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Report

Of

Study Concerning Japan's Experience with the Liberalization of Foreign Direct Investment in Japan and the Current Situation about Japan's Foreign Direct Investment in Foreign Countries

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Abstract of the Report

Parts I and II of this report are summarized as follows:

Part I provides a bird’s eye view of the historical development of foreign direct investment from the time the Foreign Exchange Law and the Foreign Capital Law were enacted (1950), through the OECD affiliation (1964), until the amendment of the Foreign Exchange Law (and repeal of the Foreign Capital Law) (1980).

A chronological analysis is performed in the sequence of “Trends Prior to the OECD Admission (1964) – Period of Industrial Protection,” “Trends from the OECD Admission to the Repeal of the Foreign Capital Law (Integration to the Foreign Exchange Law, 1980) – Foreign Capital Inflow during the Regulatory Relaxation Period and its Background –,” and “Trends after the Repeal of the Foreign Capital Law (an approximately 10-year period up to 1989) – Foreign Capital Inflow in the Period of Liberalization and its Background.”

The history of foreign direct investment is presented, starting with how it began to be substantial around 1970 and grew rapidly with the start of the 1980s. The analysis also shows that foreign direct investment was initially made mostly in the manufacturing sector but later spread to the non-manufacturing sector. It also shows that foreign direct investment was fed mainly by US capital at first but that European and other regional money also started to flow in later. In addition, the analysis compares the government policies and programs, etc. that were adopted at each stage of this historical development.

This analysis and digest presents a clear picture of the details of the government policies and programs, as well as their background and usefulness.

For example, the report reveals that the “capital liberalization” process, which was carried out in five phases between 1967 and 1973, was implemented after the government clearly established a stance of “promoting the liberalization of foreign direct investment” as it recognized events on the international stage, including Japan’s transition to the status of an IMF Article VIII nation and its membership in OECD, as well as economic changes such as a surge in Japan’s trade surplus and its becoming the second largest economy of the world.

Furthermore, the report shows the fact that the “capital liberalization” was implemented flexibly by applying fine-tuned methods. For instance, all domestic industries were classified into either Class I Liberalization Industries or Class II Liberalization Industries, based on their stages of development and their competitiveness, whereas liberalization of the automobile industry, one of the most important industries of the time, was handled separately from other industries.

The effects of this “capital liberalization” are evident. Foreign direct investment in both the manufacturing and the non-manufacturing sectors grew rapidly. In the

manufacturing sector, a cumulative total foreign direct investment of $168 million was made prior to the “capital liberalization” (five accumulative fiscal years between 1961 and 1965). After the “capital liberalization,” the cumulative total foreign direct investment between the 1976 and 1980 fiscal years rose to $1,092 million. In the non-manufacturing sector, cumulative total foreign direct investment was $12 million before the “capital liberalization” (between the 1961 and 1965 fiscal years). After the “capital liberalization”, the cumulative total foreign direct investment between the 1976 and 1980 fiscal years rose to $387 million. Among the investor countries, the United States remained the top provider of capital. However, the results of the analysis point at increased diversity. After the “capital liberalization,” European capital inflows grew, and some investment began to be made by Asian countries as well.

In Part II, the insights gained from the observation of historical developments relating to foreign direct investment in Japan are summarized together with the insights gained from the analysis of Japan’s external foreign direct investment.

The analysis of external foreign direct investment is performed by first summarizing industry-by-industry and regional trends over the period between the 1970s, when a regulatory relaxation took place, and 2003. This is followed by a description of major examples in the manufacturing sector, situations in recipient countries of foreign direct investment, changes in local production by Japanese companies, a shift of focus to China, and other changes relating to international trade and economic structures surrounding Japan.

As for the insights gained from the observation of the historical developments relating to foreign direct investment in Japan, the importance of “sequencing” and flexible response is pointed out. Japan’s capital liberalization was carried out in a flexible manner and in phases by first constructing a framework of “inward direct investment liberalization” at the government level, and evaluating economic situations at every step of the way. This paved the way for an increase in foreign direct investment in the 1980s.

Similarly to foreign direct investment, Japan’s external direct investment started in the 1970s and grew rapidly at the start of the 1980s. Investment was initially made mostly in the non-manufacturing sector but grew to include the manufacturing sector. The United States was the primary destination of investment at first, but European and other regions began to be included.

The first conclusion that can be drawn from the analysis of external direct investment is the potential for the growth of the industries of countries accepting foreign direct investment.
Recipient countries of foreign direct investment enjoy such benefits as advanced technology and high production efficiency from top-grade foreign corporations, etc., and gain the potential to enable specific domestic industries in their countries to become stronger and their industries to grow.

Secondly, an expansion and sophistication of investment and international trade in the recipient countries of foreign direct investment can be pointed out. A recipient country of foreign direct investment can increase its foreign currency reserves, stabilize its international balance of payments, and reduce the risks associated with inflows and outflows of short-term funds. At the same time, goods manufactured at local plants that are constructed with foreign direct investment money are initially marketed in the local market but soon begin to be exported to foreign countries, thanks to productivity improvement. As a result, imports of materials and parts from the country making the foreign direct investment, as well as exports of parts of finished goods to foreign markets, increase and boost international trade. By accumulating such experiences, countries gradually move from exporting industrial products with low added value to exporting industrial products with high added value. Through this process, the quality of international trade rises.

Thirdly, the effectiveness of policies to attract foreign direct investment can be pointed out.
In the background of a rapid expansion in Japan's external direct investment were various countries' programs to attract investment. These programs to attract foreign direct investment and their PR activities have been found to be quite effective. Additionally, it appears necessary to devise plans that take advantage of individual countries' uniqueness and strengths in the competition for attracting capital. This may include considering the possibility of attracting non-manufacturing companies, as well as manufacturing companies outside of the electric appliance and transport machine industries.

The merits of accepting foreign direct investment are clear. It would therefore be highly meaningful for countries and regions to take positive steps toward capital liberalization in a sequence that they deem to be proper. At the same time, the advanced countries of the world, including those in Europe and America, as well as Japan, which are already in a period of competition for funds that flow in from top-grade foreign corporations, should endeavor to make their countries into attractive markets to foreign corporations.

The insights developed from the observation of Japan's history of foreign direct investment and analysis of its external direct investment may not be viewed to be widely applicable considering the fact that individual countries and regions are in different stages of capital liberalization. Nevertheless, such insights should serve as useful information for the emerging market economies of the APEC countries, which are expected to shoulder responsibilities as core members of the global economy along with Japan.

Part I: History of the Liberalization of Foreign Direct Investment in Japan (from the 1950s to the 1980s)

After adopting the General Framework of Liberalization of International Trade and Foreign Exchange in 1960, Japan's rate of import liberalization (the percentage of liberalized items (import volume restrictions on which were lifted) in the total value of imports) reached 92% in 1963, a level comparable with the European and American countries. Subsequently, Japan became an IMF Article VIII country in 1964, and also joined the OECD about the same time. These events marked Japan's transition to an open economy both in substance as well as name. In the following sections, we will take a bird's eye view of the historical development from the enactment of the Foreign Exchange Law and that of the Foreign Capital Law (1950) to the OECD admission (1964), and further on to the amendment of the Foreign Exchange Law (repeal of the Foreign Capital Law) (1980). Furthermore, insight developed through observation will be examined.

Specifically, detailed analyses will be performed in Chapter 1 "Trends Prior to the OECD Admission (1964) – Period of Industrial Protection," Chapter 2 "Trends from the OECD Admission to the Repeal of the Foreign Capital Law (Integration to the Foreign Exchange Law, 1980) - Foreign Capital Inflow during the Regulatory Relaxation Period and Its Background –," and Chapter 3 "Trends after the Repeal of the Foreign Capital Law (an approximately 10-year period up to 1989) – Foreign Capital Inflow in the Period of Liberalization and Its Background." This will be followed by supplementary explanations in Chapter 4.

Chapter 1: Trends Prior to the OECD Admission (1964)

– Period of Industrial Protection –

(1) From the Enactment of the Foreign Exchange and Foreign Trade Control Law (the Foreign Exchange Law) and the Law Concerning Foreign Investment (the Foreign Capital Law) (1950) to the Establishment of the General Framework of Liberalization of International Trade and Foreign Exchange (1960)

1) Enactment of the Foreign Exchange Law, and that of the Foreign Capital Law, a special law of the Foreign Exchange Law (1950), and their revisions in phases.

Foreign exchange and capital transactions were centrally controlled and regulated under the Foreign Exchange Law, which had been promulgated in December 1949, and the 'Foreign Capital Law' (promulgated in May 1950), which was a special law of the Foreign Exchange Law, as well as other related cabinet orders and ministerial ordinances. Japan's policy goal of the time was to secure funds for growth that was needed for post-war reconstruction by importing foreign capital. There was therefore a need to limit foreign currency outflow as much as possible.

The foreign exchange and capital transaction regulations of the time had the following three major characteristics:

(i) Adoption of a foreign currency budget system with respect to imports
Budget amounts were established for each import item or category, and for each payment currency by the council of ministers, created pursuant to the provisions of Article 3 of the Foreign Exchange Law, so as to regulate foreign payments (1950 – 1964).

(ii) Adoption of a mechanism of "prohibition as a general rule, and liberalization on an exception basis."
The government adopted a mechanism under which foreign exchange and capital transactions were banned as a general rule with permissions and approval doled out on a case by case basis, such as by the lifting a ban with a cabinet order or a ministerial ordinance.

(iii) Adoption of a system of central control of foreign currencies by the government.
Only foreign exchange banks, etc. were allowed to hold foreign currencies so as to enable the government to grasp and control foreign currency transactions (1952).

The 1952 amendment of the Foreign Capital Law extended its controls and regulations to corporate bond and loan claims that were not tied to technological assistance, and gave conditional guarantee of repatriation with respect to the proceeds of stock sale or those of ownership sale by foreign corporations. The amendment also revised rules concerning approval of stock rollovers by foreign corporations.

In 1957, a yen-based system (a system of unrestricted acquisition of yen-based stocks) was implemented, and revisions were made to the rules concerning approval for acquisition of outstanding shares of Japanese corporations by specified foreign investors. (The revision applied only to countries which were required to be given national treatment by a treaty, and excluded "restricted industries" such as the infrastructure, financial and broadcasting industries.)

2) Foreign Corporations in Japan in the 1950-1960 Period

In the post-war era, foreign corporations began to make inroads to Japan in 1950, when the Foreign Exchange Law and the Foreign Capital Law were enacted, and repatriation of the original investment and earnings by foreign investors was guaranteed when the foreign capital inflow was deemed to contribute to the independence and sound growth of the Japanese economy and improvement of the country's international balance of accounts.

During this period, a large number of corporations were created with foreign capital as the domestic economy began to show signs of restoration while US corporations initiated aggressive investment abroad because of low profitability in their own country. The objective of the government policy was to promote the importation of high-quality and long-term foreign capital. The majority of these corporations were those that met this objective. They were characterized by the fact that many were US-based, and that the major part of the investment was in such core industries as petroleum and chemicals.

Furthermore, many investments took the form of additional equity participation in existing companies that had already accepted foreign capital. Very few were purely foreign corporations (i.e. corporations whose entire capital was supplied by a foreign corporation or a foreign individual).

3) Japan's International Trade in the 1950-1960 Period

Starting in 1950, Japan made its way back to the international economy. A look at its performance reveals that Japan's trade balance was fundamentally in a deep deficit throughout the 1950s. Especially between 1953 and 1954, and again in 1957, a rapid fall in foreign currency reserves forced the Japanese government to resort to stringent policies (so-called the 'ceiling on the balance of international payments'), and obtain a loan from the IMF, etc.

Reflecting such fragility of Japan's balance of international payments, wide-ranging (quantitative) restrictions were placed on imports throughout the 1950s. The liberalization rate of imports remained at a meager 22% in 1956 and 33% in 1958.

(2) From the Establishment of the General Framework of Liberalization of International Trade and Foreign Exchange (1960) to the Admission to OECD (1964)

1) Policies of the Japanese Government and the Ministry of Finance on Foreign Capital Inflow in the 1960-1964 Period

Convertibility of Japanese yen with currencies of Western European countries was restored at the end of 1958, while Japan's positions with foreign countries, including its balance of trade surplus, improved in 1958 and 1959 as the result of a surge in exports, as well as a request by the United States for liberalization at a GATT meeting. These events caused the liberalization of international trade and foreign exchange to gain momentum. In June 1960, the General Framework of Liberalization of International Trade and Foreign Exchange was adopted. The General Framework set a goal to raise the import liberalization rate to approximately 80% (or 90% in the event that petroleum and coal were also liberalized) in three years (from 40% as of April 1960). (In August 1963, the international import liberalization rate grew to 92%, a level comparable with those of European and American countries.)

While so doing, the government took a cautious stance, refraining from disclosing specifics of the liberalization or its time frame by indicating only that in the area of foreign exchange, current transactions would be liberalized as a general rule within two years and that "regulations on capital transactions would be eased sequentially while attention would be paid to ensure that no adverse effects would be inflicted upon the growth of the domestic economy."

The policies of the Foreign Exchange Bureau of the Ministry of Finance at the time can be condensed into the following three points:

(i) Fundamental Philosophy
Liberalization of current transactions would be followed by the liberalization of capital transactions. Liberalization of capital transactions would be implemented gradually by heeding its impact on small and medium-sized corporations, concerns about corporate control through stock acquisitions, and effects on the financial and foreign exchange markets.

(ii) Loans and Technology Transfers
Foreign capital imports that are accompanied by loans and technology transfers contribute to a reduction of interest burdens and advancement of Japan's technology. For this reason, restrictions would be eased by establishing criteria with respect to the scope of the industries that receive capital and the terms of agreements.

(iii) Stock Acquisitions
Restrictions would be eased gradually with respect to the ceiling for stock acquisitions by foreign investors through the open market, etc. and repatriations of the initial investment, corporate bonds, and securities that represent beneficiary interest.

Pursuant to these policies, regulations on foreign capital imports were eased in 1960. The key points of the relaxation were as follows:

(i) The maximum percentage of stock ownership by foreign investors was raised to 10% in restricted industries (from 5%), and 15% in unrestricted industries (from 8%). (With respect to stock purchases by foreign investors in the stock market, ceilings had been set for stock (type) ownership by foreign investors in individual corporations.)

(ii) The period in which repatriation of the original investment in stock was restricted was shortened from seven years to two years, followed by repatriation in installments over a five-year period.

(iii) Regarding foreign currency loans not to exceed $100 thousand, regulations were eased to automatic approval by the Bank of Japan.

Additional relaxation measures followed in the ensuing period. For example, the period in which repatriation of the original investment in stock was banned was shortened to six months in 1962. In 1963, the restrictions on such capital repatriations were completely lifted. It had taken 13 years between the time that the restrictions on repatriation of original investment were placed and their complete lifting.

2) Foreign Corporations in Japan in the 1960-1964 Period

By around 1960, Japan's rapid growth was fully on course. Japan's attractiveness rapidly increased not only as an export market but also as a place for foreign corporations to make investment in and capitalize on its growth potential.

Foreign corporations that were set up during this period were mostly in the chemical, machinery, and petroleum (refining and sales) industries. In addition, companies were increasingly moving into consumer goods markets, such as foods, textile, and paper and pulp. As before, most of these foreign corporations were US-based. However, many European corporations also began to move into the Japanese market around 1959.

One characteristic aspect of the major foreign corporations that came into being around 1960 is that many were yen-based. The reason was that foreign direct investment was possible without the approval required under the Foreign Capital Law as long as no foreign remittances were made to repatriate capital or dividends. A number of purely foreign-owned corporations were created not only in commerce but also in manufacturing because investors were free to start up yen-based companies in any industry.

Chapter 2: Trends from the OECD Admission to the Repeal of the Foreign Capital Law (Integration to the Foreign Exchange Law, 1980)

– Foreign Capital Inflow during the Regulatory Relaxation Period and Its Background –

(1) Transition to an IMF Article VIII Nation, the OECD Admission and Policy Responses

In 1964, Japan became an IMF Article VIII nation and also became a member of OECD. As a result, Japan became unable to place any restrictions on foreign remittances for reasons of balance of international payments as a general rule. Furthermore, the United States and other countries of the world began to exert ever greater pressure on Japan to liberalize capital transactions.

The key points of the measures to liberalize foreign direct investment that the Ministry of International Trade and Industry devised in 1967 in light of the circumstances at the time were as follows:

(i) Necessity of measures to prevent confusion in the domestic market, caused by the entry of foreign corporations

(ii) Necessity to improve conditions so as to give domestic industries a chance to grow competitive and stand on an equal footing with foreign corporations. In particular, the importance of providing funds necessary to prevent management control by foreign capital, promoting debt guarantees and measures to aid individual corporations to proceed with measures for stable stock ownership were confirmed.

In the same year, the final government policies on foreign direct investment were approved at a cabinet meeting as the "Liberalization of Foreign Direct Investment, etc." after deliberation by the Council on Foreign Capital. Its content was in line with the fundamental stance of the Ministry of International Trade and Industry, and included the Liberalization Measures, which indicated the framework for specific steps to press forward with capital liberalization and its schedule, as well as the Liberalization Countermeasures, which were the "countermeasures to strengthen the competitiveness of the Japanese corporations and prevent chaotic behavior by foreign capital."

(2) History of Liberalization of Capital (Foreign Direct Investment) starting in 1967 (From the Initial Round of Capital Liberalization in 1967 to the Fifth Round of Capital Liberalization in 1973)

Liberalization of foreign direct investment (capital liberalization) occurred over a six-year period, starting with the first round in 1967 and ending with the fifth round in 1973.

In the initial round of capital liberalization that took place in 1967, 50 industries were liberalized. (33 industries in Class 1, and 17 industries in Class 2). Foreign ownership up to 50% was automatically approved when a new corporation was established in the liberalized industries in Class 1. Similarly, in the liberalized industries in Class 2, foreign ownership up to 100% was automatically approved. In the second and third rounds of capital liberalization, the number of liberalized industries gradually increased over a three and a half-year period.

Liberalization in the automobile industry, which was separately handled from the ordinary liberalization, occurred in 1971. Six industries, consisting of the automobile manufacturing, manufacture of automobile bodies or accompanying vehicles, manufacture of automobile parts or accessories, manufacture of piston rings, manufacture of internal combustion engine electrical components, and automobile lamp manufacture, were designated to be the liberalized Class 1 industries.

The fifth round of capital liberalization came in 1973. All industries, with the exception of five industries, were placed in the Class 2 category and were 100% liberalized. Of the five exception industries, agriculture, forestry and fishery, petroleum, manufacture of leather and leather goods, and retailers with more than 11 stores were to be subject to case-by-case reviews whereas the mining industry and retailers with 11 or fewer stores became the industries with the 50% liberalization rules. Additionally, a decision was made to 100% liberalize 17 industries, including the computer and the pharmaceutical industries, after a waiting period of a few years.

(3) Foreign Corporations in Japan in the 1964-1980 Period

1) Analysis by Industry

The total amount of foreign direct investment, combining the manufacturing and non-manufacturing industries, has been on a rising trend as capital liberalization progressed. On the dollar basis, foreign direct investment reached its initial peak in the 1971 fiscal year at $254 million, and the second peak in the 1979 fiscal year, when the Foreign

Exchange Law was extensively revised (and the Foreign Capital Law was repealed), climbing to $524 million, and continued to be on a rising trend.

In the manufacturing segment, changes in foreign direct investment by industry and on a dollar basis were as follows: total for the manufacturing sector amounted to only $62 million between the 1956 and 1960 fiscal years, but grew rapidly to $168 million between the 1961 and 1965 fiscal years, $271 million between the 1966 and 1970 fiscal years (a 61.3% increase over the preceding period), $696 million between the 1971 and 1975 fiscal years (up 156.8%), and $1,092 million up 56.9%) between the 1976 and 1980 fiscal years. Funds in excess of $100 million have flowed in annually, starting in the 1971 fiscal year. Increases were especially noticeable in the 1971 and the 1979 fiscal years. The former was the result of liberalization in the automobile industry. An inflow of $151 million to the machinery-related industries occurred. The second massive increase is attributed to the repeal of the Foreign Capital Law. Petroleum-related industries posted conspicuously large increases.

A comparison across industries reveals concentration of foreign direct investment in such areas as electrical machinery, machinery, including automobile, chemicals, including pharmaceuticals, and petroleum. Very little investment was made in textile, rubber and leather goods, or foods. Investment in the metal industry, or the glass, earth and rock product industry (mainly cement-related products) was also scant.

In the non-manufacturing segment, total amount was nil between the 1956 and 1960 fiscal years, $12 million between the 1961 and 1965 fiscal years, $50 million between the 1966 and 1970 fiscal years (a 316.7% increase over the preceding period), $206 million between the 1971 and 1975 fiscal years (up 312%), and $387 million (up 87.9%) between the 1976 and 1980 fiscal years. Although these rates of growth were high, the levels of investment were low compared with the manufacturing segment. Funds in excess of $100 million did not flow in until after the repeal of the Foreign Capital Law in 1979, nearly ten years behind the manufacturing segment.

A comparison across industries reveals that commerce and international trade industry has maintained a certain size and increased. On the other hand, the transport and communication industry, and the financial and insurance industry were at very low levels.

2) Analysis by Country and Region

Of the total amount of foreign direct investment in Japan by major investing countries and regions (U.S.A., U.K., West Germany, France, Switzerland, the Netherlands, Hong Kong, and Chinese-Taipei) between 1966 and 1980, which amounted to $2,083 million, U.S.-based capital accounted for more than 70% or $1.4 billion. Essentially the same situation was observed in any other year. Foreign direct investment in Japan by U.S.-based capital was buoyant consistently. The United States all by itself invested an amount that was more than twice the total for Europe. Until the mid-1970s, American and European capital accounted for the major part of foreign direct investment in Japan. Staring in the second half of the 1970s, however, investment by Hong Kong and Chinese Taipei began to grow. Among European countries, Switzerland and West

Germany made large investment while investment by the United Kingdom was on a decline in the second half of the 1970s.

As a fundamental trend, the size of foreign direct investment grew as the capital liberalization in Japan progressed although there were variations in the levels among countries and regions, and differences in trends.

(4) Japan's International Trade in the 1964-1980 Period

Between 1968 and 1972, foreign currency reserves surged as the result of widening current account surplus. (Japan became the second largest economy in the world in 1968, surpassing West Germany on the GDP basis.) Partly because the fixed foreign exchange system was maintained at ¥360 to a dollar, the price competitiveness of Japanese export goods became outstanding.

For four straight years between 1968 and 1971, exports grew at rates surpassing 20%, surging from $10.6 billion in the 1967 fiscal year to $24.7 billion in the 1971 fiscal year. The growth was especially remarkable among heavy industrial goods, such as steel, automobiles, ships and durable consumer goods.

In contrast, the United States became concerned of its growing deficit in its international trade balance over the same period, and adopted bold emergency economic policies, which included a 10% across-the board import levy, an end to the gold-backing of the dollar, and demand on major countries of the world to devalue their currencies the so-called Nixon Shock of August 1971. The yen exchange rate, which had been maintained in a fixed exchange rate system at ¥360 to a dollar since 1949 and whose disparity from the market rate had been pointed out, was raised to ¥308 to a dollar at the end of 1971. In February 1973, the system was replaced by a floating rate system.

Two oil crises, which hit first in October 1973 and again in December 1978, needed to be dealt with during this period, too.

With respect to the liberalization of international trade, the rate of import liberalization had reached 93% at the time of OECD entry. Although this was a level comparable with those of the European and American countries, there still remained as many as 136 import restriction items, which included agricultural, forestry and marine products, as well as key industrial products, such as automobiles, machine tools, generators and computers. Subsequent to automobile liberalization in 1965, liberalization of boilers, machine tools and generators in 1970, and liberalization of automobile engines in 1971, import liberalization roughly ran its course in 1972 with the liberalization rate reaching 95% and only 33 import restriction items remaining (24 agricultural, forestry and marine products, and 9 industrial products).

Chapter 3: Trends after the Repeal of the Foreign Capital Law (an approximately 10-year period up to 1989)

– Foreign Capital Inflow in the Period of Liberalization and Its Background -

(1) Amendment of the Foreign Exchange Law (1979) and Measures to Promote Foreign Direct Investment

In 1979, the Foreign Exchange Law was revised on an extensive scale (effective in 1980). It absorbed (abolished) the Foreign Capital Law and adopted a system of advance reporting in connection with overseas borrowings, as well as both external and inward investment in securities. With these changes, capital transactions became freed from controls as a general rule, instead of banned as a general rule as had been the case. Capital liberalization was thus complete. This amendment of the Foreign Exchange Law is outlined as follows:

(i) Capital transactions became free of controls as a general rule (with a system of advance reporting). (Overseas borrowing, as well as external and inward investment in securities as portfolio investment also transitioned to the advance reporting system.)

(ii) The regulation that gave the minister of finance to authorize the use of a permission system under certain circumstances (such as massive fund movements or rapid changes in the foreign exchange rates) was preserved. (Emergency Regulation).

(iii) The measure that gave the minister of finance authority to recommend or order a change in the content of capital transactions or suspend them under certain circumstances (such as when such transactions had the potential of inflicting negative impact on the financial market) was preserved. (Loans, securities issuance by foreigners in Japan and those by Japanese in overseas markets, external and inward foreign direct investment, etc. were covered.)

This extensive revision essentially completed the policy actions that were targeted at liberalization of foreign direct investment in Japan. In the ensuing 1980s, measures to attract foreign direct investment were implemented vigorously.

In 1984, the Committee to Facilitate Investment in Japan was established within the Ministry of International Trade and Industry. In addition, Japan External Trade Organization (JETRO) created the Industrial Cooperation Promotion Office, Center of Industrial and Technological Cooperation, Committee to Promote Overseas Investment by Small and Medium-sized Corporations, and the Committee to Promote Investment in Japan. With these organizations in place, a system of bi-directional investment and technological exchanges, and industrial cooperation promotion was established. The Japan Development Bank also started its financing programs.

In response to these foreign direct investment promotion activities at the national government level, local government-led initiatives were also adopted to revitalize regional economies. As for wide-area programs, a promotion council to attract foreign

corporations was established in four regions, consisting of Hokkaido, Tohoku, Hokuriku and Kyushu, in 1982. The Liaison Conference to Invite Foreign Corporations was organized as a national organization in 1985. These organizations actively conducted such activities as orientation meetings about locational options in Japan and sending missions to foreign countries to promote investment. Furthermore, a liaison conference to attract foreign corporations was created in the Chugoku region in March 1986, and started to provide information services to foreign corporations.

(2) Foreign Corporations in Japan in the 1980-1989 Period

1) Foreign Corporations in Japan in the First Half of the 1980s (A Chronological Analysis)

In the 1980 fiscal year, foreign direct investment totaled $300 million (a 42.7% decrease over the preceding year). This consisted of $189 million (a 55.0% decrease) in the manufacturing sector, and $111 million (a 6.7% increase) in the non-manufacturing sector. The massive drop in the manufacturing sector over the preceding year was a recoil from large petroleum-related foreign direct investment projects in the 1979 fiscal year.

Foreign direct investment in the 1981 fiscal year amounted to $432 million (up 44.0%), broken down between $295 million (up 56.1%) in the manufacturing sector and $138 million (up 24.3%) in the non-manufacturing sector. The increases are believed to be attributable to increased accessibility of foreign direct investment, a result of the extensive revision of the Foreign Exchange Law. Corporations that were fully owned by foreign interest were created in large numbers instead of joint ventures with Japanese corporations. During the 1980 and 1981 fiscal years, the manufacturing sector accounted for less than 70 percent of the total. While the non-manufacturing sector commanded an increasingly large share, due to growth of the commerce and international trade industry. In addition, large-scale investment emerged in the non-manufacturing sector, including the services, leasing and financial industries. As for countries and regions, Europe and other countries began to be more prominent than U.S. companies in both the manufacturing and non-manufacturing sectors.

Foreign direct investment in the 1982 fiscal year totaled $749 million (up 73.4%), broken down between $518 million (up 75.6%) in the manufacturing sector and $231 million (up 67.4%) in the non-manufacturing sector. In the 1983 fiscal year, the manufacturing sector posted $619 million (up 19.5%) whereas the non-manufacturing sector reported $194 million (down 16.0%), raising the total to $813 million (up 8.5%). During this period, foreign direct investment in the manufacturing industry was buoyant, and machinery, metals and chemicals grew at especially fast rates. Investment in the non-manufacturing sector decreased temporarily in 1983, partly in a recoil from the previous year. Overall, however, investment was on a growing trend, as evidenced by a record 20.3% share (the 1982 fiscal year) commanded by the commerce and international trade industry.

One characteristic of this period was a record number of new foreign corporations (corporations that were newly created with foreign capital and corporations that

received the infusion of foreign capital for the first time). (There were 412 such corporations in the 1982 fiscal year, and 568 more in the 1983 fiscal year.) Incidentally, more than 40% of these new foreign corporations were engaged in either commerce or international trade. In terms of countries and regions, U.S.-based corporations accounted for over 50% of the total during this period. (Their shares were in the 30% range in 1980 and 1981.) This was due to an increase in large-scale projects by U.S.-based corporations in the manufacturing, commerce and international trade industries.

Foreign direct investment in the 1984 fiscal year consisted of $277 million (down 55.3% over the preceding year) in the manufacturing sector and $217 million (up 11.9%) in the non-manufacturing sector, for a total of $493 million (down 39.4%). Even though a large yearly decrease was posted on a dollar basis, record 3,685 reports were filed during this period. This was due to the fact that the Foreign Exchange Law amendment increased the accessibility of foreign direct investment and even foreign corporations that are not large began to be attracted to investing in Japan. Another reason was a growing interest in Japanese startups, which generated heavy activity by foreign venture capital.

Foreign direct investment in the 1985 fiscal year reversed its course and began to rise. It consisted of $650 million (up 134.7% over the preceding year) in the manufacturing sector and $279 million (up 28.6%) in the non-manufacturing sector, for a total of $930 million (up 88.6%).

Starting in the 1984 and 1985 fiscal years, European-based foreign corporations, in addition to U.S.-based corporations, once again began to make heavy foreign direct investment in Japan. Investment by the United Kingdom, West Germany and Switzerland rose especially sharply. By industry, foreign direct investment by US corporations grew rapidly in the computer and computer software fields. In the non-manufacturing sector, trust banking and investment advisory service fields saw fast growth.

2) Foreign Corporations in Japan in the Second Half of the 1980s (Chronological Analysis)

Foreign direct investment in the 1986 fiscal year totaled $940 million (up 1.1% over the preceding year), broken down between $495 million (down 23.8%) in the manufacturing sector and $443 million (up 58.8%) in the non-manufacturing sector. In the 1987 fiscal year, the manufacturing sector posted $1,430 million (up 188.9%) whereas the non-manufacturing sector reported $782 million (up 76.5%), raising the total to $2,214 million (up 135.5%). Regarding foreign direct investment in the 1987 fiscal year, growth in the manufacturing sector was prominent. By country, the US corporations nearly doubled their conventional level of investment, to $938 million. European corporations too made record investment totaling $448 million. In particular, Switzerland posted a large increase, to $169 million. As for industries, machinery far surpassed others at $1,110 million, a 378.4% increase over the preceding year. Commerce and international trade continue to grow, and accounted for $130 million (up 51.2% over the preceding year) in the 1986 fiscal year, and $291 million (up 123.8%) in the 1987 fiscal year.

Foreign direct investment in the 1988 fiscal year totaled $3,243 million (up 46.5%), broken down between $2,425 million (up 69.6%) in the manufacturing sector and $818 million (up 4.6%) in the non-manufacturing sector. In the 1989 fiscal year, the manufacturing sector posted $1,172 million (down 51.7%) whereas the non-manufacturing sector reported $1,688 million (up 106.4%), raising the total to $2,860 million (down 11.8%). The increase in the manufacturing sector in the 1988 fiscal year continued to be at a high level, following in the wake of the 1987 fiscal year. The United States invested $1,774 million, nearly doubling the investment of the prior year as it did in the 1987 fiscal year. Machinery continued at a high level in the 1988 fiscal year as it did in the preceding year and rose to $1,732 million (up 56.0%). Although the amount fell to $808 million in the 1989 fiscal year, the commerce and international trade industry continued to grow and reached $454 million (up 56.0%) in the 1988 fiscal year, and $544 million (up 19.8%) in the 1989 fiscal year. Incorporation and participation of new foreign corporations again reached a new high and grew rapidly to 747 companies in the 1988 fiscal year and 843 companies in the 1989 fiscal year.

3) Foreign Corporations in Japan in the 1980s (Macroeconomic Perspectives)

The inroads made by foreign corporations in the 1980-1989 period that we had a bird's eye view of in 2) and 3) above, are summarized in the following section from the macroeconomic point of view with a focus on the impact of the 1979 revision of the Foreign Exchange Law. The manufacturing sector and the non-manufacturing sector will be separately discussed from macroeconomic perspectives.

With the start of the 1980s, foreign direct investment in the manufacturing industry grew phenomenally. As for changes in foreign direct investment in the manufacturing industry since the 1981 fiscal year by industry and on a dollar basis, total for the manufacturing industry was $1,092 million between the 1976 and 1980 fiscal years. Between the 1981 and 1985 fiscal years, the total surged to $2,359 million (a 116% increase over the preceding period), and $7,092 million between the 1986 and 1990 fiscal years (up 200.6%). Especially conspicuous were machinery, including electric appliances and automobiles, and chemicals, including pharmaceuticals. Petroleum, which until the 1979 fiscal year posted a large amount, dipped below foods starting in 1986. Metals achieved fast growth, whereas textile, rubber and leather goods, and glass, rock and earth products (mainly cement-related goods) posted moderate gains over the levels of the years leading up to the 1979 fiscal year.

In the non-manufacturing sector, levels of investment were low until the repeal of the Foreign Capital Law in the 1979 fiscal year. However, foreign direct investment in the non-manufacturing sector also jumped with the start of the 1981 fiscal year. As for changes in foreign direct investment in the non-manufacturing industry since the 1981 fiscal year by industry and on a dollar basis, total for the non-manufacturing industry, which stood at $387 million between the 1976 and 1980 fiscal years, surged to $1,059 million between the 1981 and 1985 fiscal years, (a 173.6% increase over the preceding period), and $4,939 million between 1986 and 1990 (up 366.4%). In the 1989 fiscal year, inflow of foreign direct investment in the non-manufacturing sector surpassed that of foreign direct investment in the manufacturing sector. This was a period that coincided

with the so-called Bubble period of Japan. Accordingly, increases were prominent in the construction and real estate industry, as well as the financial and insurance industry.

Chapter 4: Supplementary Explanations to the History of Liberalization of Foreign Direct Investment in Japan

(1) Supplementary Explanations about Macroeconomic Trends of Foreign Direct Investment in Japan

In the 1950s, both investment in securities (which are purchased in the securities market with no intention of participation in corporate management) and foreign direct investment (which is made with the intention of management participation) were at low levels. In the wake of the regulatory relaxation on foreign capital imports in 1960 and new measures to ease importation of foreign capital in 1961 (designed to relax control of investment in Japanese securities), however, both investment in securities and foreign direct investment began to rise.

Following the liberalization of foreign direct investment, which started in 1967, investment in securities began to climb in the same year. Roughly parallel to the start of capital liberalization, credibility of Japanese corporation rose against the backdrop of sustained rapid economic growth. This led to appreciation of the future potential of Japanese company stocks. Also in the backdrop were the growing perception that shares of Japanese corporations were relatively undervalued and the preference for yen-based assets, triggered by international financial uneasiness.

Although the "management participation" – type investment did not begin to increase until after stock acquisitions through the market picked up speed. It began to surpass $100 million in 1971, when the automobile liberalization and the fourth round of liberalization took place, and leaped in 1979, when the Foreign Capital Law was repealed.

(2) Supplementary Explanations about Changes in Foreign Direct Investment in Japan (by Industry) from the 1960s to the 1980s

Foreign direct investment in the manufacturing segment, totaled $62 million between the 1956 and 1960 fiscal years, but grew rapidly to $168 million between the 1961 and 1965 fiscal years. On a five-year cumulative basis, foreign direct investment jumped to $271 million (a 61.3% increase over the preceding period), $696 million (up 156.8%) in the 1971-1975 fiscal years, and further on to $1,092 million (up 56.9%) in the 1976-1980 fiscal years.

Increases were especially prominent in the 1971 and the 1979 fiscal years. The former was the result of liberalization in the automobile industry. Inflows to the machinery-related industries alone amounted to $151 million. The second massive increase is attributed to the repeal of the Foreign Capital Law, and investment was directed mostly at the petroleum-related industries. A comparison across industries reveals a

concentration of foreign direct investment in such areas as, machinery, including electrical appliances and automobile, as well as chemicals, including pharmaceuticals, and petroleum. Very little investment was made in textile, rubber and leather goods, or foods. Investment in the metal industry, or the glass, earth and rock product industry (mainly cement-related products) was also on a decline.

(3) Supplementary Explanations about Changes in Foreign Direct Investment in Japan (by Region) from the 1960s to the 1980s

Since the 1960s, the United States has consistently made large foreign direct investment in Japan. Until the 1980s, the United States alone accounted for more than double the amount of investment made by all European countries combined.

Since the mid-1980s, investment by European interest has also been growing. In the 1990 fiscal year, the total amount of foreign direct investment made by all European countries surpassed that of foreign direct investment by the United States for the first time. Among the European countries, investment by the Netherlands, West Germany and Switzerland has been growing especially fast. Furthermore, re-investment by corporations which are at least 50% owned by foreign interest (foreign corporations that are already in Japan) also grew rapidly in the second half of the 1980s.

Part II: Insight Gained from Japan's Experience of Foreign Direct Investment Liberalization and Insight from the Perspectives of External Direct Investment

In Part I, historical development of foreign direct investment in Japan was surveyed. In the subsequent sections, the insight gained from the survey will be summarized. In addition, a brief overview of Japan's external direct investment will be provided, and insight that is derived from Japan's experience will be developed.

Specifically, external direct investment by Japan between the 1970s, when regulatory relaxation was implemented, and the year 2003 is summarized by depicting industry-by-industry trends and region-by-region trends. This is followed by a description of major examples in the manufacturing sector, and an analysis of the relationship between such changes in the structure of international trade that surrounds Japan as situations in recipient countries of foreign direct investment, changes in local production by Japanese companies, and a shift of focus to China.

External direct investment started around 1970, and grew rapidly with the start of the 1980s. Initially, much of the investment was made by non-manufacturing companies, mainly in the United States. However, it soon spread to manufacturing companies and to Europe.

Such external direct investment not only serves to avoid trade friction but also helps revitalize the global economy by, for example, indirectly increasing the exports of the countries that receive investment.

Japan has achieved its growth by taking advantage of the merits of external direct investment. It can be said, however, that such external direct investment contributed to the growth of the industries in the countries that received foreign direct investment, as well as the growth of Japan's economy. These experiences are believed to be useful for the emerging market economies of the APEC countries, which are expected to be charged with responsibilities to serve as the core of the global economy alongside Japan.

Chapter 1: Suggestions about the Importance of "Sequencing" and that of Flexible Response

The most critical task will be to first construct a framework of "inward direct investment liberalization" at the government level, and implement the "inward direct investment liberalization" measures flexibly and in phases by gauging the economic trends at every point of the way.

The history of the "foreign direct investment in Japan" between the 1960s and the 1980s progressed in phases with "emphasis on sequencing." At this point, let us focus our

attention on the five rounds of "capital liberalization," which was executed between 1967 and 1973.

The consequence of Japan becoming an IMF Article VIII nation and joining OECD in 1964 was that it became unable to restrict remittances to foreign countries for reasons of international balance of payments as a general rule. After it joined GATT, it was under ever growing pressure from the United States and other countries of the world to liberalize its capital transactions.

In response to this situation, Japan adopted the "Liberalization of Foreign Direct Investment, etc." at a cabinet meeting, following discussions at the Council on Foreign Capital as a way to establish a framework and indicate to both the outside world and its domestic constituents the government's stance that supports "promotion of increased foreign direct investment in Japan." The government published the Liberalization Measures, which provided the framework and schedule of specific steps toward capital liberalization. In addition, it released the Liberalization Countermeasures, which were "countermeasures to strengthen the competitiveness of Japanese corporations and prevent chaotic behavior by foreign capital."

As a vehicle to put into action the government's stance to promote foreign direct investment in Japan, the initial phase of capital liberalization (1967) through the fifth phase of capital liberalization (1973) were implemented over a period of six years. Over this course, finely tuned flexible responses were made, including classification of industries to the Class 1 liberalization industries and Class 2 liberalization industries, designation of industries to be liberalized that took into consideration the stage of development of individual industries and their international competitiveness, and a separate capital liberalization program for the automobile industry, which was positioned to be one of the most important industries.

As the result of these various "capital liberalization" measures, foreign direct investment in the manufacturing segment by industry and on a dollar basis changed over time. Total for the manufacturing sector was $62 million between the 1956 and 1960 fiscal years, but grew rapidly to $168 million between the 1961 and 1965 fiscal years. On a five-year cumulative basis, foreign direct investment jumped to $271 million (a 61.3% increase over the preceding period), $696 million (up 156.8%) in the 1971-1975 fiscal years, and further on to $1,092 million (up 56.9%) in the 1976-1980 fiscal years.

Inroads made by foreign corporations to the non-manufacturing sector remained at low levels until 1979, when the Foreign Exchange Law was amended (and the Foreign Capital Law was repealed), but grew rapidly in subsequent years.

Chapter 2: Potential for the Growth of the Industries of Countries Accepting Foreign Direct Investment

By accepting foreign direct investment, the recipient countries of foreign direct investment are thought to have a chance at making their industries grow through the

transfer of leading edge technologies of top-grade international corporations and by strengthening specific domestic industries.

(1) Perspectives of Receiving Advanced Technology and High Production efficiency

It has been pointed out regarding knowledge transfers that many empirical studies drew conclusions that industries with high knowledge stock levels, corporations with export competitiveness, and corporations that have unique strengths in terms of productivity and technological power have contributed to the growth of external direct investment. (Ishikawa, T. "Impact of Hollowing on Employment and Capital Spending (Is Adding High Value a Countermeasure for Hollowing?)" [JCER Review Vol. 50 (October 2003) Japan Economic Research Center].

To phrase it in the words of foreign direct investment recipient countries, foreign direct investment results in the acceptance of industries and corporation with high productivity and technological power. Thus, these countries can expect to receive technology transfers and develop industries with high productivity.

One example of this can be seen in video-related electric appliances, represented by DVD players, in ASEAN and NIES countries and regions. As production shifted from analogue products to digital products, these countries and regions have received system LSI (large-scale integrated circuits) and other manufacturing technologies from the countries making foreign direct investment, such as Japan, as well as European and American countries.

Numerous instances in which leading-edge technologies were transferred exist. For example, a Japanese electric appliance maker transferred technology to manufacture system LSI to a Malaysian semiconductor maker in the manufacture of DVD players in the country. Similarly, a Japanese automobile maker transferred to a local Malaysian corporation the technology for some of the parts used in an engine that required advanced technology.

In a study to determine the status of progress of technology transfers to local corporations, a questionnaire was sent to Japanese and European parent companies, as well as their subsidiaries in Asia, to find out the extent of technology transfers in ten Asian countries and regions. In addition, interviews were conducted at the local sites. The study produced the following evaluation. (Tejima, S. "Impact of Technology Transfer to Asia through Foreign Direct Investment on Economic Development" (Based on a Questionnaire-based Survey of Japanese and European Corporations) [Journal of Research Institute for Development and Finance, Nov. 2001, Issue No. 8, Japan Bank for International Cooperation]

(i) Japanese corporations have a relatively forward-looking posture toward technology transfers to the ten Asian countries in the areas of "products and production processes" and "efficient production systems."

(ii) The initial targets set for Asian subsidiaries with respect to the “market share,” “product inventory in days,” “(a decrease in) the incidence of occupational injuries,” “ production per employee,” “added value per employee,” and “certainty of the delivery date” have been met to a considerable extent.

(iii) Both direct and indirect technology transfers from subsidiaries that are situated in the ten Asian countries to local corporations that are associated with the subsidiaries have been smooth. Improvement has been observed in the local corporations with respect to “quality,” “delivery date,” “technological competence,” and “management awareness.”

This study points out that transfers of management know-how, including efficiency, safety and productivity improvements, have occurred in addition to technology transfers.

(2) Perspectives of Strengthening and Developing Specific Industries of the Host Countries

The next point concerns the strengthening of specific domestic industries. As one example, the high degree of integration of Japanese automobile makers in the Thai auto industry has been pointed out. The Thai government actively assists foreign automobile-related makers to move into Thailand and concentrates its efforts on improving the environment for foreign corporations. As a consequence, the local content rate of foreign auto-related makers grew and Thailand established itself as a key export center of pickup trucks. This led to increased localization of parts production, and raised the industry’s potential to be a full-fledged export industry to ship out cars as well as pickup trucks. These examples show how Thailand has raised its competitiveness to lure foreign direct investment in its country.

As a matter of fact, overseas production of Japan’s automobile industry in 2003 grew in Asia and Europe. The Asian region posted a large increase of 26.3% over the preceding year (compared with Europe’s rate of increase of 16.1%) boosting the percentage of Asian production in the Japanese automobile makers’ total overseas production from 31% to 35%. Moreover, the number of units manufactured by Japanese automakers in Thailand rose at a fast rate of 33%.

In the background of the construction of the optimum production systems by Japanese automakers in Southeast Asia, and especially Thailand was the AFTA (ASEAN Free Trade Area) which took effect in 2003. The fact that Japanese automakers and parts makers initiated action in response to AFTA early on led to industrial integration in the recipient countries of foreign direct investment.

One of the examples of industrial strengthening in recipient countries is the electric appliance industry in ASEAN. A look at shares of employment provided by local Japanese corporations in the host countries’ total employment in the electric appliance industry in 1995 reveals that Japanese corporations provided 38.77% of total employment in the electric appliance industry in Singapore, 37.27% in Indonesia,

38.04% in the Philippines, and 28.18% in Malaysia. Similar statistics in the transport machine industry were 34.33% in Indonesia, and 30.89% in Malaysia. These percentages are quite high. (Fukao, K. and Toyonaga, M. (1988) “Impact of Japanese Corporations in Asia on Japan and Asia” [Research on the Industrial Structure Policies of Asia] Institute for International Trade and Investment)

The following has been pointed out with respect to the reasons why a receipt of foreign direct investment leads to the technology transfers to the recipient countries of foreign direct investment and the strengthening of specific industries: When Japanese electric appliance makers moved abroad in the second half of the 1990s and later years, major corporations clearly did not relocate from their initially chosen sites, and continued or even expanded their business. The major reasons for this can be found in the management style of (i) preventing cost increases by expanding local procurement of parts, and (ii) transforming the products and processes which they intended to shift to local production into more advanced products and processes by making additional investment, while equipping their key production centers so that they would gradually become capable of handling advanced production, and expanding the mutually complementary functions among multiple foreign units. (Shimada, K. [Survey of Overseas Foreign Direct Investment] (1999) Gakubunsha pp. 236-240).

Foreign direct investment can be defined to be international movements of capital that are accompanied by such things as management resources of corporations, technology and knowledge stock that is accumulated through R&D and sales know-how that is built through advertisement activity. Cases that adopt a style that is similar to the one described above are highly plausible not only in the electric appliance industry but also in other industries, and in industries of countries and regions outside of Japan. It appears that technology transfers and industrial growth are steadily taking place in recipient countries of foreign direct investment.

(3) Suggestions about the Growth of Industries in the Host Countries as a Result of Accepting Foreign Direct Investment

1) By receiving foreign direct investment, recipient countries enjoy the infusion of leading-edge technologies of internationally top-grade corporations. Unlike exports, foreign direct investment entails cost, such as capital spending to construct a factory in the recipient countries of foreign direct investment. Industries and corporations that press forward and set up key manufacturing points in foreign countries in spite of such cost are limited to industries with high knowledge stock levels, corporations with strong export competitiveness, and corporations that excel in terms of productivity and technological prowess. Looking at this from the point of view of recipient countries, the invitation of such industries and corporations would foster expectations of technology transfers to the recipient countries and development of highly productive industries. In fact, the study described earlier (which surveyed corporations that moved into ten Asian countries with questionnaires and interviews) reports that Japanese corporations have a forward-looking stance toward technology transfers to the Asian countries with respect to “products and production processes” and “efficient production system.” The survey also found that efficiency, safety and productivity of their Asian subsidiaries improved,

that technology transfers have progressed smoothly, and that quality and technological competence of local corporations have improved.

2) By receiving foreign direct investment, recipient countries become able to strengthen their specific domestic industries. (Examples are the automobile industry of Thailand, the electric appliance industry and transport machine industry in ASEAN countries.)

Expectations can also be held that the businesses that are started with foreign direct investment will continue and expand and that products and processes that are shifted to overseas production, as well as overseas production locations, will grow sophisticated. Active acceptance of foreign direct investment can thus be said to have the potential of contributing to the growth of domestic industries of the recipient countries.

Chapter 3: Expansion and Sophistication of Investment and International Trade in Countries Receiving Foreign Direct Investment

(1) Perspectives of Sophistication of Investment and International Trade in Countries Receiving Foreign Direct Investment

The financial system uneasiness that assaulted Japan in 1997 exerted serious effects on the domestic economy. Nevertheless, it did not spiral into a currency crisis. The major reasons were that Japan had steadily moved forward with its capital liberalization policies, and that credibility of the yen among foreign countries had been well established, thanks to the consistent current account surplus since the first half of the 1980s. In contrast, the fundamental reason for the series of currency crises that crippled other Asian countries in 1997 was their inappropriate capital liberalization policies, which allowed the construction of economic systems that are dependent on inflows of short-term capital. Concerns about the future of these economies triggered sudden outflows of short-term capital, creating a vicious cycle in which fears were turned into reality.

Short-term capital consists of portfolio investment and short-term capital whose content is indistinguishable from others. A look at the currency crisis in Thailand reveals that in contrast to a moderate increase in portfolio investment since 1993, the short-term capital whose content is indistinguishable from others had grown phenomenally. These funds had a highly speculative nature. When these funds were loaned to domestic financial institutions to an excessive degree and used for real estate investment, they became the major cause of a bubble economy. When the bubble popped, the country's overall balance had barely been in surplus with the holding of capital inflows. As these short-term funds were pulled out of the country all at once, causing foreign currency reserve shortages and deterioration of the international balance of payments, the country became unable to service its external debt, and found itself in a currency crisis.

In comparison, medium- to long-term foreign direct investment is made to build local production facilities of foreign corporations. It has an effect of promoting industrialization, increasing foreign currency reserves of the recipient countries of

foreign direct investment by exporting products, and stabilizing the country's international balance of payments. It therefore reduces the risks of recurring crises in Asia.

However, increasing foreign direct investment takes time. It is difficult to expand it over a short term. This is because foreign direct investment requires a pool of skilled workers, supply of factory sites, and improvement of industrial infrastructure. Consequently, long-term perspectives are essential for inviting foreign direct investment.

(2) Perspectives of an Expansion and Sophistication of Investment and International Trade in Countries Receiving Foreign Direct Investment

Receipt of foreign direct investment has an effect of expanding the international trade of the recipient country, in addition to an increase in foreign currency reserves and stabilization of international balance of payments.

Until the early 1980s, Japanese corporations set up manufacturing operations in Asia mainly to produce products that were intended for the Japanese domestic market. Starting in the mid-1980s, production for local consumption and exports increased. Local production expanded in the 1990s, and local networks of manufacturing organizations were reorganized to make further inroads to the Asian market, where competition had intensified. This shift to expanded local production occurred mainly in the NIES initially. With labor cost rising in the NIES rising, however, a gradual shift to ASEAN took place. In terms of the amount of foreign direct investment by Japan, ASEAN began to surpass NIES in the 1991 fiscal year.

Over the ten-year period between the 1984 and 1993 fiscal years, the average amount of foreign direct investment made by Japan in NIES was $2,370 million. Over the same period, Japan made average foreign direct investment worth $1,953 million in ASEAN. Over the next ten years, spanning between the 1994 and 2003 fiscal years, the amount of foreign direct investment made in ASEAN exceeded that of investment made in NIES, with the former amounting to $3,312 million and the latter $2,638 million.

Goods that are manufactured at local plants that were constructed with foreign direct investment are not only sold in local markets but also exported to Japan, Europe and America. This induces an increase in imports of materials and parts from Japan, as well as an increase in exports of parts and finished goods to Japan, Europe and America as a consequence. Thus foreign direct investment has an effect of inducing international trade. In the past, both imports from and exports to the United States accounted for overwhelmingly large shares of Japan's international trade. With an expansion of local production, however, the weight of international trade has shifted toward NIES, ASEAN and East Asian countries, such as China, with increased diversity.

Regarding the impact of foreign direct investment on international trade, research on the relationship between international trade and foreign direct investment has been accumulating in such major investor countries as the United States, Japan and Germany.

Estimation results have been revealed that indicated that in many industries a positive co-relation exists between the activities of overseas subsidiaries and exports to the regions where such subsidiaries are located. A view has also been expressed that a positive co-relation exists between overseas production and exports in Asia. (Inui, T. "Foreign Direct Investment in East Asia by Japanese Corporations and the Structure of International Trade" [Medium- to Long-Term Analysis of Japan's International Balance of Payments (March 2002), Institute for Economic and Financial Research (IEFR), a Study sponsored by the Ministry of Finance]). In this study, the impact of foreign direct investment on exports varies with the objective of foreign direct investment. When foreign direct investment is made for the sake of vertical division of labor, intermediate goods are imported to manufacture finished goods locally in many cases. Accordingly, there is a strong possibility that local products and exports take place side by side. When foreign direct investment is made for the sake of horizontal division of labor, there is a strong possibility that local production replaces exports. An analysis of the impact of activities by Japanese corporation's overseas subsidiaries on the total size of exports of their parent corporations (exports to the foreign countries where such subsidiaries are located) introduces the estimation results that indicate a positive co-relation between the activities of overseas subsidiaries and exports to the subsidiaries' regions in many industries (Lipsey, R., Ramstetter, E. and Blomström, M. (2000), "Outward FDI and Parent Exports and Employment: Japan, The United States and Sweden" NBER Working Paper 7623). Furthermore, estimation of the relationship between overseas production (as gauged by the number of overseas employees as an indicator of the scale of activities) by region (Asia, Europe and North America (the Unites States. and Canada)) based on corporate-level data in the electric appliance industry and exports in each of the regions reveals a positive co-relation between overseas production and exports in Asia (Fukao, K and Hoon, C. (1997), "Overseas Production Activities of Japanese Corporations and the Structure of International Trade," Asako, K. and Otaki, M. "Modern Macroeconomics" University of Tokyo Press).

Similarly, according to an analysis of the impact of foreign direct investment made by Japan in East Asia on international trade (Koike, R. "Japan's Foreign Direct Investment and the Structure of International Trade in Japan and East Asia" [Institute for Monetary and Economic Studies, Bank of Japan/Financial Research/Oct. 2004]), such impact varies from industry to industry and foreign direct investment has a positive effect on international trade in the electric machinery, and general and precision machine industries whereas the impact is small in the textile industry. No significant impact was found in the transport machinery, chemical, metal or metal product industry.

Receipt of foreign direct investment has an effect of expanding international trade but it also improves the quality of international trade. In many instances, corporations that make foreign direct investment improve the facilities and equipment of local manufacturing plants and boost their functions as they gradually shift their production to high added-value products. For this reason, the structure of international trade, which in the initial stages of foreign direct investment centers on export of industrial products with low added value, makes a gradual transition to exporting of industrial products with high added value.

As an example, a Japanese precision machine maker began to gradually move its production of high-grade machine models, which had been manufactured in Japan, to Thailand around 2000. In the past, the company manufactured high-grade machines in Japan and low-grade machines in Thailand. This vertical division is being replaced with a new policy of gradually shifting the manufacture of some high-grade machines to Thailand and exporting them from the country.

A new move emerged at the outset of the 1990s to manufacture high added-value models in Southeast Asia and at the same time develop domestic markets in Southeast Asian countries, presenting a rise in the quality of international trade within the region. An example of this move can be seen in the establishment of a sales company in Thailand by a Japanese electric appliance maker to sell AV (audio-visual) equipment.

Japan's foreign direct investment in the United States became vigorous in the second half of the 1970s. In the backdrop of this trend was a issue of growing trade friction between Japan and the United States. In the electric appliance and transport machinery-related industries, in particular, corporations became unable to make profit by manufacturing domestically and exporting. Corporations concluded that constructing their plants in the United States and selling in the US market was the solution. As a result, trade friction was eased.

Because local production with foreign direct investment has an effect of export expansions, the recipient countries of foreign direct investment face a possibility of trade friction with the countries to which products are exported. It should be noted that in such situations foreign direct investment and local production for the sake of export replacement may become a necessity.

(3) Suggestions about an Expansion and Sophistication of Investment and International Trade in Countries Receiving Foreign Direct Investment

1) To prevent the recurrence of the 1997 Asian currency crises, proper foreign direct investment liberalization policies, combined with close monitoring of short-term capital inflows and outflows, is necessary. Receipt of foreign direct investment, which has an effect of increasing foreign currency reserves and stabilizing international balance of payments, is also important from the point of view of reducing risks of crises.

When accepting foreign direct investment, long-term perspectives are essential because a supply of skilled workers and industrial infrastructure improvement are needed.

2) Receipt of foreign direct investment has an effect of expanding the international trade of the recipient country. Japanese corporations that expanded to Asia initially manufactured goods for the Japanese domestic market, but gradually shifted the focus of their production to local consumption and exports. Imports of materials and parts form Japan, as well as exports of parts and finished goods to Japan, Europe and America increased, and expanded international trade. Japan's international trade, of which trade with the United States accounted for an overwhelmingly large share, began to see increasing diversity and growing percentages being claimed by NIES, ASEAN

and such East Asian countries as China as the progress of local production. Regarding the impact of foreign direct investment on international trade, research has been accumulating in investor countries. It has been proven that a co-relation exists in many industries between the activities of overseas subsidiaries and exports to the regions where such subsidiaries are located, that a positive co-relation exists between overseas production and exports from the regions, and that foreign direct investment has a positive effect on international trade in the electric machinery, and general and precision machine industries.

3) Receipt of foreign direct investment has an effect of improving the quality of international trade, as well as expanding international trade. In many instances, corporations that make foreign direct investment improve the facilities and equipment of local manufacturing plants and boost their functions as they gradually shift their production to high added-value products. Japanese precision machine makers and electric appliance makers are moving in the direction of manufacturing high added value models in Southeast Asia and exporting them.

Chapter 4: Specific Examples of Policies to Attract Foreign Direct Investment and the Verification of their Effectiveness

(1) Cases of Policies to Attract Foreign Direct Investment and the Verification of their Effectiveness

Recipient countries of foreign direct investment provide a variety of preferential treatments and conduct PR activities to lure foreign direct investment by top-grade international corporations, and the effectiveness of such programs has been recognized. However, there is competition among countries in attracting foreign direct investment. It is therefore necessary to devise new measures to attract investment, including preferential treatments that are built on the "liberalization of international trade and investment," which has become the dominant international trend.

First, several cases are introduced in which efforts were made to attract foreign direct investment by top-grade international corporations.

Japan's foreign direct investment in North America exceeded $1 billion in the fiscal 1978, and continued to grow at a healthy pace in subsequent years. Major reasons for this growth were an economic expansion in the United States and a stronger yen, which reduced investment cost. These two factors thus induced investment. There was also a decision by Japanese corporations to strengthen their manufacturing systems in the United States against the backdrop of a growing trade friction. What should not be overlooked also, however, were the attempts by states within the United States to actively bring Japanese corporations during this period. In Asia, too, the Philippines approved an investment preferential program as a special measure and provided an income tax cut when Ford of the United States built an automobile assembly plant in 1998. It also makes focused efforts to attract foreign corporations by narrowing the target industries to semiconductor wafer makers, for example.

Japan's foreign direct investment in the Philippines, which amounted to $381 million in the 1998 fiscal year, when this policy was adopted, rose to $637 million in the 1999 fiscal year, and reached a record $791 million in the 2001 fiscal year.

Japanese parts makers moved in to Thailand around 1995 with an expansion of operations by Japanese corporations, including automakers. At the same time, investment in such raw material industries as steel was also prominent. Behind this background, however, were the steady efforts made by the Thai government to attract corporations by, for example, sending an investment attraction mission to Japan to hold orientation meetings on investment in Thailand.

Japan's foreign direct investment in Thailand was $1,240 million in the 1995 fiscal year, when this program was in force. It grew to $1,403 million in the 1996 fiscal year, and reached a record $1,867 million in the 1997 fiscal year. Japan's investment in Thai transport machine industry (actual external direct investment by industry, in yen) jumped from ¥11.9 billion in the 1995 fiscal year to ¥54.6 billion in the 1997 fiscal year.

As these examples show, programs to attract foreign direct investment are being used by a number of countries. They appear to be highly effective to the extent determinable, based on the observation of the changes in the amount of foreign direct investment made by Japan.

The main bodies that make foreign direct investments are not governments but corporations. Accordingly, activities to attract foreign direct investment must be designed to communicate the merits of investment to a wide audience of major foreign corporations. Furthermore, the important thing about measures to attract foreign direct investment, which are used in many countries, is continuity.

A comparison of the cumulative amount of Japan's external direct investment between 1994 and 2003 with that of Japan's external direct investment made over the preceding ten year period reveals that investment increases in the electric appliance and automobile industries were exceptionally high, with the electric appliance industry posting a 2.3-fold increase, and the transport machinery industry posting a 2.6-fold increase (compared with a 1.9-fold increase in the manufacturing sector, and a 1.3-fold increase in all industries). In these two industries, international division of labor is widely practiced after having gone through a change from vertical division of labor to horizontal division of labor, and a change from the division of labor across industries to division of labor within an industry, and further on to division of labor within a corporation. In these industries, the concept of local production penetrates relatively easily compared with other industries. Recipient countries of foreign direct investment can thus hope to attract foreign direct investment more readily by offering active support and improving infrastructure. Conversely speaking, however, a race to attract foreign direct investment and comparison of labor cost among recipient countries can be said to have fueled increasingly intense competition.

For receiving re-investment in these two industries in which Japan makes sizable external direct investment and also for industrial integration, additional aids and

continued improvement of infrastructure are important. In addition, it is important to study ways to attract new industries so as to increase the amount of future foreign direct investment to be received.

For example, the cumulative investment amount by the Japanese machinery industry over the 1994-2003 period grew only 1.3 folds over the preceding ten-year period. This cumulative amount of investment is small compared with the electric appliance and transport machine industries, and the rate of growth is also slow. In particular, the machine tool industry lags behind the automobile and electric/electronic industries with respect to local production in consumer markets. Overseas production centers are limited in numbers and the major ones are still in Japan. One of the major reasons for this situation is that there is an order-made element to the production as revisions are added upon request by users instead of relying on mass production. Another reason is that experience-based skills are required for adjustments and finishing of machinery. This means that same quality products cannot be made unless workers are given adequate training.

Attracting these industries is much harder than attracting electric appliance or transport machine industries. Conversely, it is meaningful to pursue these industries at policy levels because of limited competition. One possibility may be to spend time to construct the foundation for receiving investment, such as by raising the education standards of the people and training skilled workers.

Study of ways to attract not only manufacturing companies but also non-manufacturing companies is also important. Unlike the manufacturing industry, international transport of finished products is difficult in the non-manufacturing industry. Foreign corporations thus have to build production centers directly in consuming countries. Countries with relatively high labor cost and those in which labor cost is rising are less competitive for attracting foreign corporations to build manufacturing plants. These countries should therefore find it easier to attract non-manufacturing companies.

As these examples indicate, countries should devise programs that capitalize on their uniqueness and strengths when attempting to attract foreign direct investment.

(2) Suggestions about Policies to Attract Foreign Direct Investment

1) Measures taken by recipient countries of foreign direct investment to attract foreign direct investment by top-grade international corporations and their PR activities have been found to be quite effective. In the background of an expansion in Japan's foreign direct investment in North America are energetic efforts on the part of state governments of the United States to attract Japanese corporations to their states. Similarly, policies to attract corporations were present in Asian countries in the background of an increase in Japan's foreign direct investment in NIES and ASEAN. Because of the effectiveness of these policies to attract foreign direct investment, countries must devise programs to communicate to major corporations of the world the merits of investing in their countries, and ensure continuity of such policies.

2) The recent growth in the amount of Japan's external direct investment is most prominent seen in the electric appliance and transport machine industries. The main reason for this increase is the fact that local production can be easily expanded, due to the progress of international division of labor in these industries. However, competition among recipient countries of foreign direct investment has grown intense. Assistance for encouraging re-investment and industrial integration, as well as continued infrastructure improvement, is important. There has thus arisen a need for a new perspective, which is to examine the possibility of attracting new industries, such as the machine industry. While attracting these industries may be difficult on hand, the reverse side of the coin is that competition is limited. Countries should consider taking time in attracting foreign corporations by taking such steps as training experienced workers. Furthermore, it is equally important to consider attracting non-manufacturing companies in addition to manufacturing companies. Countries with relatively high labor cost and those in which labor cost is rising are less competitive in inducing foreign corporations to build manufacturing plants. To these countries, attracting non-manufacturing companies should be an easier alternative.

Based on the analytical results about the current status of Japan's external direct investment, this report has made suggestions about what should be feasible while keeping in mind the emerging market economies of APEC countries. At the same time, it pointed out the fact that receipt of foreign direct investment has such effects as contributing to the growth of industries through such means as the transfer of leading-edge technologies that are possessed by top-grade international corporations; reducing risks associated with inflows and outflows of short-term funds; and expanding international trade and improving its quality. These suggestions may not be viewed to be generally applicable considering that individual countries and regions are in different stages of capital liberalization. Nevertheless, Japan's history of external direct investment since the days of regulatory relaxation and its history of international trade and capital transactions with foreign countries should serve as useful information for policies for the emerging market economies of the APEC countries.

As stated in this report, the merits of accepting foreign direct investment are large. It would therefore be highly meaningful for countries to take positive steps toward capital liberalization in a "sequence" that they deem to be proper. At the same time, advanced countries of the world, including those in Europe and America, as well as Japan, are already in a period of competition regarding fund inflows from top-grade foreign corporations. Efforts to make one's country an attractive market to foreign corporations are desired.

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