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U.S. DIRECT INVESTMENT IN JAPAN: ANOTHER DIMENSION OF THE ECONOMIC RELATIONSHIP[1]

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Many economic forces create barriers to foreign direct investment in Japan — excess domestic savings, low rates of return on capital, an appreciating currency, high costs, geographic distance from potential investors and cultural distance in business practices. Added to these impediments are others erected by government and business that reduce the effectiveness of measures used elsewhere to break into local markets, such as mergers and acquisitions. However, there also are strong incentives for investing in Japan — an economy that is the world's second largest and average incomes ranked among the leaders, the opportunity for foreign firms to take advantage of their specialized skills and efficiencies in high-cost, unproductive Japanese industries, and the need to be on the spot to service local customers.

The balance of these forces has kept foreign investment in Japan very low by world standards, but this situation is changing gradually. Japan rose from ninth as a target for U.S. foreign direct investment in 1980 to fourth in 1995. These investments of some $40 billion generated almost $100 billion in sales in 1994 and another $10 billion in exports from the United States. The rate of return on capital invested in Japan has averaged about the same as foreign investment elsewhere by American firms, which is slightly higher than the returns to domestic investment in the United States and considerably above the rates earned by foreign companies in their own countries or in the United States.

U.S. direct investment in certain industries in Japan has been growing quite rapidly. America's innovative strength in software is reflected in that area tallying the largest number of U.S. investment activities in the last year or so. Liberalization of regulations restricting retail trade has had a positive effect in attracting American retailers and merchandisers; they have been as innovative as software developers in pioneering new approaches to marketing. If deregulation continues as proposed by official rhetoric and in political platforms, the prospects for profitable American direct investment in Japan could be quite significant in areas as diverse as finance, transportation, retailing and telecommunications.

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Strong Disincentives To Foreign Investment

Investing from abroad in Japan is like water flowing uphill. So many forces act to retard the flow that strong incentives are required to overcome them. For starters, domestic savings are more than sufficient for local investment requirements; in fact, since 1980, Japan has exported its excess savings to the rest of the world in the form of persistent current account surpluses. As a result of large, cumulative domestic investments, economywide average rates of return on capital had fallen to an estimated 3.9 percent in 1990 — 30 percent below comparable American returns. Japan, therefore, is not the place to embark on a broad search for high returns.

One of the major incentives for foreign direct investment is to locate production in low-cost countries. On these grounds, too, Japan falls short, as its unit labor costs in manufacturing are among the highest in the world. The American Chamber of Commerce in Japan lists the high cost of doing business as the number-one factor inhibiting inward investment.

Another cost-related barrier is the exchange rate. It pays to produce a product for local sale or reexport in a host country whose currency is depreciating rather than in one with an appreciating exchange rate, since that penalizes exports. Here as well, the incentives act in the wrong direction. The long-term appreciation of the yen favors Japanese production in the United States but works against U.S. production in Japan.

An additional disincentive to American direct investment in Japan is the fact that some of the strongest U.S. industries face equally strong, productive and technologically advanced competitors there. This is especially true in motor vehicles and certain sectors of the semiconductor and electronics industries. However, as discussed below, this is not the case across-the-board. And, even where the competition is particularly strong, American companies often have products or niches that are dominant.

The empirical literature on foreign direct investment cites similarities in business practices and culture as promoting this activity, whereas cultural and physical distance acts as a deterrent. Economists studying the subject note that potential investment targets with "low information costs" "bulk disproportionally large as destinations for U.S. FDI."[2] The typical overseas expansion sequence for an American company starts with Canada and proceeds to the United Kingdom, Germany, Mexico, Australia and France. This

[2]Richard E. Caves, *Multinational Enterprise and Economic Analysis* (New York, New York: Cambridge University Press, 1996), p. 52.

pattern repeats itself for other countries. French companies go first to French-speaking countries and then to adjacent European neighbors. Australian businesses invest disproportionately in New Zealand. Italian enterprises start with neighboring southern European countries and go on to countries with heavy immigration from Italy. Measured by this yardstick, Japan is light-years away from the United States along many of the dimensions of business culture.

Positive Incentives For FDI In Japan

Despite the many obvious barriers to American direct investment in Japan, there are also positive attractions that often overcome the impediments. The most important of these also turns out to be the single most important factor promoting FDI anywhere: firm-specific assets that yield high returns to the company possessing them and that make it difficult to realize these returns by way of exports or licensing other companies to produce the products.[3] Such assets include design, production or styling knowledge that gives a firm's products special cost or other edges. They also span marketing and selling skills as well as trademarks and brand names.

A powerful correlate of FDI is the volume and the quality of a company's research and development, which often produces special knowledge that is difficult to transfer to others. Since American companies are the most productive in the world and among the most innovative, their store of specialized knowledge is the most powerful source of advantage in the Japanese market.

Despite the well-known competence of Japanese companies in several familiar industries, on average Japan lags the United States in overall productivity and technological prowess. In several industries U.S. competitors are more than twice as productive, and they have developed innovative products and processes for producing them. For example, innovations in retail formats (so-called category killers) in areas as diverse as office supplies, toys, building products and recorded music have put American retailers in top positions worldwide. Similarly, the invention of the concept of financial derivatives ranks in economic importance with many of the innovations in electronics that often are used as metaphors for technological advance. American financial services providers are uniquely qualified to expand their presence in the Japanese market with the products and the experience they have cultivated in the hotbed of Wall Street.

Many industries in which American businesses are trailblazers, such as retailing, finance, telecommunications, entertainment and Internet products (among others), have been regulated in Japan, and local rivals consequently suffer from high costs and low levels of innovation. That offers enormous opportunities for American firms. However, the very factors that have kept these industries uncompetitive in Japan also restrict the entry of newcomers, foreign or domestic, that have new products and services. As the government gradually has deregulated parts of the economy, American firms have been able to take advantage of their specialized assets. Although progress is often slow, cumulative change is producing substantial movement. Over the next decade this trend could accelerate.

In addition to specialized, difficult-to-transfer assets as a source for FDI, locational advantage is the other major incentive to establish activities in several places. In other words, being there matters. This situation is obvious where high transportation costs penalize exports from a home country. However, many other locational factors also influence investment decisions. First among these is the fact that Japan's economy is the second largest in the world; its standard of living and industrial capabilities make it an obvious target for American companies. Being better able to service users and consumers is one of the most common reasons for locating in Japan, since it often is necessary to tailor products to particular local requirements. This consideration also gives rise to the establishment of in-country design and development facilities.

A country or a region often possesses specialized technical skills that can enhance the products of a foreign firm. Since Japan is the second-biggest spender on R&D behind the United States and is especially strong in industrial technologies, many American companies have

[3]Richard Caves of Harvard University, who described the concept of "firm-specific assets," notes that no single phrase captures the essence of the term. He suggests as alternatives "proprietary assets" or "intangible assets." *Ibid.*, p. 3.

located in Japan to take advantage of such skills in both production and research across a broad array of industries and technologies.

Aggregate Long-Term Trends

Despite the presence of powerful forces that discourage FDI, equally powerful incentives encourage a foreign presence in Japan. Although the positive forces have been growing in relative strength, foreign direct investment in Japan has been notoriously low by international standards. For example, a FY 1993 Ministry of International Trade and Industry survey of companies with at least one-third foreign equity interest showed a total foreign asset position of ¥10.2 trillion ($94.7 billion at FY 1993's average exchange rate of ¥107.85=$1.00). This amount was only one-sixth the value of FDI in the United States. In fact, the total foreign position in Japan was less than just Japan's investment position in the United States. The impediments to inward direct investment in Japan noted above would be sufficient by themselves to keep the numbers low, but several additional formal and informal measures reduce the actual figures even further. Some of the more important involve laws, regulations and business relations, such as widespread cross-shareholding, that restrict mergers and acquisitions.

American companies' direct investment position in Japan ranks a surprising fourth in the league tables of countries targeted by U.S. multinationals. According to Department of Commerce surveys, Japan trails only the traditional destinations for U.S. direct investment — the United Kingdom, Canada and Germany.[4] In the past 17 years Japan, as a location for American equity capital (defined as a shareholding of 10 percent or more), has moved ahead of Belgium, France, Australia, the Netherlands and Switzerland. U.S. direct investment surged into the United Kingdom in the late 1980s, as American firms sought a position in Europe's common market. The Canadian volume of U.S. direct investment stagnated, meanwhile, because the U.S.-Canada free trade agreement allowed goods and services to pass more freely across borders without requiring the direct presence of an American company.

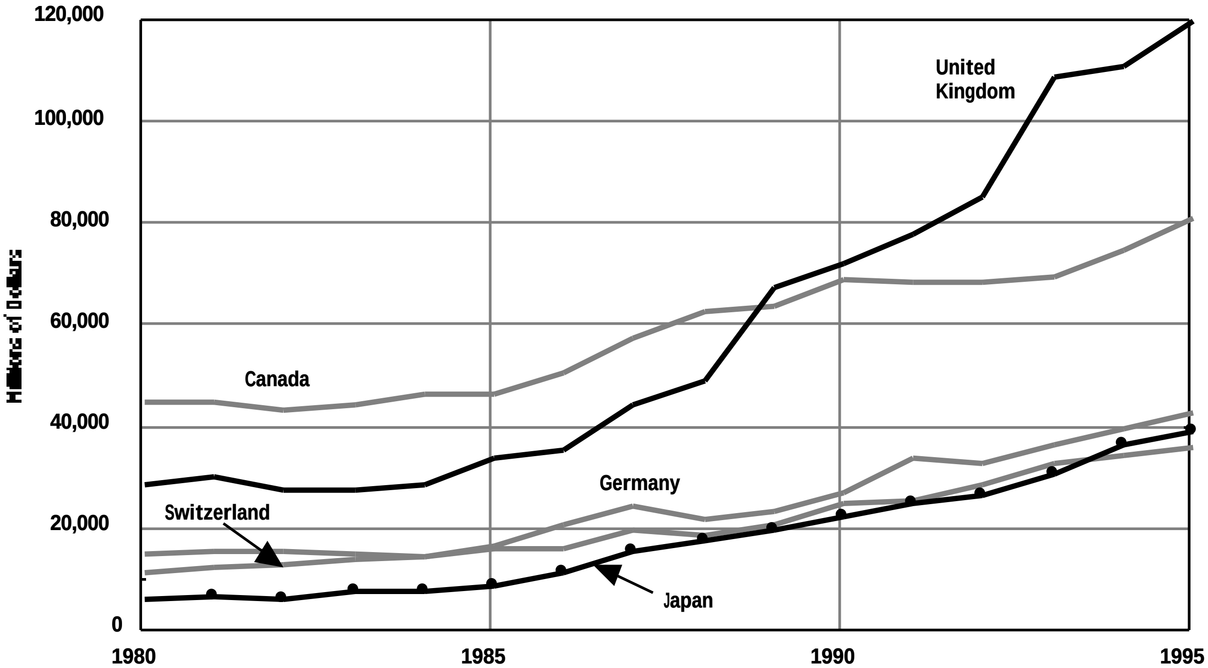
From ninth position as recently as 1980, Japan charged into fourth place in the 1990s in this country's FDI rankings (see Figure 1 and Table 1). While total U.S. direct investment abroad grew at a respectable annual rate of 8.3 percent from 1980 to 1995, the stock of investment in Japan expanded more than six times, or 13 percent annually, to almost $40 billion and is now closing in on the figure for Germany. Nevertheless, equity investment from all sources in Japan is tiny compared with Japan's outward flow of capital. Still, American investment there is large in absolute size, it is growing rapidly and, perhaps most important, it offers high returns.

The desire to invest in Japan is strong. Not only is its economy number two in the world and the standard of living among the international top 10 but income also is distributed evenly across the population. Moreover, growth rates, while considerably slower than in the past, likely will average around 2 percent annually in the future — about the same as in other developed economies. Additionally, technology and productivity are distributed unevenly across sectors. This means that profitable opportunities exist for foreign companies that have developed innovative products, services and methods elsewhere.

Both inward and outward foreign investments now are reported to the government through an informal notification system. Figures collected by the Ministry of Finance record only original investment amounts. Among other methodological discrepancies, the statistics differ from Department of Commerce numbers because they do not include reinvested earnings. On this basis cumulative U.S. direct investment in Japan since 1950 totaled $15.6 billion as of March 1996. From FY 1988 through FY 1995 U.S. inward investment averaged $1.4 billion a year. A total of 463 transactions involving American capital were reported in FY 1995. The typical investment was more than $4 million, up substantially from the

[4]The Department of Commerce reports foreign direct investment by country on a historical-cost, or book-value, basis. In most cases this is the initial acquisition cost of the foreign property. Consequently, the figures are not adjusted over time for changes in either prices or the market values of holdings. However, historical-cost accounting does include equity flows, loans and reinvested earnings. Unfortunately, FDI on a current-cost or market-value basis is not estimated for individual countries. For a discussion of the concepts of historical cost, current value and market value, see Raymond J. Mataloni, "A Guide to BEA Statistics on U.S. Multinational Companies," *Survey of Current Business*, March 1995.

Figure 1: U.S. Foreign Direct Investment, Historical-Cost Position, 1980-95



Source: Department of Commerce

Table 1: **U.S. Foreign Direct Investment, 1980-95**

(in millions of dollars, historical-cost basis)

Year	Total	Japan	Canada	Germany	Switzerland	United Kingdom
1980	$215,578	$6,243	$44,978	$15,418	$11,280	$28,605
1981	226,359	6,755	45,129	15,840	12,509	30,260
1982	207,752	6,407	43,511	15,463	12,863	27,537
1983	212,150	7,661	44,339	15,319	14,099	27,637
1984	218,093	7,936	46,380	14,794	14,865	28,635
1985	238,369	9,095	46,435	16,746	16,230	33,963
1986	270,472	11,472	50,629	20,932	16,441	35,389
1987	326,253	15,684	57,783	24,388	19,665	44,512
1988	347,179	18,009	62,656	21,832	18,734	49,459
1989	381,781	19,911	63,948	23,673	21,144	67,722
1990	430,521	22,511	69,106	27,480	25,151	72,543
1991	467,844	24,938	68,853	34,027	25,604	78,072
1992	502,063	26,591	68,690	33,003	28,698	85,176
1993	564,283	31,095	69,922	36,811	33,056	109,208
1994	621,044	36,677	74,987	39,622	34,351	111,255
1995	711,621	39,198	81,387	43,001	36,342	119,938

Source: Department of Commerce

$500,00 average of 1980. This growth indicates an expanding scale of business activity in Japan. Today American companies are more likely to be investing in substantial facilities than in the simple representation offices of 17 years ago.

Sales And Exports Of U.S. Affiliates

The sales of majority-owned U.S. affiliates in Japan amounted to more than $97 billion in 1994, the latest year for which Commerce data are available. Exports from the United States to these affiliates added up to over $10 billion, while imports were $2.8 billion.[5] Most of this trade was between affiliates and parents. These results — that exports are positively associated with FDI — are consistent with the research on the relationship between trade and foreign direct investment. A recent study by Edward M. Graham of the Institute for International Economics in Washington, D.C. finds that exports are positively correlated with FDI. In addition, he notes, "the 'runaway plant' argument is not supported by the analysis" and "the 'pauper labor' argument so often heard in the United States these days is not supported by the results." In contrast to popular beliefs, U.S. direct investment abroad and U.S. imports are more closely associated with high-wage countries than with low-wage economies, Mr. Graham says.[6]

The Commerce survey of American multinationals also found that 90 percent of the sales of U.S. affiliates in Japan were for the local market. "The U.S. market was served primarily by U.S. parents and foreign markets were served primarily by majority-owned foreign affiliates," the report's authors concluded.[7] Thus, as might be expected, American investment in Japan does not serve mainly as a platform for generating shipments back home or to third countries, although the amount of trade U.S. affiliates produce is not insignificant in absolute terms.

[5]Raymond Mataloni and Mahnaz Fahim-Nader, "Operations of U.S. Multinational Companies: Preliminary Results from the 1994 Benchmark Survey," *Survey of Current Business*, December 1996, Table 15, p. 24.

[6]Edward M. Graham, "The Relationship Between Trade and Foreign Direct Investment in the Manufacturing Sector: Empirical Results for the United States and Japan," in Dennis Encarnacion (ed.), *Does Ownership Matter: Japanese Multinationals in East Asia* (London: Oxford University Press, 1997).

[7]*Survey of Current Business* (December 1996), *op. cit*., p. 23.

Sectoral Composition

The sectors targeted by U.S. investors in Japan have changed over time. Figure 2 and Table 2 show these shifts over the 1980-95 period. The share of the petroleum industry, which was more than 40 percent of the total in the 1970s, already was down to 25 percent in 1980. Figures for 1995 put it at 16 percent, as most new investments went into other areas. Manufacturing also declined from its high of 52 percent in 1987; its 1995 share was 9 percentage points below that peak.

Services industries gained the most. Wholesale trade and financial services (other than banking but including insurance and real estate) almost doubled their combined shares from 19 percent in 1984 to 36 percent in 1995. Despite the relative gains of services broadly defined, manufacturing still represents the largest absolute amount of American investment in Japan, with a 1995 value of $16.7 billion.

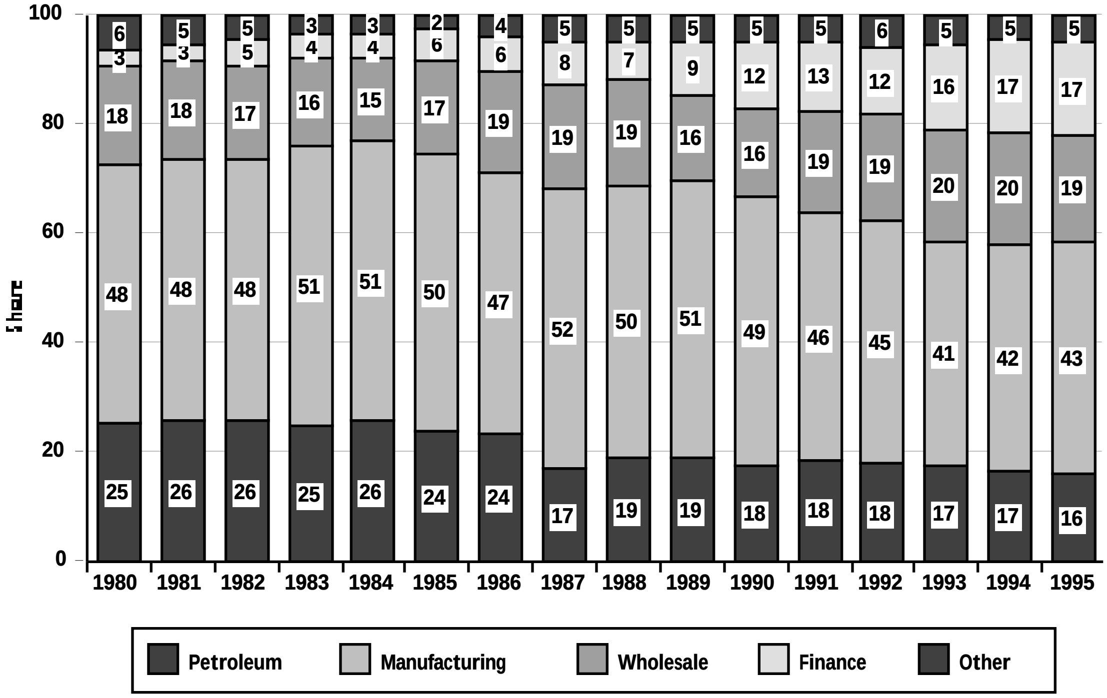
Rates Of Return On U.S. FDI

Why have American companies invested well over $40 billion in Japan? Sales of $100 billion are an insufficient incentive if the returns on FDI in Japan are not competitive with alternative investments. U.S. companies received $4.5 billion in investment income from Japan in 1995, equivalent to an 11.5 percent annual rate of return on the total $39.2 billion capital base reported by Commerce. As Figure 3 and Table 3 show, rates of return, calculated as the ratio of income earned from foreign investment to its book value, in Japan are comparable to worldwide returns.

The rate of return earned on capital that American multinationals invested in Japan averaged 11.2 percent from 1980 to 1995; worldwide returns on this country's FDI were 12.6 percent. Alternative Commerce estimates for the 1983-91 period on a current-cost basis, which adjusts book values for inflation, yield a lower figure of 8.5 percent globally. FDI generated slightly higher returns than the estimated yields on domestic U.S. investment, which averaged 8.4 percent.[8] Moreover, foreign direct investment by

[8]Domestic rates of return were calculated as the weighted average of the long-term interest rate and the earnings-price ratio of shares. See J. Steven Landefeld, Ann M. Lawson and Douglas Weinberg, "Rates of Return on Direct Investment," *Survey of Current Business*, August 1992, Table 1, p. 79.

Figure 2: U.S. Direct Investment in Japan by Sector, 1980-95



Source: Department of Commerce

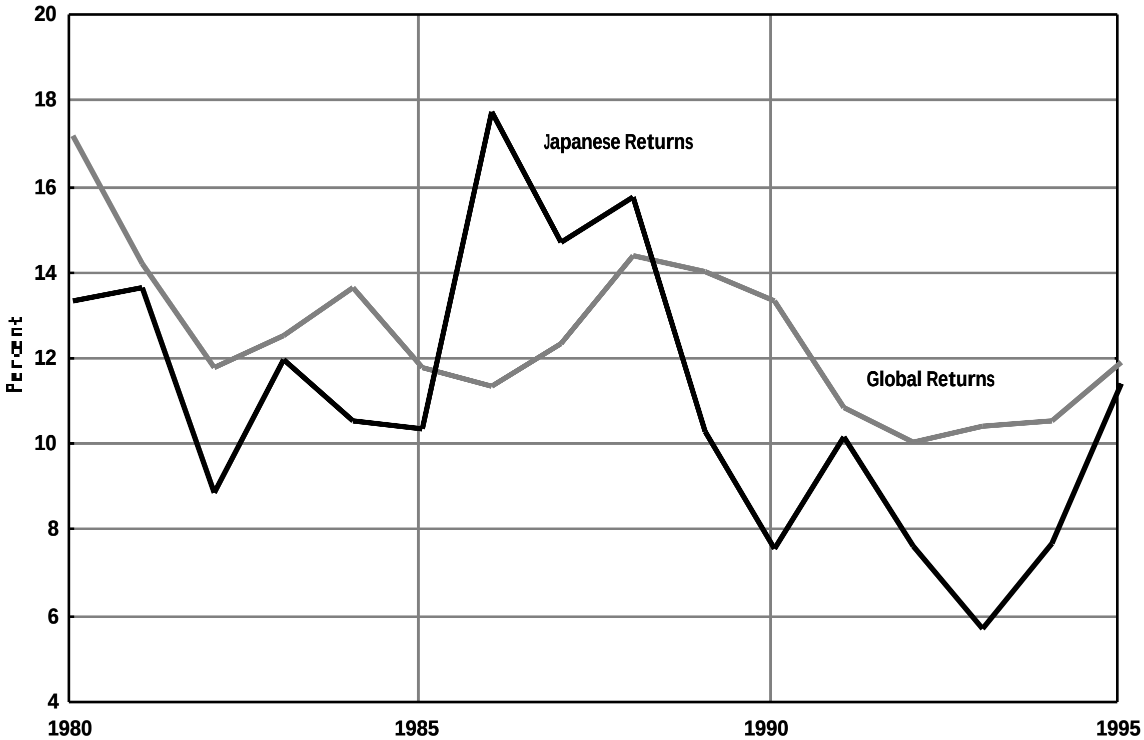
Table 2: **U.S. Direct Investment in Japan by Sector, 1980-95**

(in millions of dollars, historical-cost basis)

Year	Total	Petroleum	Manufacturing	Wholesale Trade	Finance	Other
1980	$6,243	$1,570	$2,971	$1,115	$186	$401
1981	6,755	1,737	3,236	1,215	221	346
1982	6,407	1,650	3,058	1,093	312	294
1983	7,661	1,902	3,915	1,252	325	267
1984	7,936	2,052	4,076	1,196	347	265
1985	9,095	2,184	4,584	1,581	520	226
1986	11,472	2,712	5,439	2,173	686	462
1987	15,684	2,642	8,107	2,933	1,231	771
1988	18,009	3,443	8,929	3,485	1,298	854
1989	19,911	3,776	10,119	3,142	1,879	995
1990	22,511	3,987	11,111	3,535	2,766	1,112
1991	24,938	4,600	11,362	4,623	3,190	1,163
1992	26,591	4,767	11,873	5,129	3,318	1,504
1993	31,095	5,423	12,778	6,336	4,948	1,610
1994	36,677	6,121	15,223	7,400	6,244	1,689
1995	39,198	6,346	16,664	7,561	6,736	1,891

Source: Department of Commerce

Figure 3: Rates of Return on U.S. Foreign Direct Investment, 1980-95



Source: Department of Commerce

Table 3: **Rates of Return on U.S. Foreign Direct Investment, 1980-95**

Year	Global Returns on U.S. FDI	Returns on U.S. Direct Investment in Japan
1980	17.2%	13.4%
1981	14.3	13.7
1982	11.8	8.9
1983	12.6	12.0
1984	13.7	10.6
1985	11.8	10.4
1986	11.4	17.7
1987	12.4	14.7
1988	14.5	15.8
1989	14.1	10.3
1990	13.4	7.6
1991	10.9	10.2
1992	10.0	7.6
1993	10.5	5.7
1994	10.6	7.7
1995	12.0	11.4

Source: Department of Commerce

American companies in the 10 most important destinations for U.S. capital overseas was more profitable than the average 6.5 percent return earned by home-country investors. In marked contrast, foreign direct investment in the United States on a current-cost basis generated returns of only 2.2 percent over the 1983-91 period. In short, U.S. companies make more money abroad than the average local company. They earn slightly more than the average for the United States, and they do considerably better than foreign investors in the United States.

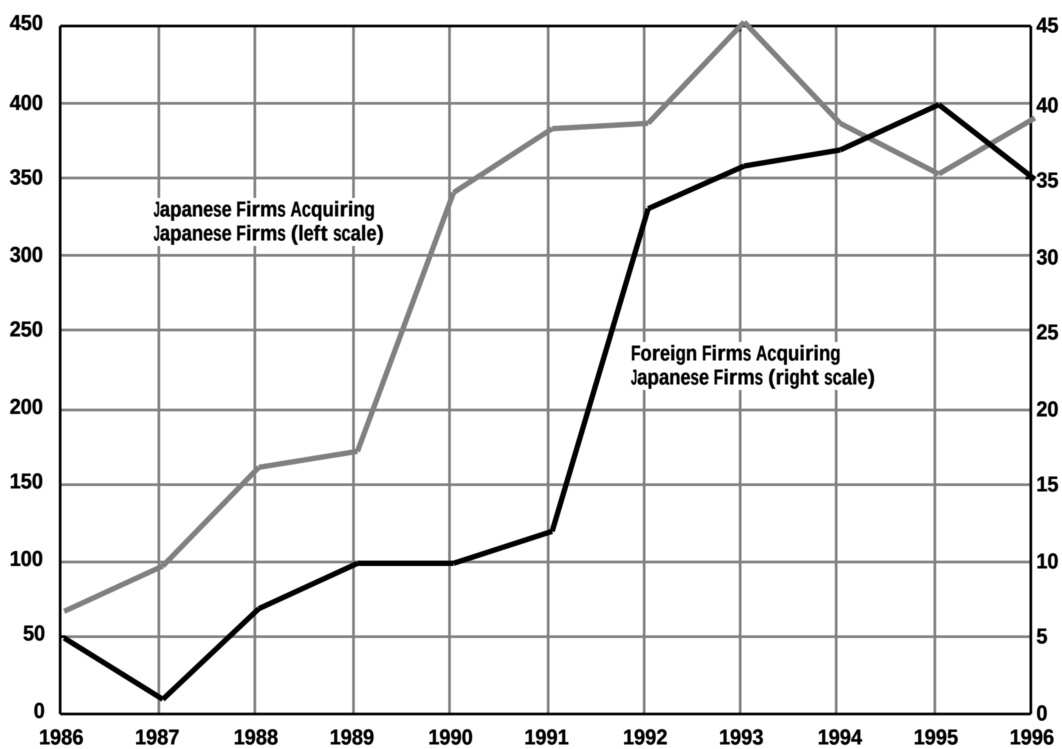
Acquisitions

One method of investment is the acquisition of existing firms. Japan is notable for its low level of mergers and acquisitions, both by domestic and foreign firms. A deliberate government policy in the postwar period removed restrictions on mutual shareholding among Japanese companies, expressly for the purpose of warding off foreign acquisitions. A large proportion of company-owned shares kept significant amounts of stock off the market, making it difficult for unrelated entities to acquire a controlling interest. The policy worked as planned (see Figure 4).

Not only were acquisition-minded foreign companies frozen out of the market but domestic transactions also were held to low levels. Hostile takeovers were virtually unknown. Domestic acquisitions of domestic firms totaled only 392 in 1996, according to Nomura Research Institute.[9] The latest figure, however, was almost six times higher than the number just 10 years ago. The low share prices of recent years and the serious financial predicament of many Japanese companies have made acquisitions more likely than in the past.

The same phenomenon has developed for acquisitions by foreign companies. Whereas only five occurred in 1986 and but a single entry was recorded the following year, more than 30 foreign takeovers of Japanese firms have transpired in each of the last four years. American companies account for about half of these. While not a very active market by U.S. standards, the loosening up

Figure 4: Acquisition of Firms in Japan by Foreign and Japanese Firms, 1986-96



Source: *Quarterly Economic Review* (Nomura Research Institute), XXVII, No. 1, February 1997, p.62.

[9] *Quarterly Economic Review* (Nomura Research Institute), XXVII, No. 1, February 1997, p. 62.

of the takeover field is a noticeable trend in Japan. From 1986 through last year 226 Japanese companies became foreign-owned.[10]

Zooming In For The Details

Just where is this money going? Who is doing the investing? What areas are they emphasizing? A review of the last 12 issues (April 1996-March 1997) of the Japan Economic Institute's monthly *Japan-U.S. Business Report*, which tracks developments involving Japanese businesses in the United States and U.S. activities in Japan, provides some tentative answers to these questions.

The compilation identified 240 activities with some form of investment. Such activities included opening or expanding a subsidiary, enlarging production capacity or opening a service center or office. Licensing agreements, distribution relationships and new product introductions were ignored. Some of these latter actions may have involved the investment of new resources, but the information available in the original sources did not provide such an indication. These cases illustrate the broad perspective of U.S. business investment in Japan. The Appendix lists these activities, classified by sector. An asterisk notes incidents of disinvestment.

Software had the largest number of transactions, accounting for 23 percent of the total; telecommunications, 9 percent. Internet-related activities were associated with 22 transactions in the software and telecommunications sectors. These ventures are at the interface between hardware and services, representing the leading edge of American high technology industry. Their broad representation in Japan, by companies both large and small, is one measure of corporate America's competitive strength.

Another illustration of U.S. productivity and innovation is in the merchandising sector, where 17 transactions were recorded. This retailing penetration runs across-the-board, from catalog stores to large discount centers for products as varied as office supplies and sporting goods. In addition to retailers themselves, the construction and real estate sector included several shopping center developments. The American retail scene is one of the most dynamic in the world; its increasing presence in Japan is consistent with this strength. One development that has permitted the introduction of larger stores is the progressively liberalized regulatory environment backing the Large Retail Store Law, a change that will be discussed in greater detail below.

There is no single path to success in Japan, but some patterns exist in the data. A common approach to investment is gradual immersion in the market. A small representative office initiates the process, often as part of a marketing agreement with a Japanese distributor. Later, expansion of this office into a service and support operation may be justified as the volume of business grows. A full-fledged subsidiary, generally responsible for marketing and sales but sometimes involving local development and production, is a next step. Finally, after the accumulation of sufficient local experience, some companies withdraw from their original joint venture arrangements to go it alone. The Appendix provides examples of all of these actions.

A 1991 survey for the American Chamber of Commerce in Japan revealed that 32 percent of the 300 respondents entered Japan as wholly owned subsidiaries, 28 percent as participants in joint ventures and 22 percent as representative or branch offices. Manufacturers tended to prefer wholly owned subsidiaries or joint ventures, while services companies were more likely to choose branch office status.[11] Whereas manufacturing dominated the number of new entries by two to one in the 1970s, investments in services equaled the number for manufacturing in the 1980s.

Nearly one-third of the respondents changed their form of organization over time, tending to move from branch office or joint venture to wholly owned subsidiary. This pattern is similar to the one drawn from the sample in the Appendix.

The ACCJ survey found that it took three to four years for at least half of the joint ventures to break even on their investments; subsidiaries took

[10] *Ibid.*

[11] American Chamber of Commerce in Japan, *Trade and Investment in Japan: The Current Environment.* (Tokyo: June 1991), p. 29. The study was conducted by A.T. Kearney, Inc.

about two years longer. Within two more years, profit levels reached the average for the United States. Half of all the responding firms exceeded parent companies' rates of return within 10 years, but 27 percent declared that it never would be possible to exceed U.S. numbers. These results at the company level are consistent with the aggregate estimates of returns presented above.

Not all investments pay off. Included in the Appendix's 240 transactions are 15 withdrawals or downsizings. Among these are three delistings from the Tokyo Stock Exchange, plus the sale of a seat on the TSE. In the heady days of the "bubble" economy of the late 1980s, when Japan's stock market was skyrocketing in value, a Tokyo listing looked like a good bet. However, the post-1989 stock market collapse of more than 50 percent and the even greater shrinkage in traded shares reduced the benefits of an active presence on the exchange. Combined with the general backwardness of Tokyo's financial markets, foreign listings have been falling over the last several years. An article for an ACCJ publication listed at least 13 other recent market withdrawals by American financial companies.[12]

The other withdrawals listed in the Appendix represent ventures that did not pan out as expected. Five of the remaining incidents (after subtracting the TSE-related activities) involved the restructuring of the operations of longtime American competitors in the Japanese market; none of these corporations withdrew completely. Four others, though, pulled out or substantially reduced their local presence. No single reason explains their lack of success but, in general, sales did not develop as planned or the costs of doing business in Japan proved too high.

Inward Investment And Deregulation

Government regulation at the industry level in Japan is a major barrier to the entry of new firms, domestic or foreign. The Economic Planning Agency asserts that regulations restrict some 40 percent of the economy. Sometimes these restraints are formal, as in insurance, banking and other financial sectors. In other cases, though, product standards for health, safety or quality that deviate enough from those in place elsewhere constitute a barrier to entry. For example, safety standards are a problem in cosmetics because the Japanese list of approved ingredients differs substantially from American and international counterparts; disputes have arisen over aerosols, liposomes and preservatives. Other regulations were designed explicitly to control domestic competition but have had the effect of limiting foreign entry as well. The monopolies formerly given to a pair of companies for domestic and international telephone services are examples.

All of the major parties vying for seats in the October 1996 lower house elections placed deregulation at the top of their platforms, broadly targeting the regulations that previous generations of political leaders had enacted to favor some group of party supporters. However, since many of these interests remain politically influential, the elimination of protective barriers is up against powerful opposition.

One such barrier protecting a favored political group is the Large Retail Store Law, enacted by the Liberal Democratic Party in 1956 as the Department Store Law to protect small shopkeepers. The 1956 law reestablished restrictions first enacted in the 1930s but suspended during the American occupation.[13] It set tight limits on the size of retail establishments. Building stores with sales floor spaces larger than 1,500 square meters (16,140 square feet) (3,000 square meters or 32,280 square feet in Japan's 11 largest cities) required lengthy and often fruitless hearings before approval commissions dominated by local store owners.

When supermarkets and department stores found ways to get around the size limits, the LDP introduced the Large Retail Store Law in 1974 to eliminate the loopholes. Implementation of the law was assigned to local governments, which introduced their own interpretations. MITI also offered guidance in implementing the legislation. The net result was even tighter restrictions than stipulated in the law; shops over 500 square meters (5,380 square feet) were severely restricted. Even when approval eventually was granted, the process often took a decade or more. Many plans

[12] David C. Hulme, "Financial Flight," *The Journal of the ACCJ*, December 1994, p. 19.

[13] This history is described in Roy Larke, *Japanese Retailing* (New York, New York: Routledge, 1994), Chapter 4.

were delayed for so long that in the end they were abandoned. Other potential entrants never even made the effort, knowing of the long and bitter fights that would be required.

American retailing giants and the U.S. government also viewed the Large Retail Store Law as a major barrier to entry, especially because many of this country's retailing innovations center around large establishments. Toy retailer Toys "R" Us Inc., when planning its entry into the Japanese market, found the law to be the one major impediment that it could not remove on its own. The company requested the Bush administration to bring pressure on the Japanese government in the late 1980s to liberalize the law.

That lobbying coincided with the 1989-90 Structural Impediments Initiative discussions, where the distribution system was one of six areas targeted for reform. Tokyo eventually agreed to liberalize implementation of the Large Retail Store Law by expanding in phases the sizes of stores requiring approval, establishing transparent approval criteria for larger stores, and setting a time limit of one year for a decision.[14]

The process is now routine. The time from first request to groundbreaking for Toys "R" Us is now 18 months, which the company says compares favorably with its experience in other countries and with the 12 months required in the United States. The change in the application of this one law has allowed Toys "R" Us to open more than 50 large stores around Japan. They now are generating close to $750 million in annual revenues.

The regulatory change also shifted forever competitive relations among industry participants. Toys "R" Us negotiated directly with Japanese manufacturers; at first they refused to deal. Only when orders went outside the country and the company introduced the leverage of its worldwide buying power did domestic producers begin to talk business. Dealing directly with manufacturers and cutting out layers of middlemen, Toys "R" Us compounded the low costs of its procurement efficiency by offering a much larger variety of products than available in the traditional Japanese store. Moreover, it managed high volumes of sales with computerized transactions and inventory systems linked to product planning and purchasing.

Prices not only fell at the innovating company, Toys "R" Us, but also throughout the industry, as local shops — forced to compete for the first time — formed cooperatives, changed purchasing and selling methods, and bargained directly with manufacturers that in the past had insisted on maintaining suggested retail prices. Thus, the partial liberalization of the regulations backstopping one law and the entry of one foreign company transformed an entire industry by introducing higher productivity and lower costs for consumers.

Merchandising is now one of the hot areas for American entrants in the Japanese market. The ability of large discount retailers to transfer their innovative and profitable formats from the United States to Japan was only possible after liberalized implementation of the Large Retail Store Law.

Other retailing areas that could benefit from deregulation include bookselling, which Japan currently protects as a cultural category (although the sale of imported books at competitive prices is allowed). Resale price maintenance laws that allow manufacturers to establish prices for up to two years after a record or a compact disc is released protect the recorded music industry. Cartel-like relations between manufacturers and retailers also reduce the recorded music industry's innovativeness. However, these restrictions also created an opportunity for Tower Records to sell imported recordings at prices substantially below local, controlled levels. By 1995 Tower Records' Japan sales of $250 million represented 3 percent of the national market and contributed 30 percent of the company's worldwide sales.[15]

So enticing has this sector become that British entrepreneur Richard Branson opened a Virgin Record megastore in Tokyo that claims to be the world's largest. Another British competitor also vies for Japan's music business. Thus, the presence of restrictive regulations plus a certain obtuse behavior by domestic companies actually created profitable investment opportunities for

[14]For background, see Susan MacKnight, "Japan's Changing Distribution System: Will It Help U.S. Exporters?" *JEI Report* No. 23A, June 17, 1994.

[15]Daniel Grunebaum, "Towering Success," *The Journal of the ACCJ*, April 1996, p. 33.

innovative foreign companies.

Advantages arising from Japan's regulatory regime, however, are not the usual route to riches there. One-quarter of the firms responding to the previously noted ACCJ questionnaire said that regulatory restrictions limited the types of goods and services they could provide and impeded their penetration of local markets. The response varied dramatically across sectors, though. A full 77 percent of financial firms were affected negatively, but competitors in other areas, such as software, saw no effect. Foreign firms entering the market for the first time were marginally more exposed to the negative effects of regulation than the existing operations of foreign companies — 30 percent of the newcomers versus 20 percent of the active businesses.[16]

Privatization and partial deregulation of the telecommunications business have enabled a wide range of new competitors to enter the Japanese market. Since the late 1980s, for example, American companies providing value-added services have used lines leased from the primary domestic operating company, Nippon Telegraph and Telephone Corp. However, considerable regulation still limits many types of services.

The prospect of a financial-sector "Big Bang" or extensive deregulation over the next five years, which Prime Minister Ryutaro Hashimoto promised soon after last fall's elections, has many American financial services providers excited. Regulations control the variety of financial products and services that can be provided and put Japan perhaps as much as 20 years behind the United States and other leading financial centers like London, Singapore and Hong Kong. Foreign companies reviewing their expansion prospects in Japan now are hiring specialists from local companies and laying out future business plans.

Transportation services also are beginning to experience the slow liberalization process. Aviation and trucking in Japan are inefficient, and prices are often at least twice American rates. Federal Express Corp. is trying to establish a nationwide package pickup and delivery service by expanding its routes into and out of Japan and by negotiating trucking permits. Both of these moves require U.S. government support in negotiations with Japan. U.S. airlines already dominate international traffic to Japan. Washington currently is trying to negotiate an "open skies" agreement to further pry open this sector. However, despite some deregulation tendencies in Japan, movement could be at a glacial pace. Each transportation area will have to be monitored closely for progress by potential American corporate entrants.

A Final Caution

The data and the results described in this report are taken from biased samples. Indeed, this bias exists in all the information on actual performance because the participants currently are operating in Japan. They have found ways to be profitable within the Japanese economic system. Companies that could not make it in that country's restrictive regulatory environment are not present in the sample. That underscores the necessity for careful planning before investing in such a potentially lucrative market as Japan.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

[16] ACCJ, *op. cit*.