## 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.