FDI into Japan has been relatively low because of a number of features of the Japanese business environment. However, the value of foreign inflows in 1998 was much higher than in 1997, despite (and in part because of) the economy’s slide into recession, and the growth of inflows accelerated through 1998 and in the first half of 1999.

Growing FDI opportunities in Japan stem from the interaction of a number of recent developments. The prolonged stagnation in the Japanese economy has encouraged regulatory
reform, and tough times and falling prices are prompting massive industry restructuring regardless of government action. The sale of non-performing Japanese business assets is putting greater amounts of domestic capital on the market than previously, and the twin pincers of deregulation and recession are eroding traditional business relationships and prompting a greater acceptance of the need for greater foreign involvement.

In addition to these general developments, the Japanese government is taking more aggressive action to promote FDI into Japan, for example via tax and credit incentives. There is a greater realisation among policymakers than before the bursting of the bubble that inward FDI offers benefits to Japan in accelerating structural reform and internationalising the Japanese economy.

Despite changing market conditions, there are still important difficulties in undertaking FDI into Japan, especially in respect of mergers and acquisitions. These difficulties include those associated with established business practices, high business costs and recruitment, as well as regulatory impediments, which remain high in some sectors.

A number of important opportunities are arising in sectors of the Japanese economy where Australian firms are strong performers. Strategies need to be developed to take timely advantage of these emerging opportunities. The current circumstances offer a window of opportunity but companies may need to spend time and effort to understand and establish themselves in the Japanese market before undertaking substantial investments. As a consequence, firms need to be considering potential opportunities now if they are to position themselves ahead of competitors.

Lack of familiarity with the changing situation in Japan may be a large obstacle to a timely ability to seize profitable opportunities, as may negative assessments of the prospects for investment in Japan arising from perceptions that are now out of date. Government bodies are able to assist in overcoming some of these difficulties, in particular a lack of information on developments in the Japanese market.

**Trends in foreign direct investment in Japan**

**Recent trends in historical perspective**

One of the key developments in world FDI trends was the emergence of Japan as a major outward investor in the late 1980s. In the late 1990s, Japan’s importance as a recipient country
for foreign investment inflows is growing. Japanese FDI inflows have risen sharply, particularly in the last three years and recorded an all-time high in 1998.

According to notifications made to Japan’s Ministry of Finance, the total value of FDI inflows into Japan in 1998 totaled JPY 1.34 trillion (A$17.8 billion) (see Figure 1). The value of inward investments in 1998 was well above the recent trend growth. Average annual inflows between 1996 and 1998 were over 200 per cent higher than between 1990 and 1995. Almost all of the increase in FDI into Japan in the last three years has been in the non-manufacturing sector, while FDI into manufacturing has been relatively stable.

The first boom in FDI inflows that occurred at the height of the bubble period in the late 1980s and early 1990s was largely the product of Japan’s own domestic economic boom. When the bubble burst, FDI fell back again. What is remarkable about the second boom that is now occurring is that FDI inflows are rising despite prolonged Japanese economic stagnation. This suggests that more fundamental changes lie behind the recent rise in FDI.

Although the total value of FDI inflows has increased significantly, the total number of inward investment projects has increased more gradually. In 1998, 1,542 cases were recorded, which represents a small increase in the number of investments on 1996 and 1997 (Appendix Figure 1).

This implies that the average size of investments is rising. Value per case of FDI has increased rapidly since 1996 and reached JPY 870 million (A$11.5 million) in 1998 (Figure 2).

Recent increases in FDI into Japan have come off a very low base. Although Japan now plays quite a large role as an outward investor, FDI inflows into Japan have historically been very low for an economy of its size. This was partly a reflection of government policy. Until the late 1960s foreign investment in Japan was very limited and approved only on a case-by-case basis. The government's main objective during that period was to improve the technology and management expertise of Japanese firms by selecting the technologies to be imported. However, since 1976, and particularly since the passage of the ‘Liberalisation Act’ in 1980, the majority of direct prohibitions on investment have been removed (OECD 1994).

Despite these changes, inward investment has remained low by international standards. In 1997, while Japanese FDI outflows constituted 6% of total world FDI outflows, FDI inflows into Japan were less than 1% of world FDI inflows, despite the fact that Japan represents around 7.5% of world GDP (Figures 3 and 4). Over the last 20 years, Japanese FDI inflows as a proportion of GDP have been 20 to 30 times less than the OECD average. Japanese FDI inflows were only a little over 0.1% of GDP in 1997 and although that proportion more than
Figure 1  Total value of Japanese FDI inflows

(JPY100 million)


Figure 2  Japanese FDI inflows (value per case)

(JPY100 million)

Figure 3  World FDI outflows by region (values)


Figure 4  World FDI inflows by region (values)

doubled in 1998 to almost 0.3% of GDP (Figure 5), it remains low in comparison to other
developed countries, where inward foreign investment of between 2–3% of GDP is not
uncommon (Figure 6). The potential growth of FDI into Japan therefore remains extremely
high.

**Trends in the form of FDI**

Until the early 1990s, FDI flowed primarily to manufacturing industries. Since then, the trend
has changed, with a marked increase in foreign investment in non-manufacturing industries
(Figure 6). The share of FDI flowing to the finance and insurance sectors has increased
particularly sharply in recent years, with those sectors accounting for 45% of all FDI in 1998.
The extraordinary activity in these sectors is largely a reflection of the shake-up in the financial
sector, considered in the next section. In 1998, the amount of foreign investment in the finance
sector was nearly three times higher than the figure for 1997, which was itself a record.

The World Investment Report 1998 classifies FDI in terms of mergers, acquisitions,
greenfield investments, real estate purchases and joint ventures. Unfortunately, Japan does
not explicitly categorise investment proposals along these lines. However, they can be
classified on the basis of the descriptions provided to authorities. From this classification, it
can be determined that M&A activity, particularly mergers or acquisitions involving a majority
foreign stake, have not in the past been common in Japan. Majority M&A is the dominant form
of FDI elsewhere because it offers a range of advantages in terms of the scale and the speed with
which new investments can be up and running. Majority M&A accounted for 70% or more of
net FDI inflows into the US, Germany, Canada and France but only 26% in Japan (see Table
1) and, at 0.006%, cross-border M&A represented a far smaller proportion of GDP in Japan
than in any other of the major OECD economies.

The low level of M&A activity has been ascribed in part to the strongly negative
perception of corporate sales and to various impediments to acquisition, such as cross-
shareholdings among companies and the difficulty of obtaining necessary corporate informa-
tion (MITI 1998).

Despite these traditional obstacles, Japan is currently going through a second boom in
M&A (Figure 8). Although some of this boom reflects a marked expansion in M&A activity
between domestic companies (marked as IN-IN on Figure 9), M&As between foreign and
domestic firms (marked as OUT-IN on Figure 9) have also been increasing gradually since the
mid-nineties. The factors contributing to the recent expansion of M&A, including the dramatic
Figure 5 Japanese FDI inflows as a share of nominal GDP


Figure 6 FDI inflows and economic scale

Table 1  Cross-border M&A in OECD countries

<table>
<thead>
<tr>
<th></th>
<th>M&amp;A inflows/GDP %</th>
<th>Inflows(M&amp;A/FDI)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All M&amp;A</td>
<td>Majority</td>
</tr>
<tr>
<td>Japan</td>
<td>0.006</td>
<td>0.002</td>
</tr>
<tr>
<td>USA</td>
<td>0.086</td>
<td>0.074</td>
</tr>
<tr>
<td>Canada</td>
<td>0.188</td>
<td>0.154</td>
</tr>
<tr>
<td>France</td>
<td>0.087</td>
<td>0.064</td>
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<tr>
<td>UK</td>
<td>0.328</td>
<td>0.298</td>
</tr>
<tr>
<td>Germany</td>
<td>0.048</td>
<td>0.045</td>
</tr>
<tr>
<td>Italy</td>
<td>0.052</td>
<td>0.029</td>
</tr>
<tr>
<td>Spain</td>
<td>0.061</td>
<td>0.026</td>
</tr>
<tr>
<td>Australia</td>
<td>0.323</td>
<td>0.223</td>
</tr>
</tbody>
</table>

Note: Majority: transactions in which the foreign investor acquires more than 50% ownership. (1995–97 average).


Figure 7 Sectoral Japanese FDI inflows (values)

process of corporate restructuring induced by the prolonged recession and the reorganisation of sectors where deregulation has been carried out, will be examined in detail below.

Figure 9 documents the number of M&A cases in the various categories. It is reasonable to think that this profile may understate the significance of the increase in foreign M&A activity over the last three years, particularly given the earlier evidence that the value per case of foreign investment has nearly tripled since 1995, as set out in Appendix Figure 4. Although it is difficult to obtain timely and reliable aggregate data on mergers and acquisitions, there is substantial anecdotal evidence confirming the conclusion that increases in M&A activity over the last twelve months have been even more dramatic than previously. Table 2 documents a number of high-profile M&A cases involving foreign firms and provides some indication of the scale and breadth of recent changes.

Figure 10 gives some indication of the sectoral patterns of M&A activity over the last two years. It indicates that manufacturing is still the largest area of M&A activity by far, in terms of the number of recorded cases. The importance of M&A in the financial sector has increased sharply from 1997 through 1998 to 1999 as the process of recapitalisation and reconstruction of the banking sector continues. Since the size of these deals has often been large, financial sector activity is probably even more important in value terms than Figure 10 and Appendix Figure 3 reflect.

**Trends in sources and destination of FDI**

For many years, the United States has been the major source of FDI inflows into Japan. Since the early 1990s, the US share has been between 20 and 50%. European investors hold second place, with between 20 and 40% over the same period. Major European investors have come from the Netherlands, Germany, the United Kingdom and Switzerland. Much of the recent Dutch investment in Japan, particularly since 1990, was made up of funds originating in other countries and channelled through Netherlands Antilles, rather than capital actually generated in the Netherlands (OECD 1994). Data for Japanese FDI inflows by region are set out in Figure 11, Appendix Figures 2, 5 and 6.

The United States has retained its lead, accounting for 60.3% of total FDI in 1998. In the same period, the Netherlands held a share of 9.5%, the United Kingdom 2.8%, and Switzerland 2.5%. The expansion of investment by foreign-owned companies already operating in Japan has also accounted for an increasing share of FDI in recent years, representing 12.9% of total FDI in 1998. In many countries, the reinvested earnings of established foreign firms account
Figure 8 The number of Japanese M&A deals

<table>
<thead>
<tr>
<th>Year</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td></td>
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<tr>
<td>1987</td>
<td></td>
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<td>1988</td>
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<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
</tr>
</tbody>
</table>


Figure 9 The form of Japanese M&A deals

Notes: IN-IN represents domestic companies merging with domestic companies; IN-OUT represents domestic companies merging with foreign companies in Japan; OUT-IN represents foreign companies in Japan merging with domestic companies; and OUT-OUT represents foreign companies in Japan merging with foreign companies in Japan.

### Table 2  Recent mergers, acquisitions, takeovers and joint ventures

<table>
<thead>
<tr>
<th>Japanese Company</th>
<th>Foreign company (Country)</th>
<th>Implementation</th>
<th>Type</th>
<th>Established company</th>
<th>Capital</th>
<th>Share</th>
<th>Remarks</th>
<th>Source</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Finance</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LTCB</td>
<td>UBS (Switzerland)</td>
<td>15/4/98</td>
<td>Joint venture</td>
<td>LTCB UBS Brison Co</td>
<td>n/a</td>
<td>n/a</td>
<td>Joint company renamed UBS Brison Asset</td>
<td>Nikkei Weekly</td>
<td>28/4/99</td>
</tr>
<tr>
<td></td>
<td>Deutsche Verkehrsbank AG (Germany)</td>
<td>99</td>
<td>Acquisition</td>
<td>n/a</td>
<td>JPY220 billion</td>
<td>LTCB 40% UBS 50%</td>
<td>Joint company renamed Warburg Dillon Read</td>
<td>JETRO Investment News</td>
<td>3/99</td>
</tr>
<tr>
<td></td>
<td>SBC Warburg Ltd/UBS Securities Ltd</td>
<td>1/7/98</td>
<td>Joint</td>
<td>LTCB Warburg Securities Ltd</td>
<td>JPY 60 billion</td>
<td>Nikko 51% SSB 49%</td>
<td>Also created securities firm in Tokyo to serve corporate clients</td>
<td>Nikkei/Dow Jones</td>
<td>18/12/98</td>
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<td></td>
<td>Salomon Smith Barney Ltd of Citigroup (US)</td>
<td>29/1/99</td>
<td>Joint venture</td>
<td>Nikko Salomon Smith Barney Ltd</td>
<td>JPY 110 billion</td>
<td>n/a</td>
<td>Nikkei/Dow Jones</td>
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<td>The Travelers Group (US)</td>
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<td>JPY 220 billion</td>
<td>25%</td>
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<td></td>
<td>Deutsche Securities Ltd (Germany)</td>
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<td>Merger</td>
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<td>n/a</td>
<td>n/a</td>
<td>Financial Banking Daily Yomiuri</td>
<td>12/11/98</td>
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<td></td>
<td>Lehman Brothers Japan Inc (US)</td>
<td>98</td>
<td>Acquisition</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>Euroyen-dominated Nikkei convertible bonds</td>
<td>Financial</td>
<td>11/12/98</td>
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<td></td>
<td>State Development Bank (China)</td>
<td>n/a</td>
<td>Tie-up</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>Investment banking Nikkei activity</td>
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<td></td>
<td>Prudential Insurance Trust Investment Co Ltd</td>
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<td>Joint venture</td>
<td>Prudential Mitsui Trust Investment Co Ltd</td>
<td>n/a</td>
<td>n/a</td>
<td>Sales of investment Reuters News Service</td>
<td>Kyodo News</td>
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<td>GE Capital Corp (US)</td>
<td>n/a</td>
<td>Acquisition</td>
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<td>Purchase at JPY 800 billion</td>
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<td>Japanese Company</td>
<td>Foreign Company (Country)</td>
<td>Type</td>
<td>Capital Share</td>
<td>Remarks</td>
<td>Source</td>
<td>Date</td>
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<tr>
<td>Industrial Bank of Japan</td>
<td>Macquarie Bank</td>
<td>Acquisition</td>
<td>n/a</td>
<td>Equity derivatives alliance</td>
<td>Macquarie Bank press release</td>
<td>12/5/99</td>
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<tr>
<td>Masuda Credit Corp</td>
<td>Ford Motor Credit Co</td>
<td>Joint venture</td>
<td>n/a</td>
<td>To establish alliance</td>
<td>Nikkei Weekly</td>
<td>12/5/99</td>
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<tr>
<td>Softbank Co</td>
<td>NASD</td>
<td>N/A</td>
<td>n/a</td>
<td>n/a</td>
<td>Nikkei</td>
<td>12/5/99</td>
<td></td>
<td></td>
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<tr>
<td>Softbank Corp</td>
<td>E-Trade Group</td>
<td>Joint Venture</td>
<td>n/a</td>
<td>GM 10%</td>
<td>JETRO Investment</td>
<td>12/5/99</td>
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<td>Suzuki Motor Co</td>
<td>General Motors (US)</td>
<td>Acquisition</td>
<td>n/a</td>
<td>Purchased at US$100 million</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td>Sumitomo Rubber Indus Ltd</td>
<td>United Microelectronics</td>
<td>Negotiating</td>
<td>n/a</td>
<td>Purchased at USD400 million</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td>Nippon Steel Corporation</td>
<td>Nissan Diesel Motor Co</td>
<td>Takeover</td>
<td>n/a</td>
<td>Bosch Braking</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td>Mitsubishi Motor Co</td>
<td>Robert Bosch Co</td>
<td>Venture System Japan</td>
<td>n/a</td>
<td>Bosch</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td></td>
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<tr>
<td>Nissan Diesel Co</td>
<td>Makita Ltd, Jidosha Kiki Co &amp; Nippon ABS Ltd</td>
<td>Takeover</td>
<td>n/a</td>
<td>Bosch</td>
<td>Nikkei</td>
<td>12/5/99</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Mazda Motor Corp</td>
<td>Ford Motor Co (US)</td>
<td>Capital tie-up</td>
<td>n/a</td>
<td>Takeover</td>
<td>Daily Yomiuri</td>
<td>12/5/99</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Renault (France)</td>
<td>DaimlerChrysler AG (Germany)</td>
<td>Tie-up</td>
<td>n/a</td>
<td>Capital tie-up</td>
<td>Nikkei</td>
<td>12/5/99</td>
<td></td>
<td></td>
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<td>Nissan Motor Corp</td>
<td>DaimlerChrysler AG (Germany)</td>
<td>Tie-up</td>
<td>n/a</td>
<td>Capital tie-up</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td>Fiat Motor Corp</td>
<td>E-Trade Group</td>
<td>Joint Venture</td>
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<td>Bosch</td>
<td>Nikkei</td>
<td>12/5/99</td>
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<td>Mitsubishi Motors Corp</td>
<td>DaimlerChrysler AG (Germany)</td>
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<td>12/5/99</td>
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<td>Fiat Motor Corp</td>
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<td>Bosch</td>
<td>Nikkei</td>
<td>12/5/99</td>
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</tr>
</tbody>
</table>

Note: The table above lists various joint ventures and acquisitions between Japanese and foreign companies.
<table>
<thead>
<tr>
<th><strong>Food</strong></th>
<th><strong>Service</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mitsu % Co Sunnyland Refining Co (US)</td>
<td><strong>Food</strong></td>
</tr>
<tr>
<td>1/99</td>
<td>Acquisition</td>
</tr>
<tr>
<td><strong>Mitsui % Co Sunnyland Refining Co (US)</strong></td>
<td><strong>Service</strong></td>
</tr>
<tr>
<td><strong>Singapore Telecom (Singapore)</strong></td>
<td><strong>Joint offer tie-up</strong></td>
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<tr>
<td><strong>The Manufacturers Life Insurance Co (Canada)</strong></td>
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<td><strong>Teleglobe Inc (Canada)</strong></td>
<td><strong>Capital tie-up</strong></td>
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<td><strong>Cable &amp; Wireless PLC</strong></td>
<td><strong>Possibly 5-June</strong></td>
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<td><strong>Acquisition</strong></td>
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</table>

**Source:** Compiled by Australian Embassy and Australia–Japan Research Centre from newspaper reports and the Nikkei Database at the AJRC, May 1999.
for the majority of recorded FDI flows. The fact that this is not true in Japan is an indication of the relatively small stock of foreign capital in Japan.

There has been some variation in the sectoral destination of investments from different countries. In 1998, the majority of FDI inflows of the machinery sector came from the reinvested earnings of existing firms and did not represent new acquisitions or ventures. The overwhelming share of FDI in the chemical industries was from European countries. North America was easily the largest source of FDI into the Japanese financial sector, while European investors were the largest participants in trading and services industries. In part, these trends reflect the comparative advantages of particular countries in terms of investment in particular sectors.
The main prefectures in which foreign affiliates in Japan based themselves in 1996 were Tokyo (701 cases), Osaka (8.3 cases), Kanagawa (81 cases), and Hyogo (23 cases) (Table 3). Tokyo also dominated other prefectures in terms of measures such as sales, the number of employees and capital investment, although Chiba and Aichi were significant locations in terms of sales and Kyoto in terms of capital investment. There is no evidence that this pattern has changed significantly in the last three years. Prefectures outside metropolitan Japan, however, are actively promoting inward FDI and, because of lower costs and locational advantages in the chain of new distribution systems, are areas of interest to new foreign investors.

Much of this distribution reflects relative economic size, although outside Tokyo other regions also have advantages in terms of lower costs. The Tokyo economy is equal in size to that of Brazil and larger than that of Canada or South Korea. Kanagawa and Chiba are neighbouring prefectures of Tokyo and benefit from being part of a region of over 31 million high income and cosmopolitan consumers. Osaka, Hyogo and Kyoto are prefectures within Kansai, the second largest metropolitan region, which has a population of over 20 million. Costs (labour and housing) there are lower than in Tokyo and local governments have put in place aggressive development plans. Aichi is part of the third largest region, also with around 20 million people and much lower costs of living than the other two regions.
This section has examined the marked expansion of FDI inflows into Japan over the last three years. Unlike earlier booms in inward investment, these trends cannot be explained by the strength of the Japanese economy. Much of the new activity has been directed towards non-manufacturing sectors, many of which were previously sheltered from foreign competition. The next section explores the factors that are driving these trends by examining the reasons why FDI into Japan has traditionally been low and why the situation for foreign investors is now changing.

Why is the foreign investment climate in Japan improving?

Although direct prohibitions on FDI have been low for some time, many features of the Japanese system have traditionally made FDI in Japan a costly and risky business. This
section describes how the traditional pillars of that system – relatively closed capital and labour markets and a tightly controlled distribution system – are crumbling. In combination with deregulation and new incentives, this is greatly improving the environment for foreign investors.

The traditional system

The historically low levels of inward FDI into Japan are the product of a number of different features of the Japanese economy that have traditionally made profitable foreign investment in Japan difficult. In some cases, Japanese policy explicitly sought to limit foreign participation and investment in particular sectors and activities such as media and communications. At the same time, the heavy burden of regulations, particularly in Japan’s notoriously unproductive services sector, effectively restricted competition (both foreign and domestic) in many industries, reducing the attractiveness of investment opportunities in Japan.

These disadvantages have been reinforced by Japan’s high corporate tax rates (until recently around 50%), which also reduced the profitability of operating in Japan. Between 1990 and 1994, the corporate tax burden as a proportion of operating surpluses was more than twice as high as the OECD average. The relatively high cost of purchasing Japanese assets and land, particularly in the late 1980s, also discouraged foreign investors.

Although the constraints of the regulatory and tax frameworks have been important impediments to FDI, more fundamental obstacles have arisen from the closed nature of capital and labour markets and of business networks. Successful foreign investment generally requires the purchase of assets and the recruitment of high quality local staff. Since a large amount of foreign investment is aimed at establishing a base for the delivery of goods and services, the ability to tap into local distribution and retail networks is also crucial.

To appreciate recent changes in Japan, it is critical to understand how the particular difficulties of acquiring assets, recruiting staff and gaining access to distribution systems in Japan have in the past combined to raise the costs and risks of starting up an operation in Japan. The stable relationships that arose between workers, employers and firms, largely as a means of sharing risk, have in practice made the Japanese system relatively hard for newcomers to access directly.

Under the Japanese keiretsu system, cross-shareholdings between companies are common. In 1994, financial institutions and corporations owned nearly 70% of all stocks. Banks, particularly the so-called main banks, have played an important part in this system both as
major shareholders and as principal lenders to related companies. Reliance on the main banks
as a source of low-cost funding meant that Japanese firms rarely saw the need to seek capital
from elsewhere. The concentrated and stable share ownership meant that large portions of
company stock were in practice not heavily traded.

As a result of this system of stable cross-holdings, rather than legal or regulatory
impediments, Mergers and Acquisitions (M&A) activity has been weak in Japan by interna-
tional standards, as noted in the previous section. Because of these arrangements, it is as a
practical matter difficult to purchase a significant part of a company’s shares. What this has
meant is that foreign investors in Japan have usually been required to establish ‘greenfields’
operations, often at substantial cost. M&A is the most common vehicle for FDI outside Japan.
The difficulties of acquiring a Japanese presence through this route have tended to raise the
entry hurdle for foreign investors.

Foreign investors have also found it hard to access Japanese labour markets. In
establishing a foreign operation, it is often important to be able to attract high quality local
staff. This is particularly true where it is difficult for foreign firms to acquire local businesses,
and their staff, in an open market. Like Japan’s capital markets, the labour market has also
been relatively closed. Under the old system of lifetime employment, it was usual for employees
to enter long-term relationships with their firms. Employers would contract or tacitly commit
to retain workers even during downturns while workers would provide loyalty and would not
seek to move to other firms.

As a consequence, employment patterns have been very stable by international stand-
ards and labour mobility, particularly inter-firm mobility, is very low. The tradition of
seniority-based pay, which effectively delivers a premium for long service with a single
employer, has also encouraged stability in employment histories while the practice of keeping
workers ‘unemployed on the job’ has artificially reduced the pool of people seeking employment.
Until recently, Japanese employees have been reluctant to leave existing employers and work
for foreign firms. The resulting difficulties for recruitment are reflected in JETRO surveys of
foreign affiliates and investors operating in Japan, with 60% reporting difficulties in securing
human resources.

The peculiar nature of the Japanese retail and distribution system has also made it
difficult for newcomers to access distribution networks. This is partly a result of direct
regulation. The retail sector has been, and still is, a highly regulated part of the economy. In
particular, the 1979 Large Scale Retail Store Law effectively limited the establishment of new
large stores until the early 1990s (see Box 1). The retailing sector has thus been characterised by a high density of small and relatively low-productivity outlets.

The high cost of land, particularly in urban centres, has also influenced the structure of the distribution network. Wholesalers, who can locate away from the most expensive areas, play a much more important part in the retail chain than in many other OECD countries and it is not uncommon for there to be several ‘layers’ of wholesaler between manufacturers and retailers. Access to wholesaling operations then becomes crucial to successful distribution and market penetration.

Vertical integration between manufacturers, wholesalers and retailers is common. Even where formal integration has not occurred, the use of rebates, special deals and staff exchanges have led to a high degree of defacto integration. For instance, sales staff for department stores may be supplied by wholesalers and manufacturers and many distributors operate open-ended return schemes for retailers. These kinds of practices have led to highly stable (and often exclusive) relationships between manufacturers, wholesalers and retailers. Until recently, it was relatively rare for retailers to switch suppliers and to move outside the established network.

These closed networks have created a distribution system that new suppliers or distributors, particularly those from abroad, have found it hard to break into. Since successful foreign investment often relies on its ability to provide the means for product distribution and service delivery, the difficulty of accessing existing networks has been a particular problem for prospective investors.

The problems of acquiring assets, recruiting staff and accessing distribution networks have tended to reinforce each other. If, for instance, it had been easy to acquire existing assets, the problems of recruiting staff or accessing distribution networks could have been overcome by direct purchase of existing operations. In effect, the existence of a wide range of stable relationships between employers, employees, firms, banks and suppliers created a closed system that has been extremely difficult to break into.

Why is the environment for foreign investors changing?

Over the last five years, the impediments to foreign investment have begun to crumble as traditional relationships are stretched to breaking point by the new and harsher economic environment. With the old system so obviously in trouble, the government has also been more willing to act on its deregulation agenda. In December 1994, a new body, the Administrative
Reform Committee, was appointed for a three-year term to oversee regulatory reform. Since then, the government has released regular action plans for deregulation in a broad range of areas. Although the political constraints on aggressive reform remain severe, there is little doubt that the pace of deregulation has picked up, particularly since the strong push by the Hashimoto government in 1996.

Pressure has come not only from deregulation but also from the new competitive forces arising from a period of prolonged stagnation and falling prices. The high-growth economy is dead and firms are scrambling to adapt to a new environment where low growth is usual and competition is fierce. The ‘hidden’ assets of the high-growth era and the 1980s boom period can no longer be called in to cover management weakness and mistakes. Errors nowadays are more likely to lead to bankruptcy or some form of takeover.

Even in areas where the government has been slow to act, seven years of economic stagnation have created an environment where change is accepted as inevitable. Institutions across Japan are contemplating radical restructuring of the way they conduct their business.
In many areas, the push for change has a momentum that is independent of the political process.

In particular, massive restructuring is taking place not only in the financial sector but also in the non-financial corporate sector. The old corporate convoy is breaking up as firms find their way ahead or drop behind in a more open and competitive business environment. The credit crunch is speeding this process of natural selection. Many small businesses, traditionally heavily supported by government, are finding it hard to survive.

As the high costs of the current economic structure are recognised, the need for further deregulation is increasingly acknowledged. Prime Minister Hashimoto began his term with an impressive program for financial market and other reforms. Although his program of fiscal consolidation and some elements of his financial package ran aground, there was significant progress with financial reform under his ‘Big Bang’ agenda. More recently, Prime Minister Obuchi established an Economic Strategy Council in August 1998, which has since recommended a series of long-term reforms that include the strengthening of the deregulation and anti-monopoly agenda.

Greater opportunities for foreigners are going hand in hand with domestic reform and tougher times. As weaker companies succumb and stronger ones look for support, foreign firms are playing a larger role in corporate Japan. There is also a huge re-positioning by embattled Japanese corporates as they seek partnerships and alliances with foreigners on their own turf.

In particular, the dramatic changes in the Japanese economy are weakening or removing some of the traditional barriers to foreign investment. The shake-up in Japan’s financial sector is creating scope for greater foreign involvement and asset purchases. Retail distribution networks are becoming more fluid, spurred by regulatory changes and increased competitive pressure. With the breakdown of the lifetime employment system, foreign firms are finding it easier to recruit. These changes in traditional relationships, examined below, are creating openings for foreign enterprises that can establish a local presence.

Since the bursting of the asset price bubble at the beginning of the 1990s, Japan’s financial system has essentially been on life support. The weakness in the banking sector imposes a drag on the rest of the economy which has seen the government move aggressively down the path of financial deregulation as part of its ‘Big Bang’ agenda. The sector is going through a massive shake-up, with consequences for foreign investors that extend well beyond the financial industry itself.

Traditionally, Japanese financial markets have been highly segmented and heavily regulated. Until recently many financial activities were restricted to particular kinds of
institutions. The result was a series of relatively sheltered and separate financial markets. These barriers are now being dismantled, increasing the scope for competition and diversification. Direct regulation of prices has gradually been abolished and financial segmentation has been reduced. As well as broadening the range of activities that financial institutions can undertake, reforms have also allowed previously prohibited activities. In 1994, forward agreements on interest rates and exchange rates were allowed for the first time. Securities firms can now offer options trading, derivatives and loan-backed securities. Under the new system, individuals can now hold accounts abroad directly, where before they could only access foreign investment opportunities through a mutual fund.

One area where the impact of reform has been particularly important and where opportunities are expanding rapidly is the pension fund industry. Until recently, private fund management was limited to trust banks and life insurance companies. The relatively closed market usually involved cosy relationships between funds and private companies. Corporate pension funds were often run not on the basis of return but invested disproportionately in the firms whose assets they were managing. As part of a series of reforms to pension provision, the pension fund market was partially opened to domestic and foreign advisory firms in 1996, leading to an immediate rise in foreign activity.

Reforms of this kind have opened the finance industry itself to greater foreign involvement (see Box 2). Foreign banks and insurers have seized the opportunity to exploit their comparative advantage in areas where Japanese banks have been weak and to gain access to the large pool of Japanese household assets, which are still held disproportionately in the form of bank deposits and cash. Their success is evidenced by a sharp increase in foreign market share in many financial activities (see Box 3).

But the implications of the ‘Big Bang’ for foreign investment in Japan reach far beyond the financial sector itself. In the long run, the more important impact is likely to be that the opportunities to acquire stakes in Japanese companies will increase, as financial reforms open up the traditionally closed system of capital allocation and firms shift financing away from banks to the capital markets. Already, the deregulation process has led to a significant shift in the balance of corporate financing with larger manufacturing companies, in particular, shifting towards raising capital through securities markets.

The corporate sector’s dependence on bank loans as a source of new fund-raising has fallen dramatically since the late eighties. Funds raised through bank borrowing were around 40 trillion yen (A$533 billion) in 1990, but have been negative in aggregate (i.e. there have been
The reforms to fund management, and to the financial sector more broadly, have prompted dramatic restructuring. The result has been a reduction in financial institution cross-holdings, a wave of mergers and divestments amongst domestic institutions and greater foreign involvement. The market share of foreign brokers almost doubled to 30% in 1997, with Morgan Stanley and Merrill Lynch moving to the top of the league in terms of trades on the Tokyo Stock Exchange, while foreign life insurers are also gaining market share. Foreign mutual funds saw an 86% increase in asset value in the last financial year and foreign banks recorded a 120% gain in pension fund assets under management over the same period.

Mergers and joint ventures are increasingly common. Merrill Lynch took over large parts of failed securities house Yamaichi to increase its foothold in the Japanese market, Salamon Smith Barney and Nikko have entered into a joint venture, Societe Generale has formed an alliance with Nomura, and Fuji and Goldman Sachs are teaming up in the mutual funds business. Joint ventures are also emerging in life insurance. GE Capital has signed up to take over the new business of Toho Mutual Life and Meiji Life is now allied with Dresdner.

The changes to fund management that allow investment advisers to manage tax-qualified pension plans are also creating enormous opportunities and foreign firms are again getting a share of the action. Following the reforms allowing pension funds to be managed by investment advisers in 1997, there was a 42% increase in funds under management in 1997. With most insurance companies currently offering returns of around 2.5% a year, many funds are switching to foreign advisers, who now manage 8% of the overall market. Even the Pension Service Welfare Corporation has boosted the share of new funds allocating to foreign managers from 15% to 52%.

The pressure for further changes has not abated. The government is currently looking to remove the ban on pension plans whose benefits vary depending on investment returns. Defined contribution plans, like the US 401(k) scheme, are being considered and the government has already instructed ministries to design the regulations necessary to implement these changes. The introduction and growth of defined contribution schemes is likely to create further pressure for higher investment returns.

With Japanese financial institutions in a weakened state, and generally inexperienced in many of the areas where new business opportunities are opening up, there will continue to be considerable scope for increased foreign involvement. Given the distinctive nature of the Japanese system, many foreign firms have chosen the path of joint venture.
Box 3 GE capital – aggressively acquiring a presence

GE Capital is a US financial services giant that developed in 1932 from providing consumer loans for products made by its parent, General Electric. Although it has had a presence in several Asian countries for some years, it has only been recently investing heavily in crisis-hit Asia, including Japan. It expects to earn healthy returns on these investments, by introducing new processes to cut costs and developing new products, like call centres and automatic loan machines, to drive revenues. The company faced some obstacles to these investments, and others such as language and lack of experience in the Japanese market remain, but these have not prevented the realisation of profitable investments. More broadly, the involvement of GE Capital has been a catalyst in boosting competition, improving services and prices, as well as improving the reputation of the financial services sector. For example, the large purchase of Japan Leasing for US$7 billion plus, which is larger than the Renault–Nissan tie-up, is expected to improve the performance of the industry and to accelerate its consolidation as well. The company’s involvement has also resulted in attracting other foreign investors who see the company’s interest reflecting market potential and have seen what is achievable.

net repayments) since 1994. Although in flow terms, borrowing from banks has fallen markedly over the nineties, the stock of liabilities has fallen more gradually. According to Bank of Japan data, borrowing represented around 45% of all non-financial sector liabilities in 1997, down from around 58% in 1989, but still significantly higher than in most other OECD countries. This decline has been balanced by a shift in liabilities towards securities, whose share of total liabilities climbed from 15% to 27% over the same period.

Much of this shift reflects the continuation of a trend towards greater disintermediation that began in the late 1980s. What is less clear from the available aggregate data is whether the shift away from bank financing has accelerated over the last two years, as the recession has taken hold and bank reform has commenced in earnest. The available data on private sector liabilities do not yet indicate a marked acceleration in the decline in importance of bank lending since the recession began. It is clear, however, from recent Bank of Japan data that Japanese banks have cut back dramatically on new lending over the last fifteen months and there is no sign yet that this trend is abating. Because of this, there are good reasons to suspect that the reliance on bank lending will continue to fall sharply as the credit crunch continues and as banks and firms seek to disentangle themselves from each other.

There is plenty of anecdotal support for this prediction. Banks, in their weakened state, are unwilling or unable to continue lending to some firms. In many cases, they are also
divesting their holdings of shares in Japanese companies as part of the process of improving their own profitability. These developments are weakening traditional relationships between banks and non-financial corporations, which have been central to the *keiretsu* system and indeed there is evidence that cross-shareholding levels are slowly but surely declining.

Faced with the credit crunch, and with Japanese banks in no position to supply new capital to ailing corporations, local firms are looking elsewhere for capital injections. In this environment, not only the banks, but the corporate sector more generally, are finding the prospects of foreign involvement, either through asset purchases or joint venture, more attractive. The recent tie-up between Renault and Nissan provides a good example of how financial sector problems are creating broader opportunities for foreign investment. No Japanese bank was in a position to take on the risk of injecting capital into the company.

The fact that even companies that have been flagships of corporate Japan and lynchpins of the *keiretsu* system are looking abroad for funding makes recent developments all the more remarkable. In that respect, Nissan’s tie-up with Renault and Ford’s takeover of Mazda in the automobile industry, traditionally one of the jewels in Japan’s corporate crown, signal the depth of the changes that are taking place, as do takeovers in the semiconductor and rubber industries (see Box 4).

The high level of bankruptcies and the need for firms in the financial sector to divest themselves of non-performing loans are also leading to a liquidation of assets on an unprecedented scale. This too is providing opportunities to acquire businesses, where in a normal context the acquisition of a controlling stake would have been difficult. Merrill Lynch’s acquisition of Yamaichi, for instance, was only possible in the context of the failure of the securities house. With asset prices low by historic standards and with local buyers short of funds, there will be potential for attractive purchases in some sectors.

Alongside the breakdown in traditional relationships between firms and their financiers, the Japanese distribution system is opening up in equally dramatic ways. Once again it is the twin pressures of an increasingly competitive deflationary environment and progress on deregulation that are driving change. Relaxation of regulations on the opening of large retail outlets has sparked the development of out-of-town shopping centres that are setting new patterns in retailing. Sales by department and chain stores are stagnating. Tokyu closed its 300 year-old premises in Nihonbashi earlier this year. But sales of convenience stores are growing rapidly in spite of the recession and new theatre entertainment centres are all the rage.
Ford has had a long-standing alliance with Mazda since 1969, which was formalised when it took a 25% equity stake in the Japanese car firm in 1979. This tie-up was taken to a higher level in 1996 when Ford increased its share in Mazda to a controlling 33.4% stake. In 1997 a jointly-owned distribution network set up by the two companies, Autorama, became Ford Sales Japan, leading to a much larger direct marketing presence for the American auto giant than before. Ford now plans to take over part of Mazda’s own dealership network to expand its control of distribution of its vehicles in Japan.

The key regulatory changes have involved a series of easings of the Large Scale Retail Store Law between 1990 and 1994, streamlining the procedures for applying to open large stores and relaxing the limits on approvals and on opening hours. The result has been a sharp and persistent rise in the number of new large stores over the last four years.

An equally powerful dynamic has come from the various responses to stagnating sales, weak consumer spending and falling prices. The difficult business climate for retailers has led to uncharacteristically aggressive attempts to find ways to reduce costs. Discount stores have expanded their market share substantially at the expense of traditional retailers. They have been prepared to locate in suburban areas, to contract directly from suppliers without using the wholesale network, and to exploit competition between suppliers to secure the lowest cost products. Supermarkets too have increasingly been prepared to make purchases outside the normal distribution channels and are proving more willing to switch suppliers in response to lower prices. Supermarkets are a strong growth element in retailing and the provision of payments services (for telephone and utilities services, for example) importantly because of their lead in the application of computer technologies.

As a result, the strong vertical relationships that have traditionally made it difficult to access the Japanese distribution system are breaking down and the system as a whole is becoming much more fluid. Manufacturers are finding it hard to control or standardise prices across stores and, under pressure to reduce prices, distribution routes are becoming more efficient. Sales between wholesalers dropped 42% between 1994 and 1997, as layers of wholesaler transactions were eliminated.
As retailers and wholesalers achieve greater independence, the percentage of companies reporting that they maintain strong ties with suppliers has dropped sharply. The increasing willingness to move to new suppliers and to operate outside traditional distribution channels is proving to be an enormous advantage to foreign producers looking for openings in the Japanese market. Even small producers are finding that a local presence can now provide a base for supplying directly to supermarkets and other stores, in a way that would have been close to impossible ten years ago.

With the recession dragging on and companies seeking to restructure more aggressively, the Japanese labour market traditions of low unemployment, high job security and low mobility are also coming under threat. The unemployment rate now stands at 4.8%, a post-war record, and there are no signs that the rise is abating. Some analysts are predicting that the unemployment rate could reach levels of close to 10% before the period of recession and reform is over. The rises in joblessness has been particularly severe for the young. The unemployment rate for the under-24s is now 9.3%, around twice the overall average. The number of last year’s graduates who have not yet found employment is also at record levels. Figure 12 describes trends in the labour market between 1985 and 1998.

Deteriorating labour market conditions are bringing a new flexibility to employment arrangements. The notion of ‘lifetime employment’ is in retreat, job insecurity is rising, even for those employed by large domestic corporations, and the high ratio of unemployed to vacancies is increasing competition for jobs. As a result, recruiting and placement agencies are expanding their operations and Japanese workers, particularly young graduates, are more and more willing to contemplate careers in foreign firms. The human resource constraints faced by foreign firms are also being eased by efforts to allow access to professional qualifications. The Ministry of Finance is reintroducing an exam for foreign-trained accountants in 1999. There has also been an easing of access for foreign legal consultants and efforts are underway to increase mutual recognition of qualifications with major trading partners.

The increased openness of the financial sector, the distribution system and the labour market in Japan represent general improvements in the ability of foreign investors to operate in the Japanese market. Other aspects of deregulation are also important for access in individual sectors.

The government’s Deregulation Action Plan announced in 1995 and its subsequent revisions have aimed to reduce the regulatory burden in a wide range of industries with varying degrees of progress and success. As well as the changes to the financial and retail sectors already discussed, there have been changes in public procurement, in transport and in...
telecoms (see Box 5). Some of these changes have explicitly sought to ease restrictions on foreign access.

For instance, in 1994 the government altered public procurement procedures for telecommunications products and medical technology in order to expand opportunities for foreign firms. Foreign direct investment in the cable TV industry was also recently approved and the ability to offer international telephone services via the internet was liberalised in August 1997.

Even where deregulation measures do not directly affect foreign access, they may have important consequences for foreign firms investing in Japan. Many of the most heavily regulated sectors (transport, telecoms, energy) provide critical inputs for businesses in Japan. Traditionally, the cost of these inputs has been much higher than in other developed countries and this has contributed to the high cost of doing business in Japan. Successful deregulation is the key to bringing these costs down, and lowering the cost of doing business generally. For instance, calling long-distance in Japan is now over 75% cheaper than it was in 1997.

Alongside these sectoral changes, attempts have been made to strengthen the effectiveness of competition policy more generally. Enforcement of the Anti-monopoly Act is to be toughened. The number of cartels exempt from the Act has fallen from 1,079 in 1976 to 12 in 1997. Proposals to streamline the processes for taking action against unfair trading practices are also under review.
Box 5  Key deregulation measures in Japan

**Telecoms**
- Simplification of procedures for broadcasting licences.
- Agreement as part of WTO negotiations to allow greater foreign investment. 33% limit on ownership of many telecommunications firms abolished.
- Liberalisation of international telephone services via the internet.
- Cable TV opened to foreign investment.
- NTT, Japan’s major telecoms carrier, to be split up in the second half of 1999.

**Financial sector**
- Abolition of remaining interest rate controls. Forward interest rate and exchange agreements permitted for the first time.
- Changes to pension funds management allowing foreign advisory firms the right to manage funds.
- Relaxation of restrictions on cross-border transactions.
- Ban on financial holding companies scrapped. End to ‘5:3:3:2’ rule specifying the distribution of pension fund assets by asset type and removal of restrictions limiting advisory firms to managing only half of fund assets.
- Deregulation of commission on equity transactions. Foreign Exchange and Control Law changed so that currency dealing is no longer restricted to authorised banks.

**Retail**
- Changes to Large Scale Retail Store Law (LSRSL) streamlining application procedures for large stores and relaxing limits on operating hours.
- Easing of provisions for large supermarkets to obtain liquor licences.
- New law to replace the LSRSL to be delivered by June 2000 to set out more transparent criteria for the approval of stores.

**Transport**
- New agreement allowing airline codesharing and improving access for greater number of airlines signed.
- Fare controls to be abolished in most transport sectors, with ceiling prices replacing direct controls.

**Energy**
- Liberalisation of imports of refined petroleum products. Electric utilities allowed to source power from outside providers.
- Deregulation of petrol stations begun, with self-service stations now permitted.
- Deregulation bill expected by the end of 1999 but free entry at retail level in electricity has been ruled out.
- Advisory panel recommended abolition of price controls on petroleum products.

**Procurement**
- Public procurement for medical technology and telecommunications procedures revised to give greater access to foreign firms with advanced technology.
While there are still substantial obstacles to aggressive reform in Japan and some sectors remain highly regulated, there are signs that the government’s reforms are having some effect. According to OECD calculations, the relative price of goods and services in Japan relative to other countries fell twice as fast for deregulated items than for others.

As well as improvements in the regulatory environment in some sectors, the corporate tax system and direct incentives available to foreign investors have improved in the last five years. The overall corporate tax rate (combining national and local taxes) has fallen from around 50% at the beginning of the nineties to 41% from April 1999, making it comparable to that of other OECD countries.

Tax concessions for foreign investors have also been made more generous. In July 1995, a series of measures was announced to encourage FDI inflows and a new body, the Japan Investment Council (JIC), was set up to coordinate policy on FDI. Foreign investors can now carry forward business losses for up to ten years, rather than the previous seven-year limit, a move designed to reduce the high initial costs of start-up in Japan, and loan guarantees to businesses dealing with designated foreign investors have been extended.

Some steps have also been taken to facilitate M&As and prevent restrictive business practices. Changes in 1990 to the Security Transaction Law mean that prior notification of M&A is no longer necessary. The end to the ban on holding companies in June 1997 is also likely to make it easier to buy Japanese companies.

Some foreign firms have been quick to take advantage of the new opportunities for involvement in Japan. Foreign involvement has been most obvious in the financial sector. But other sectors are also experiencing sharp increases in foreign participation. WorldCom’s application to offer long-distance services in Japan has been approved, in April 1999 British Telecom and AT&T acquired a major stake in the domestic carrier Japan Telecom, and Cable & Wireless have made a bid for IDC, a Japanese international telecoms carrier (see Box 6).

Beyond the high profile cases, the Nissans and the Renaults, the Yamaichis and the Merrills, a quieter revolution is also taking place amongst smaller firms. Individual success stories, particularly in retailing, of foreign businesses which have set up local operations and established a presence in Japan, and then expanded rapidly, are multiplying.

**Remaining obstacles**

Despite the progress, impediments to operating in Japan remain, at least in some sectors. Recent JETRO surveys identify the high costs of doing business, high level of customer
Box 6 British Telecom and AT&T – trading on expertise and regulatory change

In April 1999, British Telecom (BT) and AT&T acquired a 30% stake in Japan Telecom, the country’s second-largest fixed network telecoms operator. British Telecom will also take a stake in Japan Telecom’s mobile phone consortium which is applying for a licence in Japan next year. The joint investment builds on BT’s own presence in Japan, first established in 1985. Analysts have argued that success in penetrating the massive Japanese telecoms market will be helped by joining forces with a Japanese ‘insider’. The two foreign companies are planning to use their new venture to develop data, mobile and internet businesses, areas where they have a technological edge and where domestic companies have traditionally been weak. The renewed interest in acquiring stakes or forming alliances with Japanese telecoms operators has in part been prompted by the growing liberalisation of the telecommunications sector which is making these kinds of arrangements easier. Cable & Wireless is currently attempting to win control of another Japanese operator, IDC, a move that would have been prohibited not long ago.

requirements, and difficulty in securing human resources as key problems (see Box 7). Although labour market slack is making it easier to recruit, the change on the ground appears to be gradual. The activities of recruiting and head-hunting firms are still tightly controlled by government legislation, with limits to the range of professions that may be handled by employment agencies and restrictions on the working arrangements of employees hired through this channel. These restrictions have continued to make it difficult to find staff.

Many sectors (agriculture, transport, mining, energy and construction) remain heavily regulated and even in those like retail and communications where progress has been made, there is scope for substantial further liberalisation and streamlining of administrative procedures. Since many of the high-cost, low-productivity sectors provide services that are used as inputs in other sectors, they tend to raise the cost of doing business in Japan. Although in 1991 the Foreign Exchange and Foreign Trade Control Law was amended to restrict the need for prior notification of FDI projects to a limited group of industries, case-by-case approval is still required in a significant list of sectors including agriculture, forestry, petroleum, mining, utilities, telecoms and air transport.

Nor is it always clear how much regulatory changes will improve the ability to operate in particular sectors. The replacement of the Large Scale Retail Store Law in 2000 looks like
Box 7  Reported problems of doing business in Japan

The Japanese External Trade Relations Organisation (JETRO) conducts regular surveys on the operation of foreign affiliates and subsidiaries in Japan. These surveys have consistently identified a number of problems faced by foreign companies. In 1997, around 75% of surveyed companies identified the generally high costs of doing business in Japan as a problem, while over 65% reported that the strict requirements of Japanese consumers presented difficulties. Despite evidence of increasing fluidity in the labour market, around 60% of firms also agreed that difficulties in finding qualified staff was an obstacle to doing business (Figure 13). By contrast, inadequate incentives to invest and difficulty in procuring materials were not generally viewed as serious obstacles.

Figure 13  Problems involved in operations in Japan

There is patchy evidence from these surveys of improvements in the operating environment in some areas in recent years. Fewer companies identified market closure or high business costs as problems in 1997 than in 1995 and the number of firms complaining about regulations and inspections fell sharply from over 50% to not much more than 30%. But in many areas, the surveys still register a high level of difficulty in certain aspects of conducting business as a foreign firm in Japan, indicating that there is much that can still be done to make FDI in Japan a more attractive proposition.

In our own conversations with them, the dominant perception among Australian firms operating or advising in Japan is that progress towards removing remaining impediments continues to be slow and that resistance to foreign involvement remains strong, particularly in traditional manufacturing sectors. Several firms complained that the kind of accurate, timely information needed to assess opportunities was often hard to come by. While some of these perceptions may be based on past experience, they suggest that it may take some time to convince Australian companies that the prospects for entry into the Japanese market have improved and for increased activity to take off.
progress, but the sector will still be quite tightly regulated and retailers continue to expect
difficulties under the new law that will take its place. Since that law gives considerable
discretion to local authorities to administer the new arrangements, there is substantial
uncertainty about how it will operate in practice.

More generally, potential investors still complain of a lack of information or familiarity
about opportunities, commercial practices and customer requirements. Partly for this reason,
joint ventures rather than complete acquisitions have been common. Non-transparent and
non-uniform accounting standards continue to make it difficult for purchasing companies to
assess M&A opportunities. The move to consolidated accounting from 1 April 1999 should ease
these problems but Japan’s accounting and disclosure standards still differ from those in other
developed countries in a number of respects.

The political problems of vigorously implementing further reforms remain serious. The
delay between approval of measures and implementation is often three or four years. But
against the backdrop of the recession, reform does now have some independent momentum. As
the high costs of the current economic structure are recognised, particularly in the financial
system, the need for further deregulation is increasingly acknowledged.

The foreign investment climate has changed dramatically over the last five years. The
combination of restructuring and reform has increased the ability of foreign firms to acquire
assets in Japan, to recruit staff and to access Japanese distribution and wholesaling systems.
With the easing of regulations in several key sectors and the falls in the corporate tax rate,
these changes have substantially improved the prospects for profitable foreign direct invest-
ment in Japan. With land and asset prices still relatively low, there are good reasons for
Australian firms to examine the opportunities available now, despite the generally poor
macroeconomic news.

The trend towards greater fluidity in capital markets, supply networks and in labour
markets is likely to continue over the next five years, as restructuring intensifies. In that sense,
the climate for foreign investors can be expected to improve further, regardless of the Japanese
government’s policy decisions. The fate of further regulatory reform is less certain. On paper,
the prospects look good. The government has asked MITI to review all permitting and licensing
regulations by March 2001 and the 1998 Deregulation Action Plan has charged the Fair Trade
Commission with assessing all areas of the economy where entry is restricted. A new Retail
Law is expected by June 2000. And financial sector deregulation continues, with a high
probability that ‘defined contribution’ pension plans will soon be allowed.

On the other hand, the political process is still to prove that it can consistently deliver
decisive change. It is one thing to set out ambitious plans and quite another to implement them.
Even when Japan’s leaders have clear ideas and a firm resolve to reform, they face extraordinary obstacles in imposing their will on a fractured party system and deeply entrenched sectional and bureaucratic interests. With an LDP leadership contest scheduled for September 1999 and the next general election scheduled for October 2000, there is little time for dramatic action. In this climate, it seems likely the political focus will remain firmly on the short term and scope for extensive reform may be limited. But there is a glimmer of hope that the new mood among the public and the more potent threat of electoral retribution is beginning to create an environment where inaction is dangerous.

What is undeniable is that there has been a permanent shift in the environment facing foreign investors in Japan and in attitudes towards them. Greater foreign involvement in the Japanese economy is now treated as inevitable reality and the important role it has to play in Japan’s restructuring is widely accepted, if not welcomed everywhere.

As the environment changes, new opportunities are surfacing in a number of sectors. The next section looks at what recent developments could mean for Australian firms and examines some of the stories of successful foreign businesses in Japan.

**Opportunities for Australian investors in Japan**

As a result of the changing environment, new opportunities are opening up for foreign investors in Japan. This section highlights these opportunities and the experience of some companies that have successfully established a presence in the Japanese market. At a time of rapid change, Australian companies may want to act now to make themselves aware of the opportunities and threats to their business arising from current developments in Japan.

**A time for reassessment**

The last five years have been a time of unprecedented change in the Japanese economy. The previous section illustrated how Japan’s extended recession, associated deregulation measures and industry restructuring are changing traditional business relationships in Japan, creating a trend towards more open labour and capital markets and easier access to distribution that will continue over the next five years.

Much of the day-to-day coverage of events in Japan has focused on macroeconomic weaknesses and the problems in the financial sector. It is important that negative perceptions
of Japan’s macroeconomic climate do not lead investors to overlook the important positive developments at the microeconomic level. Despite the recession, the foreign investment climate is improving.

With land and asset prices low (see Figure 14), regulatory change opening previously closed industries to foreign competition, a more favourable tax environment and a break-up of traditional business relationships, it is a good time for Australian investors to reassess the opportunities for investing in Japan. Past views of the opportunities and obstacles of operating in the Japanese market are less and less relevant in a rapidly changing investment environment. A reassessment is needed to identify new opportunities in a timely fashion.

Investors from around the world are already reassessing their options in Japan. The costs to Australian firms of failing to do the same are not simply lost opportunities. In some cases, new foreign investment from other sources may worsen the competitive environment for existing Australian suppliers. For instance, if rival firms seize new opportunities to establish warehousing and distribution operations in Japan, Australian firms may find that competing suppliers gain a competitive advantage. Some large US companies such as Cargills, one of the world’s largest and most experienced grain traders, have bought into failing Japanese trading houses. These houses are the traditional means by which Australian commodity exporters enter the Japanese market. Foreign ownership could lead to these companies sourcing from suppliers with whom they have historic ties rather than from Australian exporters. The lack of a meaningful market presence can also be a threat. The New Zealand food industry, which competes with the Australian food industry in much of the Japanese market, has an increasingly substantial presence in the Japanese market in terms of personnel and investments. With the Japanese distribution system now easier to break into, it is likely that foreign suppliers will be more willing to invest in their own distribution network in Japan as they do in many other countries, with implications for competing Australian suppliers.

It is also important to be aware of progress in deregulation. For example, deregulation is occurring in the Japanese construction sector where costs have been much higher than those in countries such as the US and Australia. However, if new standards are established that more closely meet US industry practices, then Australian construction-related businesses could be disadvantaged.
Identifying opportunities

There is a great variety in the opportunities that are arising. Successful investors have spanned a number of sectors. Some have used acquisitions as the route for investment, others have gone down the path of joint venture or greenfield operations.

Different investors have had different motivations. In some cases, firms have sought to exploit their technological edge or superior expertise (see Box 8), while in others they have sought to enhance market presence to aid distribution. The new opportunities in some instances opened up as a result of bankruptcies, in others through local firms seeking alliances or capital injections and in others they were the product of regulatory changes that allowed foreign firms to operate for the first time.

Opportunities are not confined to large firms. Although most of the high-profile cases of foreign involvement in Japan have involved large transactions, smallness is no disadvantage in many new sectors such as services (see Box 9). Moreover, such investments offer a rapid means for small companies to grow and small-scale investments often evolve. Firms that start by setting up an office overseas to be closer to customers and to know their requirements, may move on to a joint venture or to an even more substantial investment.
Because of the wide range of experiences it is not possible to take a cookie-cutter approach to investing in Japan. The nature of foreign investment will vary according to the project. In some areas, where local knowledge of the markets, culture and practices is particularly important, joint venture will be attractive. In others, outright acquisition may be preferable. For some sectors, the geography of investment will be important. For instance, opportunities in food processing or distribution may be best located outside of Tokyo or other major economic centres where the costs of land are cheaper but the advantages of being close to these large consumer markets still apply.

Although it would be useful to get a sense of the areas in which Australian firms are likely to have particular advantages, in practice it is difficult to do so in a meaningful way. Current exporters need not necessarily make future investors. For example, if raw material suppliers invested upstream, they could end up competing with many of their current customers. On the other hand, they could invest in more neutral upstream areas, such as warehousing and distribution, and gain more control over the promotion and delivery of their products.

Given the difficulties of establishing general rules, the best approach is for individual firms to make themselves aware of the changing environment in their sector. The most useful forms of assistance will involve helping them in this task.

What can be said is that many of the areas, such as distribution, processed foods, finance, telecommunications and computer software applications, that are changing most rapidly and where new foreign investment is increasing most dramatically are areas where there are highly successful Australian performers. In these sectors, where openings are greater than elsewhere and where other foreign players are acting, it is particularly important that Australian firms reassess the current opportunities for them in Japan and the competitive threats from rival firms who are prepared to invest in the Japanese market.

The recent changes in the foreign investment climate appear to have been starkest in non-manufacturing industries, particularly in the financial sector, retail and services. In general, these are sectors where Australian companies are relatively efficient and used to operating in a relatively lightly regulated, consumer-orientated environment. In many of these areas, local Japanese firms have had a history of weak productivity, sheltered markets and low innovation. In some sectors, like the pension fund industry and some parts of the telecoms market, Japanese operators have had little experience of providing newly permitted services at all. In these markets, Australian firms may find that they have much to offer in terms of expertise, new technologies and approaches.
Box 8  The fast-food revolution – flexible investment through franchising

In the late 1960s, the designation of food services as an industry that could be fully liberalised stimulated a large inflow of foreign capital into the sector mainly from the US. This capital brought with it innovative management and the American concept of the franchised, self-service, fast-food restaurant. At the time, most restaurants in Japan were small operations, often family-run and of highly variable quality. The arrival of US operators prompted a modernisation of the traditional Japanese food service industry. Success did not involve a duplication of the American system and indeed firms which just adopted American features wholesale, such as large drive-in systems, without appreciation of Japanese tastes often failed. The industry today is not dominated by foreign affiliates, although franchising of foreign chains is now very common. Foreign participation was a catalyst for change in the domestic industry. This industry development is continuing to this day through the entry of relatively new operators such as Starbucks coffee shops. Links with new players in food retailing are important to success in exporting food to Japan, especially processed foodstuffs.

Box 9  Harvey World Travel – A small start is possible

Harvey World Travel, one of Australia’s largest travel service companies but small in the world scene, has started to look at investing in Japan. Its initial venture was in the management of Aurum Hotels and Resorts jointly with a Japanese company, HIS Travel, the second largest travel retailer in Japan. This venture will allow the company to offer more attractive travel packages with the price and availability of the accommodation component more within their control. No shares were exchanged in this venture although financial equity was discussed and future arrangements are expected to evolve into an expanded relationship and a broader range of services such as joint flights. In this way, initially small investment relationships can often evolve as the parties become more familiar with the circumstances and more confident in their degree of involvement.

As investors from Europe and the US increase their involvement in the Japanese economy, Australian firms that operate in the sectors in which other foreign firms are now having increasing success should at the very least be asking the question ‘Why not us?’.

New approaches

For investment opportunities to be realised, suppliers of FDI need to be aware of the available opportunities, to be able to assess their potential to exploit them and to have the relevant
information and assistance to be able to carry out a successful investment strategy. In many cases, lack of information can be a problem, both in terms of overseas companies assessing local opportunities and in terms of market information including key competitors and the regulatory environment.

Lack of suitable information, or an easy route to acquire it, can substantially raise the cost and risks of a new investment. Some companies have set up a small local presence as a means of getting around this kind of problem. Many trading companies, such as Bonlac, invest in an overseas office so they can be closer to all their customers and be aware of their requirements.

Other channels of information, including industry associations and embassy links, have an important role to play in helping firms to get a handle on the latest developments in Japan.

As part of a strategy aimed at improving their ability to assess and undertake investment opportunities in Japan, Australian firms will need to make renewed efforts to make themselves aware of recent regulatory changes in their sectors, to identify remaining impediments and to find out about the direct incentives available to foreign investors in their area of business. They may then consider the possibility of establishing some form of market presence on the ground.

Government bodies will have an important role to play in addressing general and particular obstacles through bilateral negotiation, maintaining awareness of bilateral negotiations with other countries to ensure that Australian interests are not compromised and encouraging further negotiations on FDI in multilateral forums. The establishment of further support networks with government involvement, such as the Australian Wine Bureau, is another route.

The recession and the changes it has induced in the Japanese economy means there is a new environment for investment into Japan. Some of the historic difficulties of investing in Japan no longer apply or are substantially weaker than before.

Potential investors need to think beyond traditional perceptions and consider the opportunities this new environment offers to avoid being left behind. The current circumstances offer a window of opportunity but companies will need to spend time and effort to understand and establish themselves in the Japanese market before undertaking substantial investments there. Firms will need to consider these opportunities now if they are to position themselves ahead of others. With lower asset prices and a rapid expansion of openings in some sectors, this is a good time for firms to apprise themselves of recent developments and to reconsider the potential for foreign direct investment in Japan.
Acknowledgements

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Note

1 FDI is defined as capital inflows with some managerial control. There are two basic forms of FDI: mergers and acquisitions (M&A) of existing investments and greenfield investments, which could incorporate joint ventures as a sub-form. Real estate/land acquisition is another separately identified form of FDI (World Investment Report 1998).

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Nikkei Database, Australia-Japan Research Centre.
Appendix: Figure 1  Total number of Japanese FDI inflows


Appendix: Figure 2  Japanese FDI inflows by region (values)

Appendix: Figure 3  Sectoral Japanese FDI inflows by value and number of cases

- **Value (manufacturing)**
  - Y-axis: Value (JPY100 million)
  - Case counts: 0, 50, 100, 150, 200, 250, 300

- **No. of cases (manufacturing)**
  - Y-axis: Number of cases
  - Value: 0, 500, 1000, 1500, 2000, 2500, 3000

- **Value (food)**
  - Y-axis: Value (JPY100 million)
  - Case counts: 0, 50, 100, 150, 200

- **No. of cases (food)**
  - Y-axis: Number of cases
  - Value: 0, 50, 100, 150, 200

- **Value (textiles)**
  - Y-axis: Value (JPY100 million)
  - Case counts: 0, 2, 4, 6, 8, 10, 12, 14

- **No. of cases (textiles)**
  - Y-axis: Number of cases
  - Value: 0, 50, 100, 150, 200

- **Value (rubber/leather)**
  - Y-axis: Value (JPY100 million)
  - Case counts: 0, 2, 4, 6, 8

- **No. of cases (rubber/leather)**
  - Y-axis: Number of cases
  - Value: 0, 50, 100, 150, 200
Appendix: Figure 4  Sectoral inward FDI, by value per case
Appendix: Figure 5  Japanese inward FDI by region of origin and number of cases

Value (USA)

No. of cases (USA)

Value (Europe)

No. of cases (Europe)

Value (UK)

No. of cases (UK)

Value (Germany)

No. of cases (Germany)
Appendix: Figure 6  Japanese inward FDI by region of origin and value per case
## Appendix: Table 1  Japanese FDI inflows by sector

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### Appendix: Table 2 Japanese FDI inflows by region

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<p>| Proportion of total (%) |
|-------------------------|-----------|-------|---------|-------|-------------|-------|---------|-------|--------------|-------|------------------|-------|------------|-------|------------|-------|------------|-------|------------|-------|------------|-------|------------|-------|------------|-------|------------|-------|
| 91                      | 100.0     | 100.0 | 12.8    | 30.7  | 42.1        | 31.1  | 10.1    | 9.9   | 4.5          | 4.0   | 10.2            | 7.4   | 17.2         | 9.7   | 21.3        | 14.7  | 23.8        | 23.5  |
| 92                      | 100.0     | 100.0 | 28.6    | 32.7  | 31.2        | 33.5  | 4.8     | 6.2   | 7.2          | 3.1   | 4.2             | 5.1   | 14.9         | 21.2  | 15.3        | 8.2   | 24.9        | 23.6  |
| 93                      | 100.0     | 100.0 | 29.6    | 30.2  | 27.4        | 33.3  | 4.5     | 2.2   | 3.7          | 3.6   | 5.1             | 9.2   | 14.1         | 18.4  | 15.0        | 11.2  | 28.0        | 25.3  |
| 94                      | 100.0     | 100.0 | 30.6    | 38.4  | 27.6        | 36.4  | 3.5     | 3.0   | 4.3          | 12.1  | 5.6             | 12.6  | 14.2         | 8.8   | 14.4        | 7.5   | 27.5        | 17.7  |
| 95                      | 100.0     | 100.0 | 36.4    | 47.9  | 25.9        | 34.5  | 5.0     | 3.1   | 4.5          | 4.5   | 4.6             | 14.5  | 11.9         | 12.4  | 12.7        | 6.3   | 24.9        | 11.3  |
| 96                      | 100.0     | 100.0 | 31.5    | 31.0  | 27.1        | 28.6  | 4.5     | 5.3   | 4.6          | 6.2   | 4.8             | 10.4  | 13.2         | 6.7   | 11.6        | 13.0  | 29.8        | 27.4  |
| 97                      | 100.0     | 100.0 | 35.0    | 22.4  | 25.3        | 45.4  | 3.4     | 6.6   | 5.4          | 8.1   | 4.6             | 21.6  | 11.9         | 9.1   | 12.2        | 12.4  | 27.5        | 19.8  |
| 98                      | 100.0     | 100.0 | 40.5    | 60.3  | 26.1        | 22.6  | 3.9     | 2.8   | 6.9          | 2.5   | 5.6             | 9.5   | 9.8          | 7.7   | 14.1        | 12.9  | 19.3        | 4.3   |</p>
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