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JAPANESE FOREIGN DIRECT INVESTMENT

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ABSTRACT

Japan's outflows of foreign direct investment (FDI) have increased dramatically in recent years, to the point where Japan has become the world's largest overseas direct investor. This paper documents the increase in Japanese FDI, as well as its breakdown across industries and countries. Investments in real estate and financial services have grown most rapidly, as has Japanese FDI into North America, which now accounts for fully half of Japan's outflows. The paper then goes on to discuss and evaluate some of the most popular explanations for this explosion in investment: Japanese current account surpluses; actual or anticipated protectionism abroad; appreciated stock prices and value of the yen; and changes in international tax policy.

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1. Introduction

Over the past several years the pace of Japanese direct investment abroad has exploded. The rate at which Japanese investors and corporations are purchasing controlling – as opposed to passive "portfolio" – interests in overseas productive facilities has risen almost twelvefold from March 1980 to March 1989, an increase from 6 to almost 30 percent of total world FDI outflows. Investments in real estate and financial corporations have led the way, both in the U.S. and in the rest of the world.

The reaction to this explosion has been sensational. In the U.S., which is host now for almost half of the Japanese outflow, the discussion carries emotional, and sometimes xenophobic, overtones. There is little agreement about why such large flows have recently emerged and about whether anything should be done to stop them. In Japan, concern about a possible overreaction within the U.S. has led to confusion and uncertainty about the proper response.

In a sense, these difficulties could have been predicted a decade ago: in the past, large FDI inflows have reliably triggered host-country concerns, and Japan, which emerged as an economic power in the 1970s, did not at that time exhibit anything like the level of overseas production typical of other major economies. Based on this alone, today's sensible prediction would then be that Japan should be catching up to others' level of overseas ownership, and once it does so, the FDI imbalances will subside, taking with them any remaining concerns about foreign investment.

Some observers, however, take issue with this view. They hold that the current trends show little sign of transforming Japanese overseas production into something that closely resembles the overseas production of other industrialized countries. They argue that Japanese affiliates behave differently than other foreign-owned

firms, and that Japan's borders remain all but closed to the affiliates of other countries. In addition, they assert that Japan has in many respects already caught up, and is on the verge of a "productive overpresence" abroad. In fact the geographical distribution of Japanese FDI is increasingly highly skewed toward major developed economies, and this alleged overpresence is confined primarily to the U.S. (although Canada, the U.K., and Spain are finding surges in the Japanese presence in their economies. Flows of FDI to all developing countries, and especially to the NICs in Southeast Asia, have fallen in importance in the last several years.

This paper provides a background from which to assess these issues. We try to characterize in some detail the evolution and nature of current Japanese in- and out-flows, and to shed some light on why the outflows might have risen particularly rapidly to developed instead of developing countries. We also try to identify those dimensions along which Japanese FDI looks both plausibly similar to and legitimately different from the FDI of other major industrial countries.

2. Background on foreign direct investment

The name foreign "direct investment" usually brings to mind international flows of capital used for the purchase of new investment goods such as physical capital. Yet FDI actually requires neither capital flows nor investment in capacity. Conceptually, FDI is the extension of corporate *control* across national boundaries. When Japanese-owned Bridgestone takes control over the U.S. firm Firestone, capital need not flow into the U.S. The purchase can be largely financed by U.S. domestic lenders. Any borrowing by Bridgestone from foreign-based third parties also does not qualify as FDI (although it would count as an inflow of portfolio capital into the U.S.). And, of course, in such an acquisition, there is no investment expenditure per se, merely an international transfer in the title of corporate assets.

While the concept of control may seem reasonably clear, its measurement can create ambiguities. In both the U.S. and Japan, a firm is classified as foreign owned if a single foreign entity holds more than a 10 percent share. It is therefore inevitable that some firms will be classified as foreign owned when they are in fact domestically controlled, and vice versa. To take a concrete example, T. Boone Pickens' purchase of over 10 percent of Koito Manufacturing Co. has made him the controlling foreign "parent" from the perspective of the Japanese statistics. In reality, however, Mr. Pickens cannot influence Koito's decision making; indeed, he has been unable to obtain even a seat on the board of directors. The opposite problem in measuring FDI can be seen in the example of a purchase of 100 percent of a Japanese firm by an American limited partnership. This purchase would entitle the partnership to de facto control, yet it would not be recorded in the data as direct investment as long as no single partner owned more than a 10 percent share. For these reasons, the recorded data are subject to errors, and these errors may be either positive or negative.

While one can often point to visible examples of such measurement errors, the examples are – at least in the case of the U.S. – exceptional. On average, foreign parents with operations in the U.S. own an 80.2 percent share of their affiliates. Thus for the majority of these affiliates, foreign ownership is both clear in practice and accurately recorded in the data.

3. Worldwide Trends in FDI

To gain a sense of perspective on Japanese FDI, it is useful to see a comparison with other worldwide FDI flows. Figure 1 graphs FDI outflows from the Balance of Payments (BOP) statistics of a number of countries. These data, which are standard measures of FDI, represent expenditures by parents in acquiring, establishing, or in extending their ownership of existing foreign affiliates. They fail to measure, however, the extent to which foreigners have leveraged their equity ownership through both borrowing and issuance of minority shares. Combined with the fact that the data report book, not market, values, the Balance of Payments measures of FDI may understate degree of control asserted by foreign-owned affiliates.

The figure shows the outflows of the three most important countries in world FDI – Japan, the U.K., and the U.S. – as well as the total for the rest of the world. It is clear that the recent surge in FDI did not begin as simply a Japanese phenomenon.[1] Outflows from the U.S., U.K., and other industrialized countries have also grown rapidly, and, through 1987, the U.K.'s FDI outflow grew nearly as fast as Japan's. Nevertheless, the Japanese presence in world outflows has indisputably risen, growing from 6 percent in the 1970s to 15 percent in the 1980s and to about 30 percent in 1988, the most recent year for which data are available.

The picture for FDI inflows, shown in Figure 2, is considerably different. While

the U.S. and U.K. together play as important a role in inward as in outward FDI, Japan has been and continues to be an insignificant host to inward FDI. The Japanese share of world inflows has not risen appreciably over the past few years. The U.S. share of inward FDI has grown steadily during the postwar period, rising from 15 percent in the 1960s, to 30 percent in the 1970s, and to about 35 percent today. A little manipulation of the numbers in Figures 1 and 2 reveals that total world inflows are considerably less than total outflows, especially over the last few years. The disparity is due to differences in accounting methods across countries and serves as a reminder of how rough these data are.

4. Patterns in Japanese FDI abroad

Until the last several years, the pattern of Japanese FDI abroad seemed built upon a strategy of exporting manufactured products to the industrialized countries. This meant vertical integration of international investments: downstream investments in wholesaling and distributing networks in developed countries such as the U.S., coupled with upstream investments in primary- and intermediate-goods production in developing countries, particularly those in Southeast Asia.

During the 1980s, the Japanese strategy has shifted from vertical integration toward geographical diversification. Specifically, the types of manufacturing activities that used to be reserved for within Japan's borders are increasingly being done abroad in the countries where the goods will ultimately be consumed. In addition, these overseas manufacturing affiliates are increasingly being joined by Japanese service firms in finance, insurance and real estate. Thus, whereas older Japanese direct investments were designed to facilitate trade, the newer wave of manufacturing investments are closer to substitutes for exports from Japan.

These trends can be distilled readily from detailed Balance of Payments data from the Japanese Ministry of Finance, which allow us to break down outflows from Japan in several ways. Figure 3 shows how the breakdown of Japanese FDI across major regions of the world evolved. Most striking is that the relative importance of flows to North America (Canada and the U.S.) has doubled since the mid 1970s, accounting for about $24 billion in 1988 (more than half of the total outflow). Similarly, the European share of FDI has risen from about 12 to 20 percent of the $47 billion outflow in 1988. These increases in the share of FDI to developed countries have come at the expense of developing-country shares. South American, Asian, African, and Near Eastern economies have become substantially less important as recipients of Japanese FDI. Indeed, the growth rate of FDI into Asia has been the

slowest of any region.[2]

Equally revealing is the breakdown by industry, presented in Figure 4. Non-manufacturing products, shown at the top of Figure 4, show a dramatic transformation. There is extremely rapid growth in financial services and real estate. The importance of primary product production, shown here by mining, agriculture, forestry and fisheries, has waned significantly. For manufacturing products, shown in the bottom half of the figure, there is a clear tendency toward greater growth in high technology manufactured products like electrical appliances and away from textiles and food.

To understand better the correspondence between regions and industries, we turn to a more disaggregated look at Japanese FDI into specific regions. Figures 5 and 6 show how flows to Asia, which from 1951 to 1976 was the recipient of the largest share of Japanese outflows, have evolved. Figure 5 displays the country breakdown of these flows. It is clear that investments in Indonesia (which were primarily in mining) and India have grown far more slowly than investments to Hong Kong, Singapore, and Thailand. Indeed, FDI into Hong Kong and Thailand has grown as rapidly as that into the U.S. The current flows to Hong Kong and Singapore are a result of purchases of financial and insurance corporations, whereas those to Thailand are dominated by manufacturing investments in chemicals, electric machinery, and transportation equipment.

Figure 6 breaks down these same flows by industry instead. It shows that mining easily remains the most important form of current direct investment to Asia. Yet the importance of mining and textiles is gradually eroding, being replaced by investments in services, trade, real estate, and finance in nonmanufacturing and by

machinery, electric appliances, and transportation equipment in manufacturing industries. Clearly, the move has been out of primary products and into intermediate manufacturing industries and sophisticated service sectors.

Figures 7 and 8 show the same breakdown for European countries. Figure 7 indicates that investment into the U.K. is growing the fastest within Europe (which in turn is the regional recipient of the fastest growing share of Japanese FDI). Figure 8 shows that the recent pattern in Asia is even more prevalent in Europe: investments in finance, services, and real estate (particularly in the U.K., Luxembourg, and Switzerland) have become very important among non-manufacturing sectors, which together account for about 80 percent of FDI flows to Europe. In manufacturing investments the greatest growth is in electrical appliances and electronics (the U.K. and the Netherlands).

Figures 9a and b show breakdowns of FDI into South America. Figure 9a shows that Brazil and Peru have seen their shares of FDI fall very rapidly. Indeed, there has been little growth in real FDI over the last 15 years into these countries. The only industry in these countries which seems to have received large increases in FDI is finance and insurance, although the absolute magnitudes remain quite small. The figure also shows that investments into Panama have grown explosively; in 1989 alone there was an extraordinary investment in Panamanian real estate of over $1.5 billion, which accounted for 90 percent of the inflows into Panama.

Finally, Figure 10 reports details of the Japanese inflow into the U.S. and Canada. Investments in real estate and financial services have grown explosively, in part at the expense of flows into trade and timber.

This breakdown shows that the overall shift seen in Figure 3 away from investment in raw materials and other primary products and into real estate, financial services, and electrical appliances is essentially worldwide. Nevertheless, there is

important diversity across regions. Real estate and finance purchases in Europe and North America are large and growing especially rapidly. Mining and investment in other primary products remain important in Asia, although inflows into other industries are growing more rapidly.

4.1. Outflows to the U.S.

Outflows to the U.S. are at once the most conspicuous and most misunderstood of all Japanese FDI. Recent purchases of landmark corporate assets such as Columbia Pictures and Rockefeller Center have created tension on both sides of the Pacific. Yet such acquisitions are unusual for the Japanese, whose investment in FDI in the U.S. has traditionally been skewed toward new construction of production and distribution facilities for manufactured products. Indeed, until very recently the Japanese have been notably absent in the hostile takeover game, now frequently played by other foreign investors.

Nevertheless, there is no disputing that the Japanese presence in the U.S. has grown. While FDI inflows from most industrialized countries have risen rapidly and are currently at all-time highs, the increase from Japan has been even more rapid. As can be seen in Figure 11, U.S. inflows from Japan have quadrupled over the last 3 years, to almost $22 billion in 1988.

Recent flows themselves, however, overstate the Japanese role in U.S. FDI, since Japan has historically been a small investor in the U.S. in comparison with Canada, the Netherlands, and the U.K. Table 1 therefore shows a variety of measures of the share of foreign affiliates controlled by Japan. The first column is the most standard measure, which is the Japanese share of the stock of FDI. It shows that the Japanese presence among all foreign investors has roughly doubled since 1983. Early estimates are that the stock of Japanese FDI will increase by another 40 percent in 1989, to a total of $75 billion, or about 20 percent of the $380 billion

owned by foreigners.

It is worth noting that other measures of the Japanese share in FDI have grown at different rates, and that the disparities in growth rates are actually instructive about the changing nature of Japanese investment within the U.S. For example, the second column in Table 1 shows the Japanese share of foreign-owned assets. This share has risen more rapidly than that of the FDI stock, due in particular to the 1987 purchases of several highly-leveraged financial institutions. Consequently, this measure probably overstates the increase in Japanese FDI, since the *net* value of the assets of such firms is quite low.

Columns 3, 5, and 7 show Japanese shares in assets, employment, and value added in the manufacturing sector. In contrast to column 2, these series show slower rates of increase than the FDI stock in the first column. The explanation for this is as follows. Japanese FDI in the U.S. has historically concentrated on wholesaling investments which facilitate the distribution of manufactured exports from Japan. In the late 1970s, the U.S. data suggest that roughly 40 percent of the stock of Japanese FDI in the U.S. was in wholesale trade, and that this share was growing steadily. However, since 1985 inflows have clearly begun to move away from trade toward manufacturing. Figure 12 shows the composition of Japanese inflows into the U.S. for the three periods in the figures above. Trade fell dramatically as a share of non-manufacturing inflows, being replaced by equally dramatic growth in real estate and finance shares.[3]

Thus, while the numbers in columns 3, 5, and 7 of Table 1 may partly reflect the Japanese emphasis on wholesale investments, the reporting lag suggests that recent increases in the share of Japanese manufacturing FDI will soon become apparent.

Some of the increase reported in the Japanese data, however, may never appear in the U.S. numbers, since the U.S. Department of Commerce continues to classify many of the foreign affiliates now undertaking manufacturing investment under the industry of their original investments in wholesaling and trade.

The auto industry illustrates this evolution from trade to manufacture. Throughout the 1970s, FDI in this sector was principally directed toward distribution networks for exports from Japan. By 1983 the FDI stock in motor vehicles and parts wholesaling affiliates accounted for about 15 percent of the total Japanese FDI stock in the U.S. This investment of $1.7 billion handled imports of $15.8 billion annually, three quarters of which were exported by Japanese parents.[4] With the introduction of VERs, the investment strategy shifted abruptly toward manufacturing production. In 1982, Honda's American affiliate produced its first car within the U.S. Soon afterward Nissan, Toyota, Mazda, Mitsubishi, Toyota, Fuji & Isuzu followed, setting up joint ventures with U.S. automakers as well as independent facilities to produce along with Honda 1.8 million units per year by 1992, more than 10 percent of the U.S. domestic automobile market. Most of these ventures attracted generous incentive packages from unions and local, state, and federal governments. In addition to the auto producers themselves, over 200 Japanese auto-parts suppliers have invested in operations in the U.S. These upstream investments serve the dual purpose of continuing long-standing customer relations established in Japan at the same time as they make it easier for Japanese auto producers to meet U.S. domestic content requirements.

A similar story can be told for investment in electrical machinery and steel products. Because it is so aggregated, Figure 12 does not indicate all areas of rapid growth in manufacturing. Investment in certain types of food processing,

for example, rose markedly in 1986 and 1987, including acquisitions of Colonial Beef and Consolidated Grain and Barge and new plants for grapefruit and tomato processing by Kagome and Glico Dairy.[5] In the 1960s and early 70s, Japanese manufacturing investments in the U.S. were concentrated in wood products, iron and steel, and electrical machinery. Today, it is clear that there is much greater diversity in manufacturing FDI.

Perhaps the greatest growth, though, has been in the real estate sector, also shown in Figure 12. This sector accounted for 5 percent of inflows between 1951 and 1976 but for 26 percent of inflows in 1988. In the last few years, inflows have been so large that in early 1988 Japan replaced the U.K. as the largest single real estate investor in the U.S., with an FDI stock of over $10 billion and assets valued at $35 billion.[6] Nevertheless, foreigners in general and Japanese investors in particular remain underrepresented in their holdings of real estate in comparison with investments in other sectors, accounting for only about a 1 percent share of U.S. real estate.

The changes in the types of investments made by the Japanese have been accompanied by changes in the nature and means of FDI. During the 1960s and early 1970s the typical FDI transaction in the U.S. was a "greenfield" investment in a manufacturing industry, such as chemicals, petroleum products, or stone, clay and glass production. Today, the majority of FDI transactions are accomplished by mergers and acquisitions. A typical recent transaction looks more like Campeau's purchase of Federated Department Stores or British Petroleum's acquisition of Purina Mills than like Volkswagen's 1976 "brownfield" rehabilitation of a mothballed

Chrysler Plant in New Stanton, Pennsylvania. Such acquisitions often have little effect on the products sold by the U.S affiliate, and do not importantly change aggregate output, employment, etc. It would be more accurate to describe them as simple transfers of title to existing assets, than as investment per se.[7]

Surprisingly, the Japanese have lagged behind in these developments more than any other major investor. From 1979 to 1986 the fraction of Japanese FDI inflows spent on mergers and acquisitions was only 23 percent in comparison with somewhat over 50 percent by all other countries. By contrast, 48 percent of Japanese FDI went into new plant and plant expansion in comparison with about 30 percent for all other countries. All indications are, however, that the Japanese are now also learning to play the M&A game. Acquisitions since 1986 have become considerably more frequent. In 1987, for example, the fraction of Japanese FDI spent on M&A rose to 31 percent, while the fraction on new plant and plant expansion fell to 25 percent. In addition, the purchase of a large equity share of the M&A firm Wasserstein-Perella by Nomura Securities might indicate an interest in channeling more Japanese investment resources into this kind of FDI.

5. Patterns in Japanese FDI inflows

After the Second World War Japan's role in world FDI was, like industrialized countries other than the U.S., primarily as a host. As recently as 15 years ago, the U.S. FDI stock in Japan stood at $3.3 billion, 10 times more than the reciprocal Japanese FDI stock in the U.S. At that time, only Canada and Switzerland were recipients of greater U.S. FDI outflows and the U.S. was the single most important investor in Japan.[8] Just under 90 percent of U.S. investments were concentrated in

two sectors: manufacturing and petroleum products.

Until Japan emerged as an economic power in the early 1970s, the government retained a variety of restrictions limiting foreign purchases of Japanese companies. As a result many of the largest U.S. FDI commitments in Japan were in the form of joint ventures, particularly in "high-tech" industries like autos and electronics. Investing firms were not permitted to establish wholly-owned subsidiaries, and had little choice but to solicit joint ventures with Japanese firms. Thus, for example, in the automotive sector several Japanese firms (Mitsubishi, Isuzu, and Mazda) developed joint ventures with the then-dominant companies in the industry (Chrysler, GM, and Ford, respectively). Prior to the 1973 liberalization of controls on FDI, only IBM and Texas Instruments operated wholly-owned subsidiaries within Japan.[9]

Surprisingly, the removal of explicit controls on foreign equity ownership did little to increase the growth of FDI inflows. From 1974 to 1984 the U.S. stock in Japan grew at a slower annual growth rate than in the previous two decades, rising from $3.3 to $8.4 billion. Meanwhile, the stock of Japanese FDI in the U.S. increased forty-fold to $14.8 billion. Much like with imports into Japan in the 1980s, the absence of restrictions did not necessarily make for greater U.S. affiliate production within Japan.

6. Causes of Japanese FDI

Most discussions of Japanese FDI are long on anecdote and short on analysis. Usually, the reasons for the recent growth in FDI are mentioned only in passing. Because they are not subjected to much scrutiny, some of the most frequently mentioned "causes" are erroneous, and those that are correct are right for reasons that may seem surprising.

6.1. The current account

Perhaps the most widely mentioned cause of the surge in Japanese FDI outflows is Japan's large current account surplus. If the Japanese are to be net exporters of goods and services, the argument goes, then they should be expected to export funds for FDI as well.

The problems with this argument are two. First, while it is true that the Japanese current account and FDI surpluses are both large today, they moved at different rates and emerged at different times. Figure 13 makes it clear that the current account and FDI have hardly moved in lockstep. Indeed, the increase in the rate of growth of these two surpluses in 1985 is predominantly a result of the change in the value of the yen. Since the yen appreciation has slowed, the current account surplus has begun to narrow, yet FDI continues to rise as dramatically as ever.

The second problem with the FDI-current-account argument is the implication that current accounts are unrelated to flows of portfolio capital. Historically, current account fluctuations in most countries have on average been financed by portfolio flows, not by direct investment. The easiest way to see this is to note that fluctuations in current account and FDI balances have been uncorrelated. Episodes of large current account changes do not bring with them similar changes in FDI. For example, the deficits run by France in the early 1980s were associated with an *increase* in French FDI outflows; similarly, today's U.K. is running a large current account deficit coupled with unprecedented large outflows of FDI. There is thus little evidence supportive of the view that current account imbalances tend to be financed through FDI.

In the case of Japan, it is tempting to argue that purchases of assets followed a stepwise progression: first portfolio acquisitions, and only afterward FDI. But

what was it that spurred such *gross* portfolio acquisitions in the first place? Once possibility is the current account surplus (a measure of *net* purchases), but a better guess would be the gradual lifting of Japanese restrictions on holdings of foreign assets. If these restrictions had been removed a decade earlier, one might expect that stepwise diversification into FDI would have taken place long before the emergence of recent Japanese current account surpluses. If so, then it is not the current account, but the liberalization of Japanese capital markets that is responsible for recent surge in FDI.

Note that this argument provides some insight into the future of Japanese FDI. If the current account and FDI balances do not move together, then even a rapid shrinkage of the Japanese current account surplus does not portend a corresponding fall in FDI. Thus, the usual reasons for arguing that large current account imbalances are temporary cannot be applied to imbalances in FDI. The Japanese wave of FDI outflows could persist, and could even grow over the medium run.

6.2. The exchange rate

One frequently hears that yen appreciation makes foreign assets appear cheap to Japanese companies. For example, stories abound that Japanese investors are prepared to bid the highest prices for prime properties in Manhattan because Japanese real estate prices in dollar terms are even higher. This simple argument makes little sense however: Manhattan buildings should sell for the present value of the after-tax rents they are expected to generate. Even if Japanese real estate is overpriced, so that buyers cannot hope to break even, that is no reason to *overpay* for office space in Manhattan.

A slightly more subtle argument can be made, however, to revive the "cheap currency" argument. When the yen appreciates, Japanese investors may find that they can more easily collateralize assets to finance new investments. Suppose for

example that a Japanese investor with 1 billion yen in cash wishes to bid for an American office building. The building will produce an expected $100 million of rental (plus ultimate resale) revenues. If the investor must make a 10 percent downpayment and needs to borrow the rest, then with the yen at 200 to the dollar, he can afford to pay 10×(1 billion/200) = $50 million. If the yen appreciates to 100 per dollar, however, he can afford to up his bid to the full $100 million expected value of the building. Notice that an American with, say, $7 million in cash, can bid a maximum of $70 million regardless of the exchange rate. Thus, with the yen at 200 the American can outbid the Japanese investor, but at 100 the Japanese investor wins. Yen appreciation can therefore itself enable the Japanese investor to pay higher prices than liquidity-constrained American bidders.[10]

While currency changes work nicely in this example, all that really matters is that the Japanese investor experiences an increase in the dollar value of his liquid assets. Thus, *anything* that increases the Japanese investor's relative ability to make downpayments will help him outbid U.S. competitors. So, for example, an appreciation of Japanese stocks or other assets than can be easily collateralized would do the same thing as yen appreciation. Of course, the stock-price boom in Japan is roughly contemporaneous with the appreciation of the yen, so that both factors may be working together to give Japanese investors an edge in financing their overseas acquisitions.

Before moving on, notice that this type of liquidity-based argument has important implications for the widely-debated question of whether the Japanese enjoy a cost-of-capital advantage over Americans. A vast literature has attempted to measure costs of capital. While the findings differ from study to study, the emerging consensus is that *today's* cost of debt financing to a Japanese firm is essentially the

same as to a comparable American firm. The above example, however, suggests that observed borrowing rates may not be a good measure of the effective marginal costs of financing. Access to additional financing may be more important to the debate than the measured cost of borrowing.

6.3. Trade barriers

Circumventing existing or prospective trade barriers is a classical explanation for FDI. If a firm's sales via exports are impeded by protection, then domestic production would seem to be the solution.

This kind of explanation is sensible, however, only for certain types of products. If foreign and domestic firms produce identical goods, protection which raises the domestic price makes investment by domestic as well as foreign firms more profitable. In such a case, protection could easily result in domestic firms snatching up all the additional investment opportunities. However, when foreign and domestic firms produce *differentiated* goods, barriers on imports of the foreign good raise the foreign firm's marginal return on investment above that of the domestic firm. In that case we would not only expect foreign firms to undertake new investments, we would also expect them to acquire some of the domestic industry's existing capacity, as foreigners would be willing to pay a price for productive facilities that exceeds domestic firms' valuation.

This kind of explanation is especially appealing for Japanese inflows into the U.S., which are predominantly complex and differentiated manufacturing products. It would, for example, fit well with changes in the pattern of Japanese investments in the auto industry, toward production and away from distribution, as trade frictions have climbed. In addition, the fact that Japanese investment is skewed toward new plant and equipment rather than acquisitions supports the view that protection is an important determinant of FDI. The reasoning is that foreign and domestic

differentiated products cannot be produced using identical plant and equipment. If the differentiation of goods is important, then even if a foreign firm purchases an existing U.S. factory (rather than build the factory from scratch), it would need to spend resources on redesign and retooling. For these reasons we would expect Japanese FDI inflows to respond to existing and prospective protection, more so than inflows from other countries.

6.4. Taxes

It has been suggested that corporate taxes in the U.S. in the 1980s have affected the incentive for Japanese FDI into the U.S. Specifically, the changes made in the 1981 tax reform, particularly the introduction of more favorable depreciation schedules, reduced foreign firms incentives to acquire U.S. corporations, and that the tax law changes of 1984 and 1986 which rolled back these more favorable depreciation schedules, enhanced foreigners incentives to acquire U.S.-based facilities.[11]

Figure 11 suggests that there is some evidence for this hypothesis in Japanese inflows into the U.S., although the only noticeable effect comes from the 1986 reform. Even since 1986, however, Japanese outflows to the U.K. have grown faster than outflows to the U.S., as have outflows to the rest of Europe. Thus, while changes in the U.S. tax law may be helpful in explaining inflows into the U.S., they may have trouble explaining the overall surge in Japanese FDI.[12]

7. Implications

The two most frequently-heard complaints about Japanese FDI are: first, that Japanese overseas affiliates do not behave like other local firms in the industry; and second, that Japan is not itself as open as it expects its trading partners to be.

Critics offer several points concerning the behavior of Japanese overseas affiliates. Perhaps most commonly mentioned is that Japanese affiliates in developed countries are not run like other domestic companies, with domestic decision makers and senior executives. Sanger (1989) quotes an official Japanese study that found that 85 percent of Japanese affiliates operating in the U.S. were run by a Japanese chief executive, whereas 20 percent of U.S. affiliates in Japan were run by Americans. A second criticism is that Japanese manufacturing affiliates tend to avoid using domestic suppliers, importing roughly three times as much per worker as other foreign manufacturing affiliates in the U.S.[13] Evidence on Japanese affiliates in Australia suggests that they purchase their capital goods almost exclusively from Japan, whereas other foreign affiliates in Australia purchase from nations other than their home.[14]

Both of these points may reflect a nationality bias in Japanese behavior, or they may simply be a result of the relative youthfulness of Japanese foreign affiliates. Clearly, the average Japanese affiliate has been in operation in the for a shorter time than the average affiliate in Japan. And so far there is little evidence which suggests that the Japanese tendency to purchase from home-country suppliers and to employ home-country executives is anything but a standard part of the ordinary overseas affiliate's life cycle. Nevertheless, the strong bias in purchases and the tendency for downstream manufacturing affiliates to bring their upstream suppliers with them when locating abroad has made it difficult to dispel the notion that Japanese firms do not buy and sell on the basis of price and quality alone.

The second complaint – the treatment of foreign affiliates in Japan – raises similar questions. The lack of investment in Japan may reflect insufficient foreign

business diligence, or it may reflect invisible barriers, sociological as well as regulatory, to entering Japan and building a profitable business. Prior to the liberalization of the mid 1970s, the government used explicit restrictions to control the behavior of foreign affiliates, requiring joint ventures, licencing of proprietary technology, and use of Japanese suppliers. Those restrictions may have been appropriate for the Japan of the 1950s and 1960s, where all the opportunities for technology transfer were inward. Today, of course, the opportunities are both inward and outward, and the explicit restrictions on FDI inflows are gone. Yet the pattern of FDI inflows they established remains.

In a certain sense Japan is just beginning to experiment with openness. In spite of large current FDI outflows, Japanese overseas affiliates actually produce relatively little in comparison with the affiliates of other industrialized nations. Overseas production accounts for just 5 percent of total Japanese output, compared with 15 to 20 percent for the U.S. and some European countries. Although this fraction has grown rapidly over the last decade, the fraction of output produced by foreign firms within Japan has fallen. While the share of foreign-owned firms in U.S. sales grew from 5 to 10 percent between 1977 and 1986 and was at even higher levels in Europe, that share in Japan fell from 2 to 1 percent over the same period. By these measures, Japanese economic openness is both very new and very skewed toward the territory of others.

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Endnotes

1. In 1980, Japan changed the required threshold for international investments to qualify as direct instead of portfolio from 25 to 10 percent. The U.K. continues to use a minimum 20 percent ownership threshold for classifying foreign investments as direct.

2. These data are for Japanese fiscal years. Thus, for example, the data marked 1988 cover the period from April 1, 1988 to March 31, 1989.

3. These data are from the Japanese Ministry of Finance. Comparable data from the U.S. Department of Commerce show a similar pattern over time, but consistently exhibit a higher fraction of investment in wholesaling. The disparities are presumably due to the fact that the U.S. applies a largest-source-of-revenue criterion to determine the industry in which a given foreign affiliate is recorded, while Japanese allow individual affiliates to choose their industry independently each year.

4. Encarnation (1986), page 126. Total Japanese exports to the U.S. in 1983 were $43 billion.

5. The timing of these investments coincides closely with steps taken by the Japanese to liberalize imports of certain foods. Exports of food products from the U.S. to Japan have already grown rapidly over the last

6. At the end of 1988, the U.S. Department of Commerce reports that FDI real estate stocks owned by the U.K. and Canada totaled $5.3 and $4.2 billion, respectively. Since these investments are recorded at book value and since they were on average made earlier than Japanese investments, these numbers probably understate the holdings of the U.K. and Canada relative to those of Japan.

7. One piece of evidence for the view that M&A is the fastest growing type of FDI transaction is that while FDI into the U.S. has been growing dramatically throughout the 1980s, investment expenditures on new plant and equipment by foreign affiliates has remained roughly constant.

8. Encarnation (1986), Tables 4-1 and 4-2.

9. In return for the right to operate a wholly-owned subsidiary, Texas Instruments had to agree to undertake a separate joint venture with Sony and to make its proprietary technology available to Japan for a licensing fee of 3.5 percent (see Encarnation, 1986, page 124).

10. For more on this argument see Froot and Stein (1989).

11. See Scholes and Wolfson (1989) for a complete elaboration of this argument.

12. For empirical evidence on the effect of U.S. taxes on U.S. FDI, see Slemrod (1989).

13. See Graham and Krugam (1989).

14. See Kreinin (1989) for evidence.

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Figure 13 Japanese External Balances

Table 1
Alternative Measures of Japanese Share
In U.S. FDI

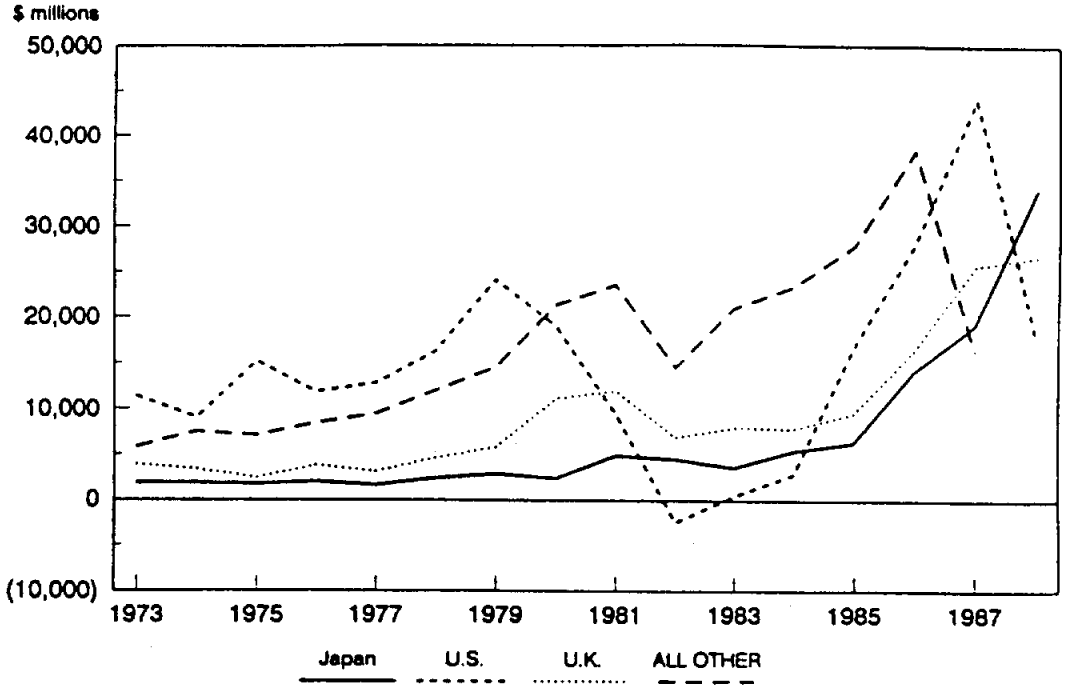
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1977	5	11.8	4.8	6.3	3.1	7.1	3.4
1978	6.5	12.2	4.8	6.3	3.4	6.7	3.7
1979	6.4	10.6	5	6	3.6	6.9	3.7
1980	5.1	9.5	4.7	5.7	3.3	7	3.4
1981	6.4	8	4	5.7	3.7	6.6	3.5
1982	7.8	7.5	4.2	5.7	3.6	7	3
1983	8.3	7.3	4.5	6.4	4	7.4	3.7
1984	9	8.6	5.8	7	4.7	9.1	4.6
1985	10.5	8.7	6.1	7.4	5.1	10.1	5
1986	12.2	11.7	5.8	7.5	5	9.7	4.9
1987	12.9	21.1	NA	9	5.4	NA	NA
1988	16.2	NA	NA	NA	NA	NA	NA

Column (1): Share in FDI Stock
Column (2): Share in Total Assets
Column (3): Share in Manufacturing Assets
Column (4): Share in Total Employment
Column (5): Share in Manufacturing Employment
Column (6): Share in Total Value Added
Column (7): Share in Manufacturing Value Added

Source: Graham and Krugman (1989).

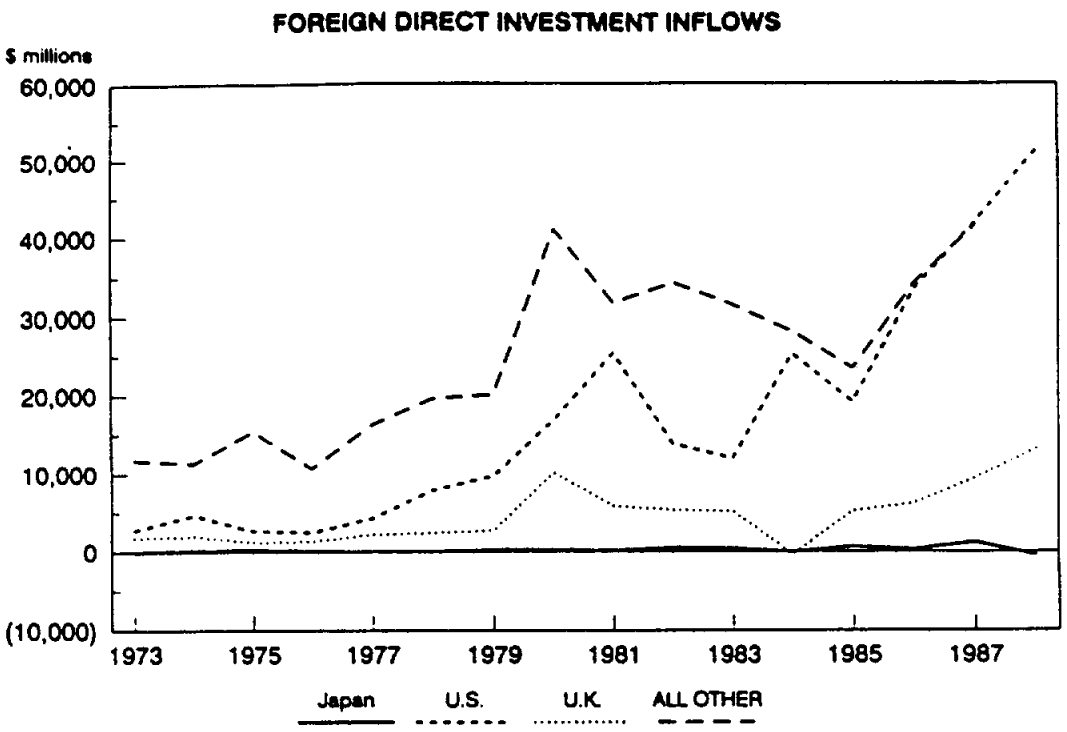
Figure 1

FOREIGN DIRECT INVESTMENT OUTFLOWS



SOURCE: IMF,Survey of Current Business,
Bank of England, Bank of Japan

Figure 2



SOURCE: IMF,Survey of Current Business,
Bank of England, Bank of Japan

Figure 3

JAPANESE FDI BY REGION

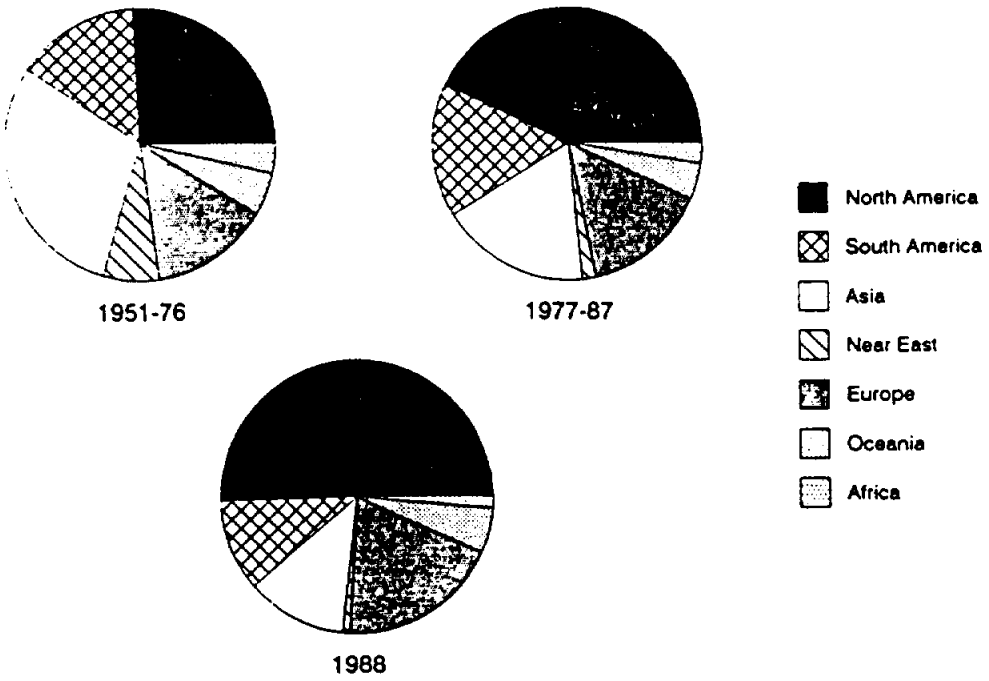


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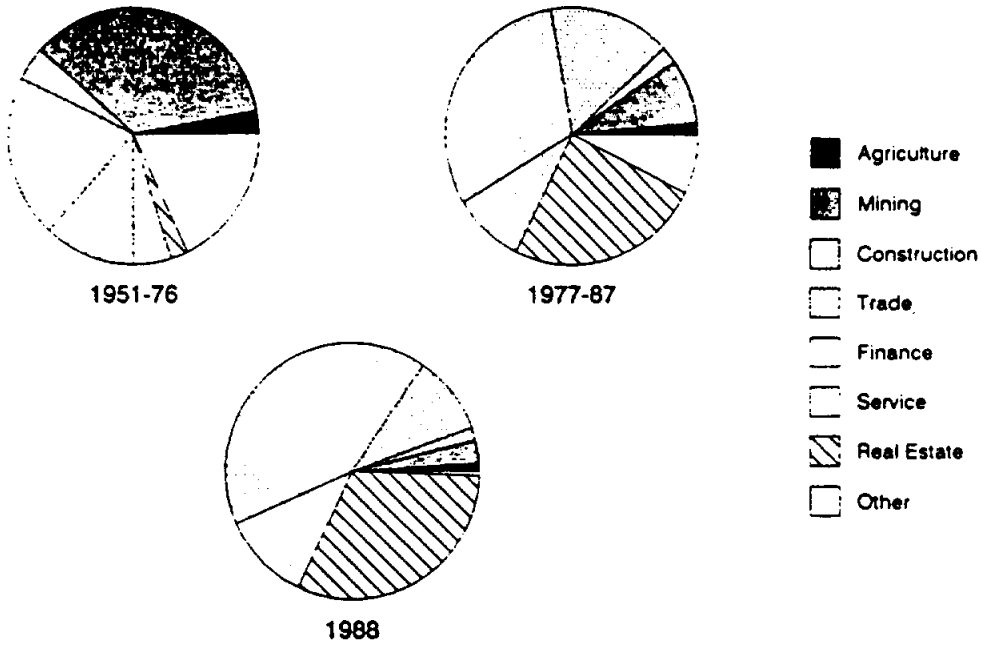
Figure 4

COMPOSITION OF JAPANESE FDI
BY NON-MANUFACTURING INDUSTRY



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COMPOSITION OF JAPANESE FDI
BY MANUFACTURING INDUSTRY

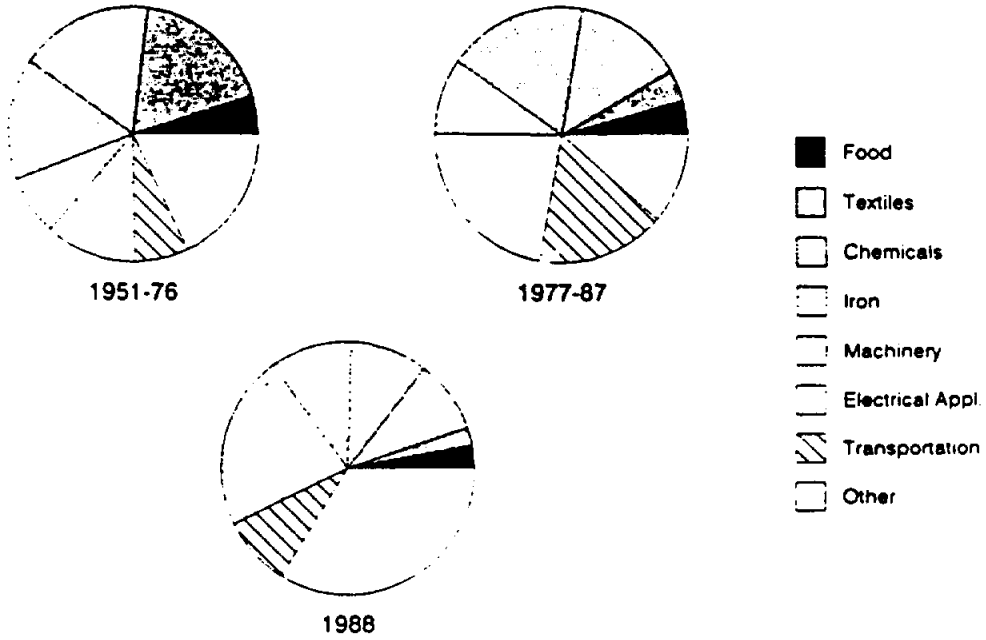

Figure 5

JAPANESE FDI IN ASIA

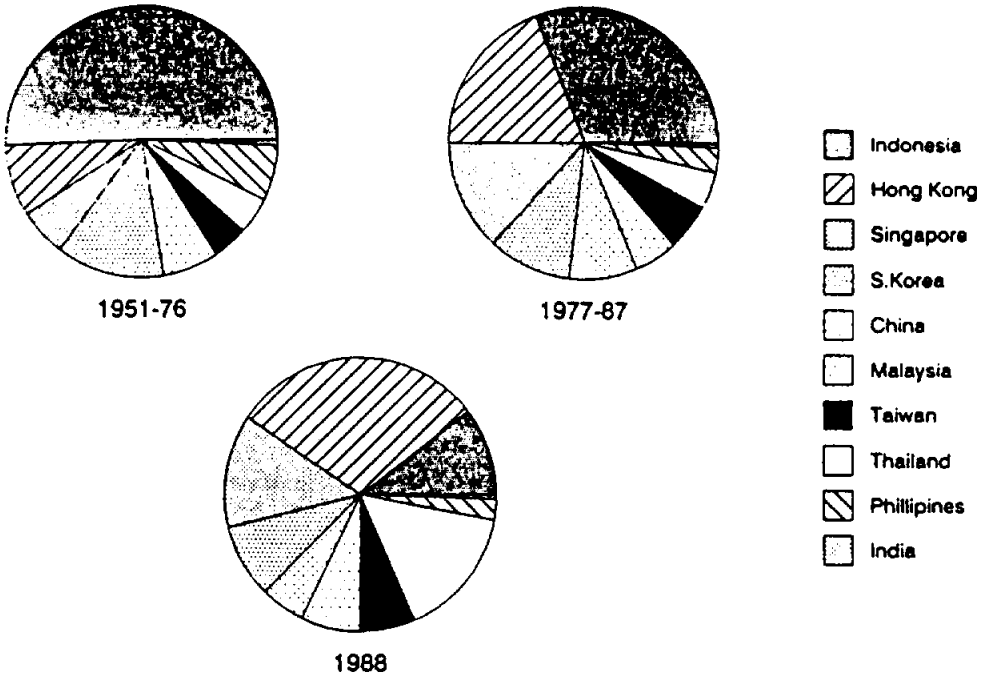

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Figure 6a

JAPANESE FDI IN ASIA
BY NON-MANUFACTURING INDUSTRY

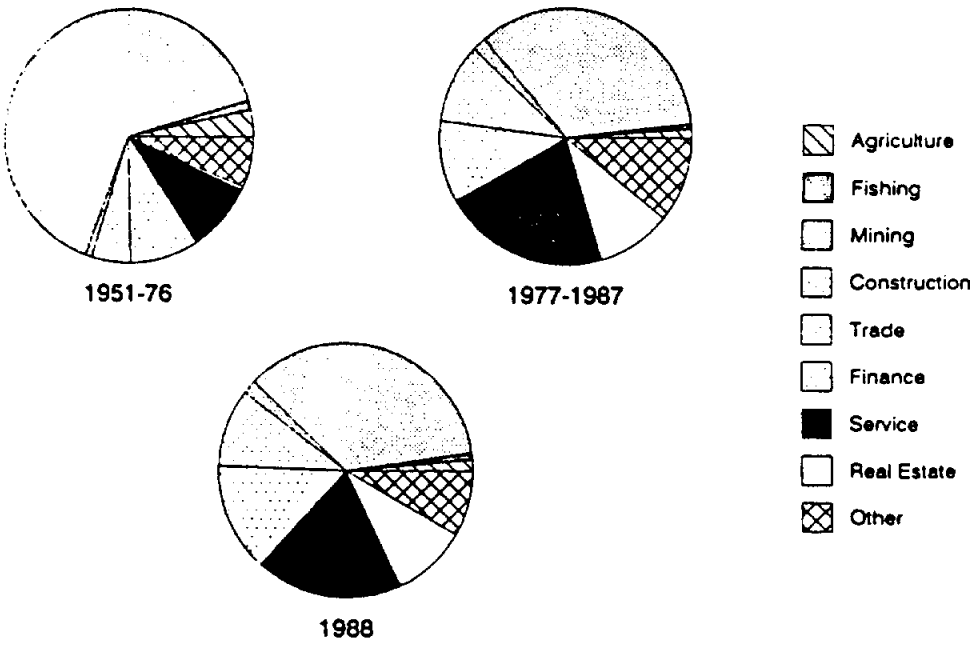

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Figure 6b

JAPANESE FOREIGN INVESTMENT IN ASIA BY MANUFACTURING INDUSTRY

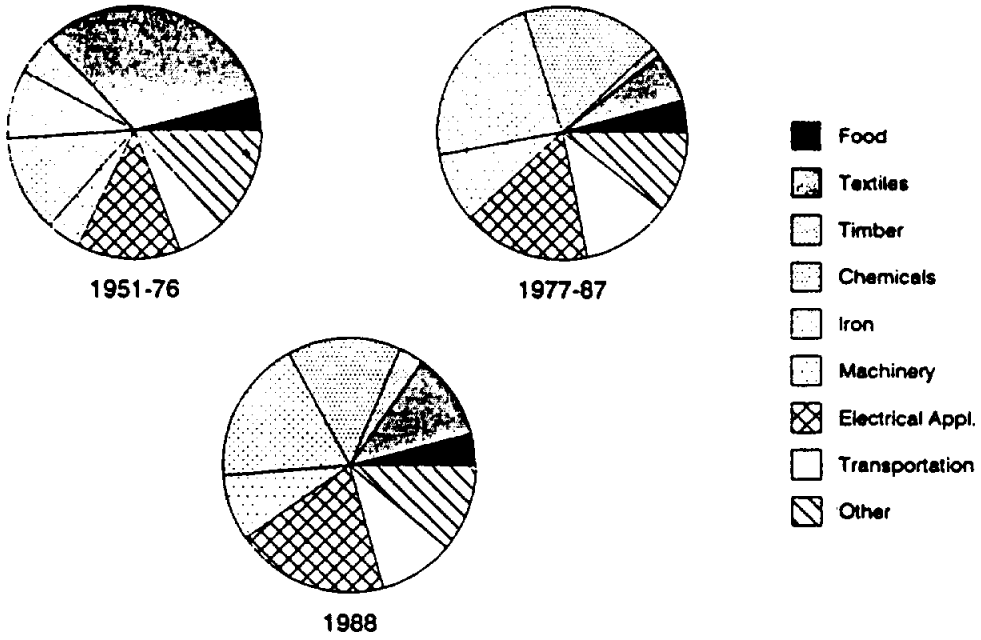

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Figure 7

JAPANESE FDI IN EUROPE

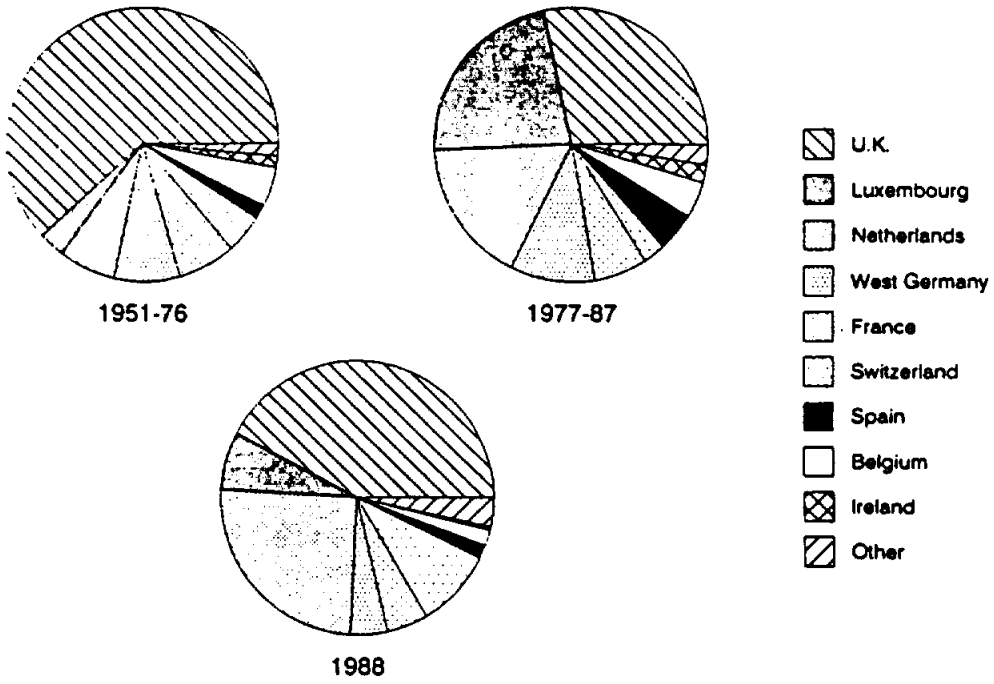

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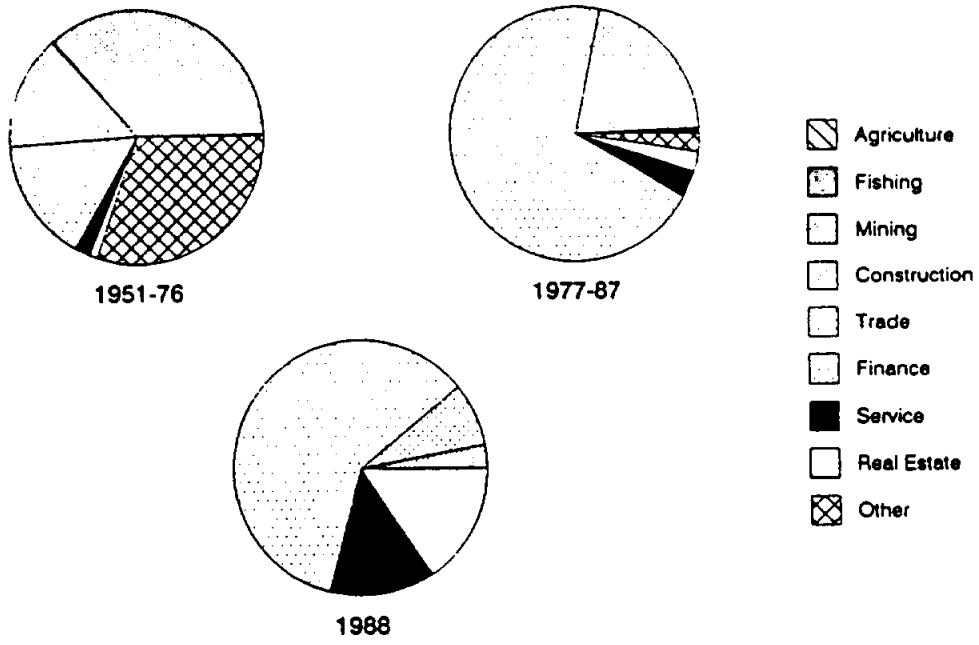
Figure 8a

JAPANESE FDI IN EUROPE
BY NON-MANUFACTURING INDUSTRY



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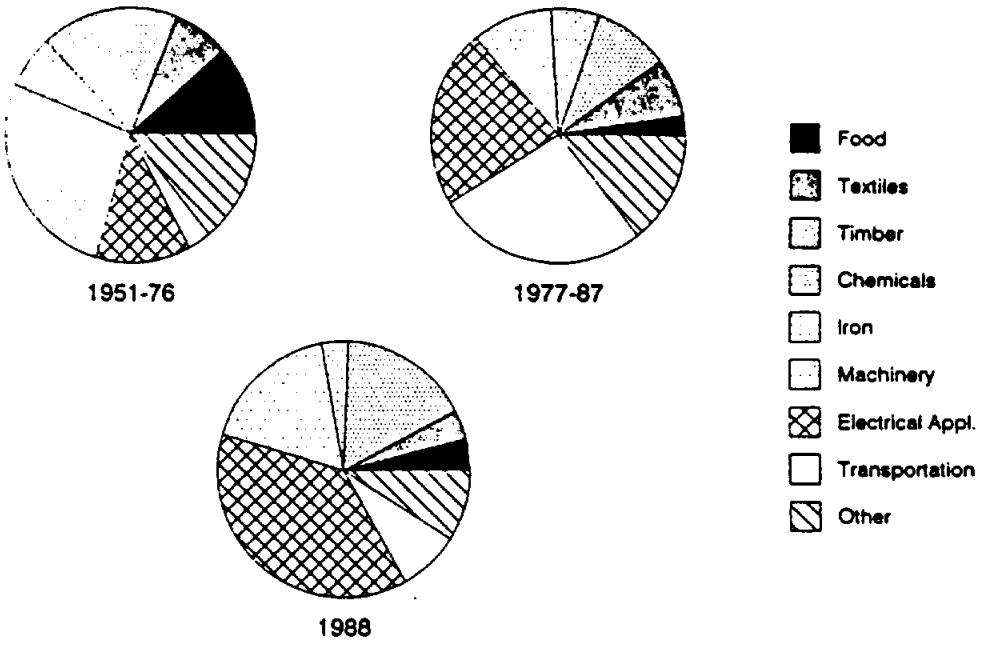

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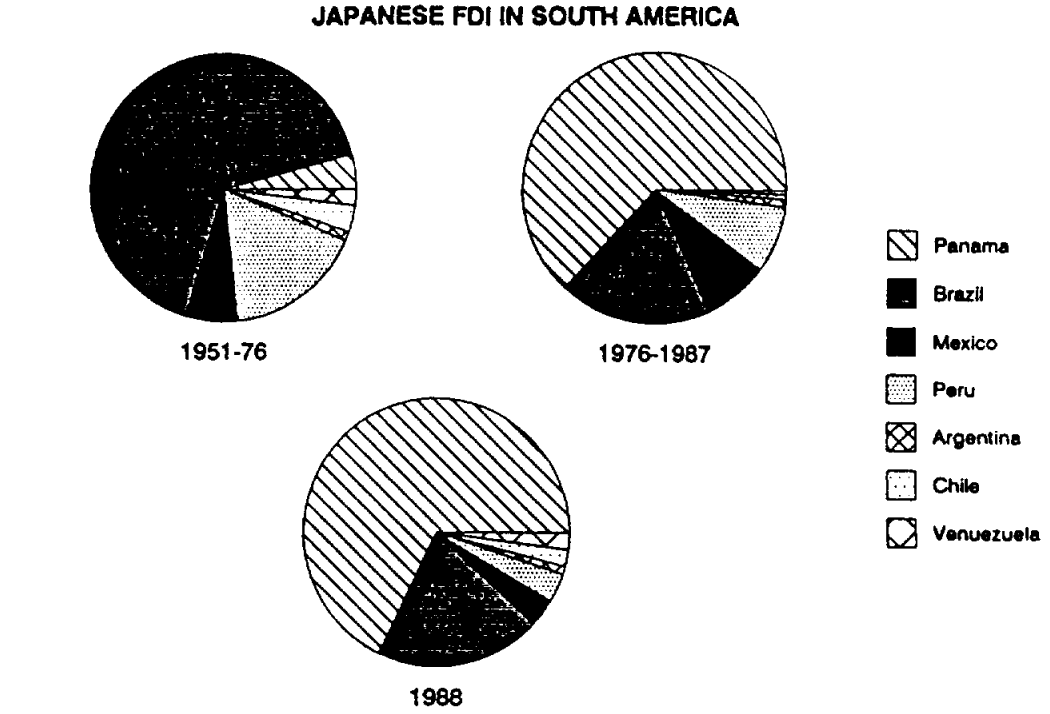
Figure 9a



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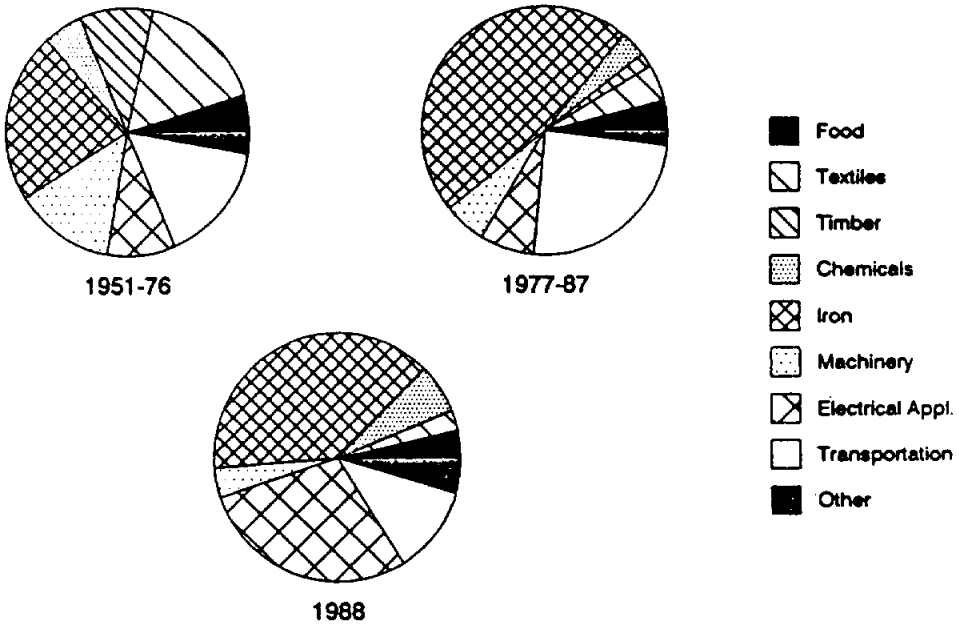
JAPANESE FDI IN SOUTH AMERICA
BY MANUFACTURING INDUSTRY



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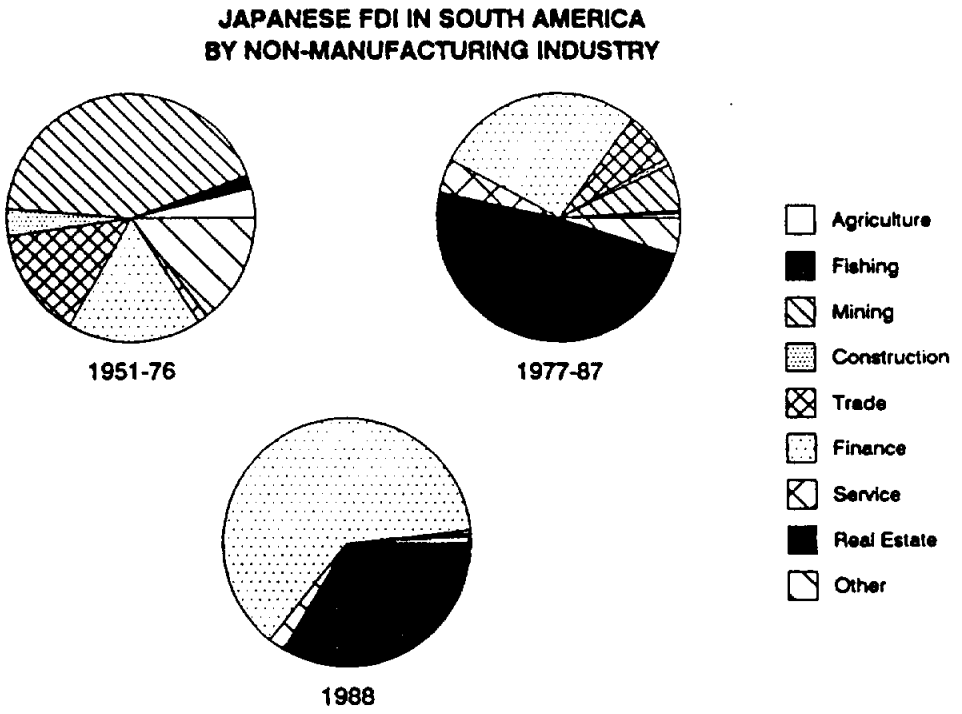

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Figure 10a

JAPANESE FDI IN NORTH AMERICA
BY NON-MANUFACTURING INDUSTRY

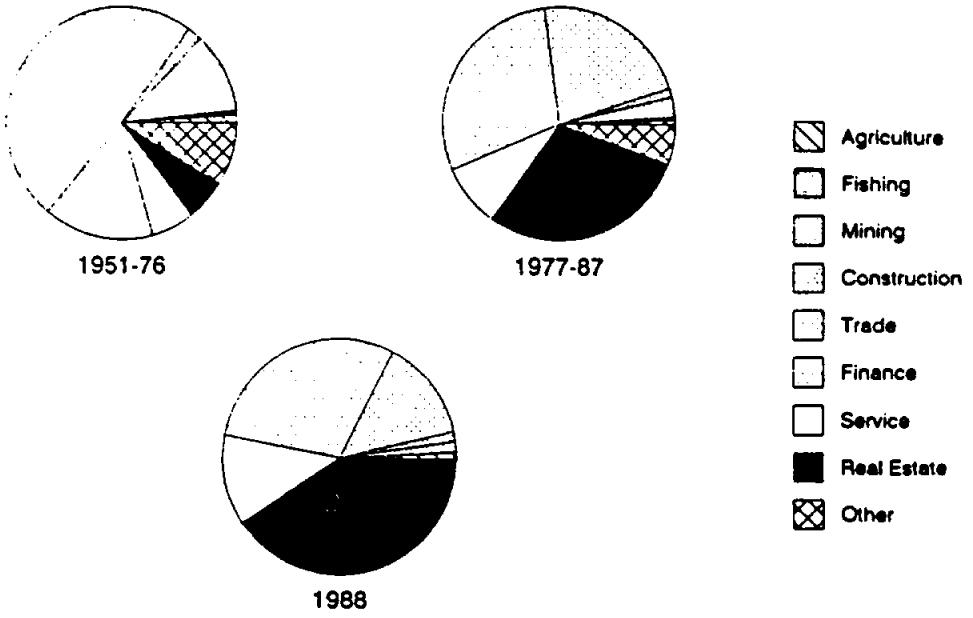

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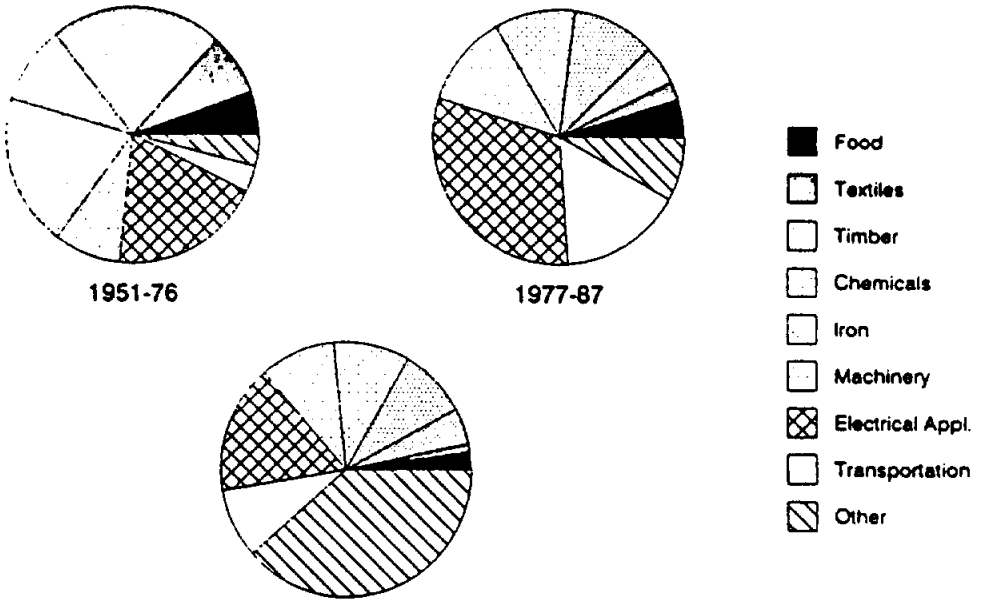
Figure 16b

JAPANESE FDI IN NORTH AMERICA
BY MANUFACTURING INDUSTRY



SOURCE: MOF

Figure 11

COMPOSITION OF JAPANESE FDI IN U.S. MANUFACTURING VS. NON-MANUFACTURING INDUSTRY

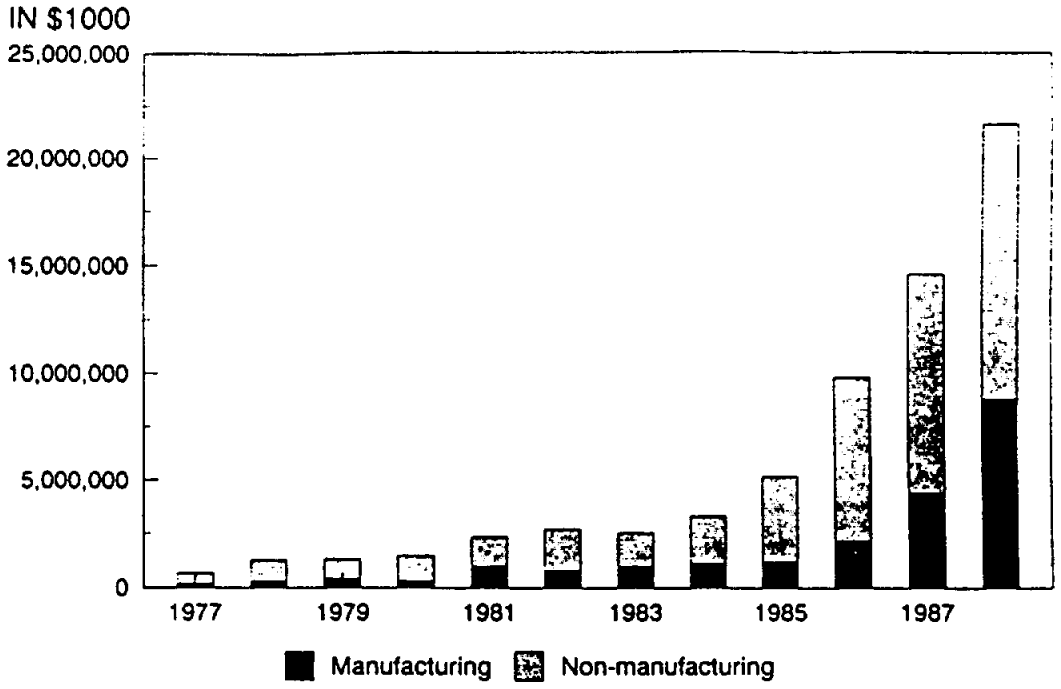


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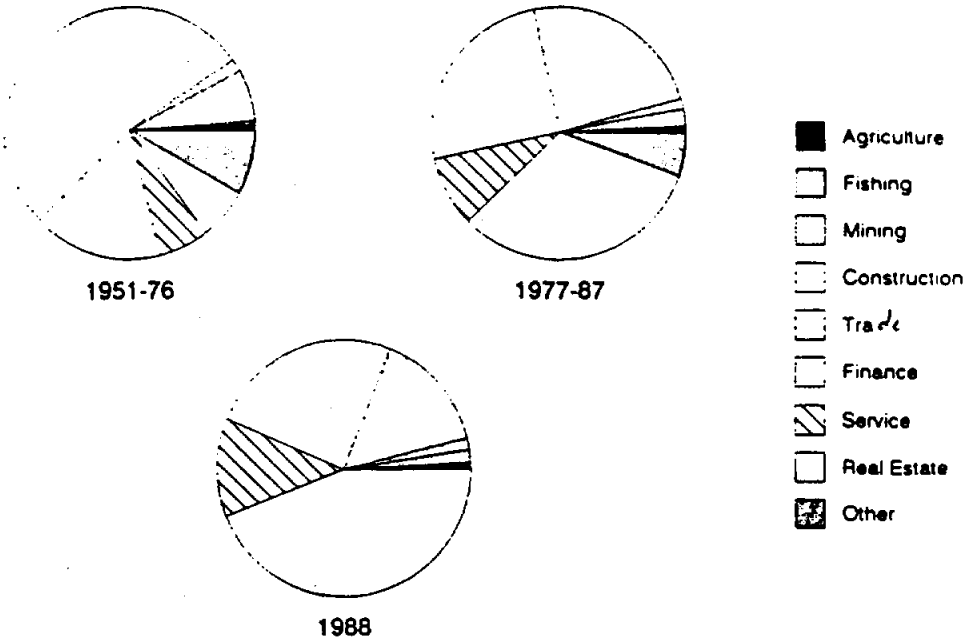
Figure 12

COMPOSITION OF JAPANESE FDI IN U.S.
BY NON-MANUFACTURING INDUSTRY



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COMPOSITION OF JAPANESE FDI IN U.S.
BY MANUFACTURING INDUSTRY

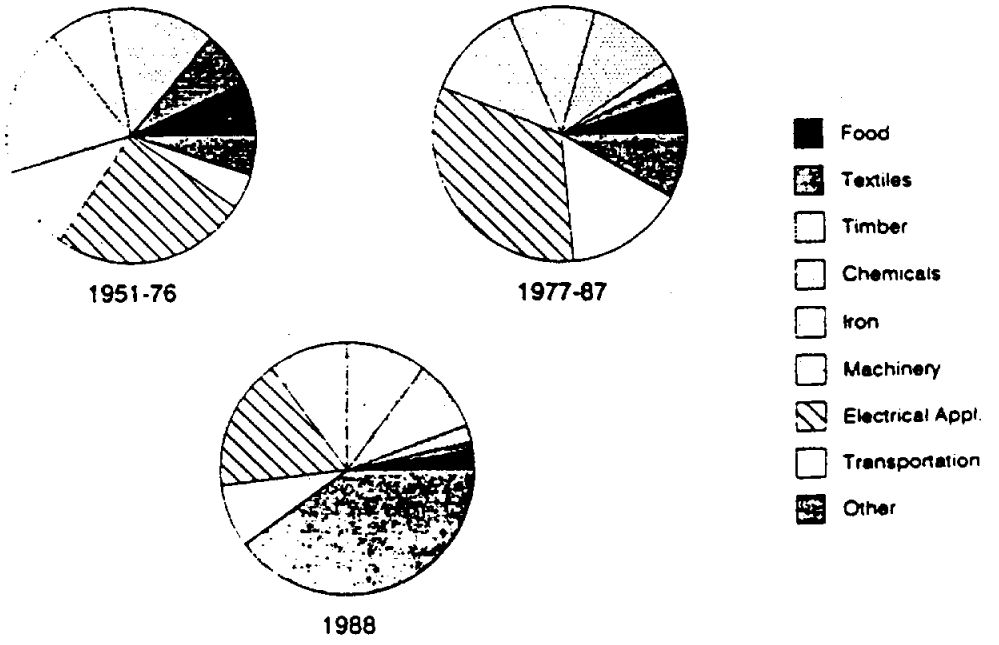
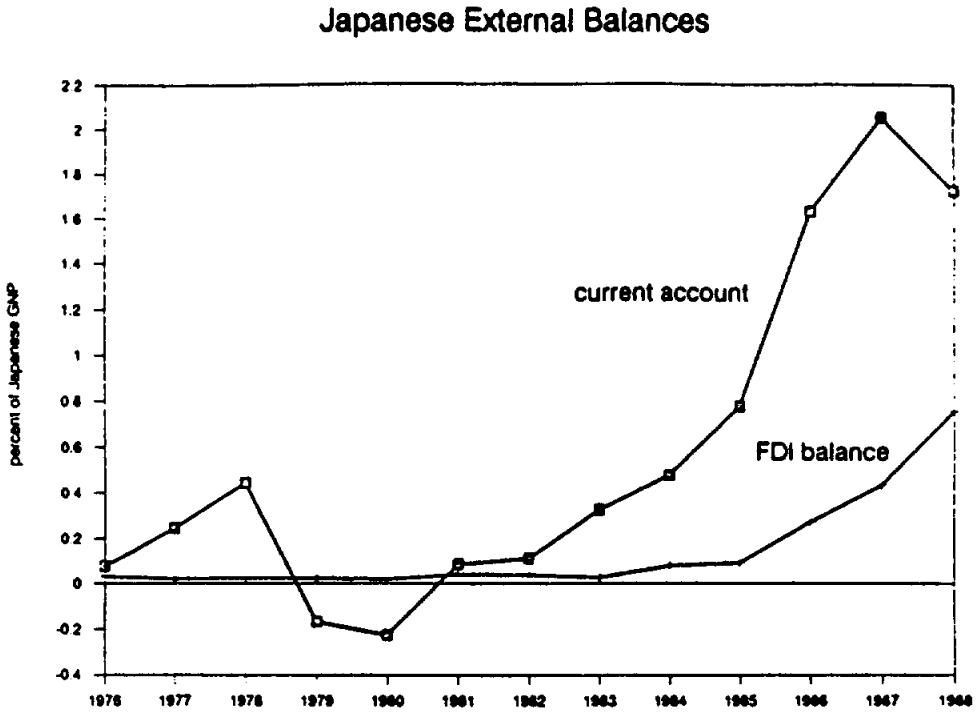


Figure 13


Japanese External Balances
percent of Japanese GNP
2.2
2
1.8
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
-0.2
-0.4
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
current account
FDI balance