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MAJOR DETERMINANTS AND POTENTIAL IMPACTS OF FDI ON JAPAN'S ECONOMIC GROWTH

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Abstract *As in the last years there has been observed a relative growth in the levels of inward FDI inflows in Japan, the aim of the present paper is to analyze the beneficial role of the Japanese inward investment for the country's sustainable economic development. In our research, we will focus on revealing the main determinants that have contributed towards this increment in inward FDI, pointing out the comparative advantages of Japan over the other developed countries (national investment-friendly policies, political stability, technological infrastructure, etc.). Furthermore, the analysis will underline the potential political measures that Japanese government may undertake in order to further increase the FDI inflows in the country, highlighting also the potential risks for the sustainable growth.*

Key words:
FDI inflows, comparative advantage, technological infrastructure

JEL Codes:
E, E02, E22, F21, O, O11, O38

1. Introduction

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

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

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

2. Short overview on FDI theory

There are many theories which attempt to explain the determinants of FDI. According to trade theory (Helpman, 2006) the direction and magnitude of capital flows is determined by differences in factor proportions among countries, which cannot be addressed by international trade. According to this theory, a difference in factor proportions, say, between two countries, stimulates an adjustment of real exchange rates between them and consequently encourages countries with abundant capital and labor shortages to implement FDI into countries in the opposite situation. In this case, FDI functions as one way to bridge an inter-temporal gap of capital demand and supply, and, like other capital inflows, increases the production frontier of host countries, which are experiencing a need to increase their capital. Other theories (Krugman, 2000) sustain that FDI has many features that distinguish it from other forms of capital inflows, such as loans and portfolio investments, the particularity of FDI being that it involves not only a transfer of resources but also the acquisition of control. Thus, the determinants of FDI can be affected by factors which concern multinational firms' motives to extend controls beyond country boundaries. This also helps to explain the actual movements of FDI, which are not always consistent with the direction implied by the law of factor proportions.

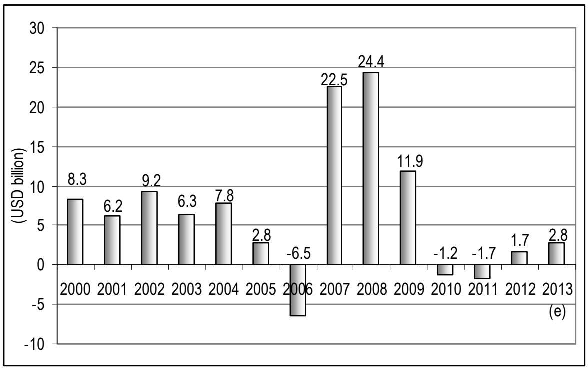
Taking into consideration those theories, our analysis aims to respond to one particular question: what is the case of Japan regarding the major determinants of FDI flows?
A detailed examination of trends of inward FDI and their impact on the Japanese economy shows the evidence that, although historically much less open to foreign trade and investment than other developed economies, Japan experienced a marginal value of FDI inflows around the turn of the millennium. The profound changes in Japan that made this jump possible it's represented by foreign firms' potential contribution to productivity and overall economic growth. This tendency allowed Japan to embrace fully, and therefore benefit substantially from globalization.

3. General outlook of FDI inflows in Japan and impact of the crisis

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

Graph 1. FDI inflows in Japan, 2000 -2013

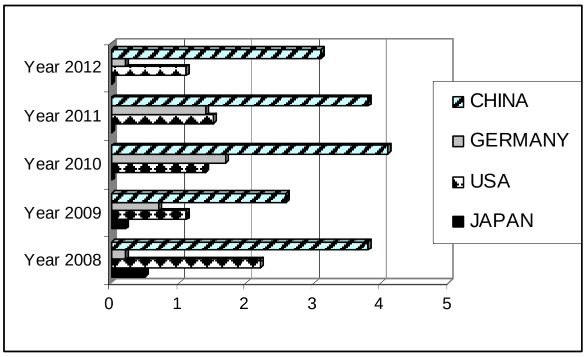
(-USD billion-)



Sources: UNCTAD (2013), UNCTAD (2014)

As shown in the Graph 1, the FDI inflows in Japan rose dramatically starting with 2007, than, after a sharp decline in 2009, due to the negative effects of financial crisis, for two other successive years it has recorded a net divestment. Beginning with 2012, the trend turned positive again, though the inflows were relatively small. According to preliminary estimations of UNCTAD (2014), in 2013, an upturn in M&A sales helped FDI inflows to Japan and they rose by almost 61% (Table 1), reaching USD 2.8 billion. Albeit Japan's potential appeal is strong comparing with other developed countries, according to the illustrated figures, its performance in terms of FDI reception was very weak in the years following the economic financial crisis, endorsing the outcome that of late the country didn't fully exploited its foreign investment potential for capital formation (UNCTAD 2012).
Even if they have increased during 2007 - 2009 (as shown in the Graph 1), Japan's inward FDI as percentage of GDP is still ranking the lowest position among other major developed countries (see Graph 2).

Graph 2. FDI inflows as % of GDP, 2008 -2012
%



Source: OECD, 2013

Thus, within traditional "triadic" - consisting of EU, USA and Japan – when compared with USA and EU (the main FDI world receptor), Japan share's in global inward FDI - that was on average 1% prior crisis - does look insignificant. Although the FDI to Japan increased in the last two years, its stake in world's FDI inflows declined even further.
As stated in the literature in the field (Paprzycki, Fukao, 2012), the financial crisis of East Asian countries has again played up the importance of FDI as a source of capital inflow directed to the countries in the region, including Japan.

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

(-%-)

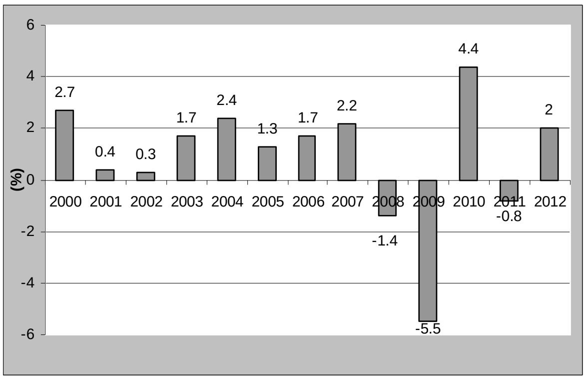
Region	2007	2008	2009	2010	2011	2012	2013	Growth rate 2012-2013
EU	42.9	30.0	29.5	26.9	26.7	19.1	19.6	38.1
USA	10.8	17.0	11.8	14.0	13.7	12.4	10.9	-4.8
Japan	1.1	1.3	0.9	...[1]	...[1]	0.1	0.2	60.7

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

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

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

Graph 3. Japan's annual growth rate, 2000-2013
-%-



Source: UNCTAD database

4. Major determinants of FDI in Japan

As in terms of inward FDI, in the last years on the Japanese market it was noticed a net predominance of large developed countries (JETRO, 2013), the fact may suggests that major motivation to invest there is market seeking, companies looking to develop their activities into markets similar to their own, or protect their domestic market from foreign competition.

Considering the dimension of the market and the presence of various multinational firms, in Japan there is a great availability of capital resources and intangible assets such as technological knowledge and marketing expertise that can be useful to establish foreign production to meet consumer demand in the host country. Also, considering the fact that presently Japan can provide highly educated labor force, since government policy has encouraged constantly education and R&D, this can be considered a comparative advantage for multinationals that seek to develop high innovative business. Friendly policy measures toward FDI have been developed recently in Japan consisting in reforms in the financial, communication and distribution sectors that have encouraged foreign investments in those industries. Another input for FDI attraction is represented by the re-examination and simplification of Japan's Company Law, measure that have provided a better access for foreign investors. Also the cultural factor of traditional respect for engagements, has determined a high security of foreign investments since Japan has never been involved in any case of disagreements concerning FDI and, to the present, bilateral disagreement have given rise to no expropriation. However, supplementary measures may be undertaken by national authorities related to facility lease fee, equipment costs and promoted in form of subsidies for initial investment of global companies in Japan. The key incentives for direct investment in Japan could be represented by technology, brand & expertise existing on national labor market that could be fully exploited by companies investing in information communication technologies and other knowledge intensive industries.

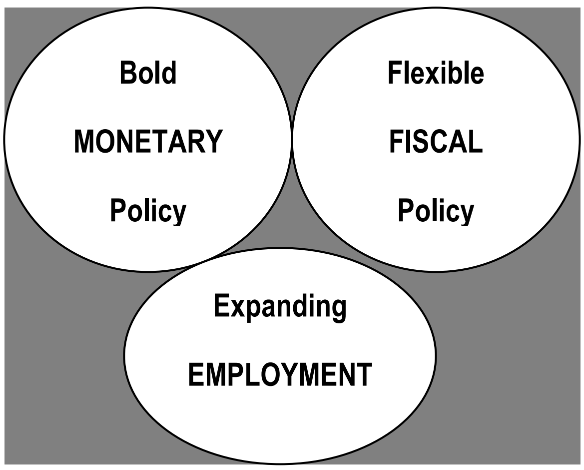
5. Potential risks of FDI growth for Japan

As some analyst have shown (Assaf, Efraim, Chi-Wa, 1999), through FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This fact provides them an informational advantage over "uninformed" domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high-productivity firms under their ownership and control and sell low-productivity firms to the uninformed savers. As with other adverse-selection problems of this kind, this process may lead to overinvestment by foreign direct investors. Excessive leverage can also limit the benefits of FDI. Typically, the domestic investment undertaken by FDI establishments is heavily leveraged owing to borrowing in the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by foreign-owned firms. Recent work has also cast the evidence on the stability of FDI in a new light. Though it is true that the machines are "bolted down" and, hence, difficult to move out of the host country on short notice, financial transactions can sometimes accomplish a reversal of FDI. For instance, the foreign subsidiary can borrow against its collateral domestically and then lend the money back to the parent company. Likewise, because a significant portion of FDI is inter-company debt, the parent company can quickly recall it. There are some other cases in which FDI might not be beneficial to the recipient country - for instance, when such investment is geared toward serving domestic markets protected by high tariff or non-tariff barriers. Under these circumstances, FDI may strengthen lobbying efforts to perpetuate the existing misallocation of resources. There could also be a loss of domestic competition arising from foreign acquisitions leading to a consolidation of domestic producers, through either takeovers or corporate failures. Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on host countries. For Japan there are also some other potential risks: FDI can be reversed through financial transactions and a high share of FDI in total capital inflows may reflect its institutions' weakness rather than their strength.

6. National policy measures to promote FDI

Although Japan has eliminated most of the formal restrictions related to the FDI inflows that were put in place in the 1970s, investors continue to criticize the barriers that impede foreign penetration of the market. Restrictive market practices such as a closed distribution system, cartel-like behaviors and entrenched arrangements that make it difficult for new entrants to compete in terms of product, service and price, are frequently mentioned as impediments that are particular to Japan. In order to further encourage FDI in Japan, government could offer subsidies covering half of the expenses for small firms and a third of the expenses for the medium and large ones. Such measures would prevent the domination of very large multinational on the market, hence eliminating the risk of capital reversion. Current Abenomics Programm may also contribute on fostering FDI by three essential pillars: monetary policy, fiscal policy and measures to increase employment.

Figure 1. National Strategy to boost FDI



Source: Own synthesis based on literature in the field.

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

7. Conclusions

Over much of postwar period, and even through the 1970s and 1980s, inward foreign investment was not a priority for Japan, but in the light of the negative effects generated by the economic and financial crisis, Japanese authorities had to reconsider the potential benefits of inward FDI to boost economic growth. As shown in our previous analysis, FDI can play a fundamental role in revitalizing economic growth. Like others economy in the region, Japan's economy depends on FDI for a crucial part of its net capital inflows. FDI positive impact is helping to create jobs, boost national and regional development and also can contribute decisively to fostering competitiveness. Presently, FDI in Japan is focused in the form of global alliances with capital tie-ups between companies in the same industry, to survive tough international competition. Traditionally, Japanese corporations have found such partners mainly among American and European firms, but recently there have been a growing number of partnerships with Asian firms. In particular, there has been increased investment from Chinese firms that recognize the value of the technologies, brands and expertise held by Japanese firms and is aiming to obtain these business resources. Nevertheless, since the total share of FDI inflows as percent of GDP is still low in Japan, compared with other "powerful economies" as USA, Germany and China, various policies and measures will be needed for encouraging foreign corporations to invest in Japan. There are some particular industries, as for example, low carbon industry that have an important potential in attracting FDI (according with national statistics, in 2010, the field of the green-industry was one of the most active fields in terms of entries made by foreign firms). In order to further encourage such positive trend, Japanese government should implement more location-based subsidiary program to encourage industries with many revolutionary low-carbon technologies to locate their operation within Japan. Furthermore, since Japan's ICT infrastructure was rated the best among 24 major countries and regions, taking into consideration such factors of broadband usage fees and speed, more measures two support and encourage new FDI in the field are necessary. In our opinion, the Japanese government measures for promoting investment should focus on discounts in form of reduction of taxes, guarantees on loans and loans with reduced rates.

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