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JAPANESE DIRECT INVESTMENT IN THE UNITED STATES: REVISING AND UPDATING PERCEPTIONS

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Japanese direct investment in the United States surged in the late 1980s, reaching a record $20 billion in 1990. In the peak years of 1988 through 1990, megadeals — acquisitions valued at $750 million or more — accounted for a quarter to a half of the annual investment inflow from Japan. The visibility given these giant deals in the media and on Capitol Hill led to an American image of corporate Japan as a marauder. A closer look at the totality of the experience reveals a different picture.

Most Japanese investment abroad is in relatively low-risk portfolio assets like government and corporate bonds. Less than 10 percent of the stock of Japan's overseas assets takes the form of direct investment. The United States is the location of just under half of that total.

With the wave of Japanese money flooding into this country during the 1980s, Japan moved up from a seventh-place standing on the list of big foreign direct investors in the United States to the number-two position in 1988. It retains that ranking today, even though investment activity has bounced back only partially from a steep slide in the early 1990s.

The main driving force behind the late 1980s' surge in Japanese direct investment in the United States was the availability of inexpensive capital at home, as stock markets there roughly tripled in value between 1985 and 1990. That factor, combined with an appreciating yen over much of the 1980s and the relatively weak prices of assets in the United States, gave corporate Japan sufficient purchasing power to establish or acquire thousands of American businesses.

Other developments, such as the reality or the possibility of restrictions on a number of important Japan-made products and the prospect of the yen's long-term appreciation, pulled or pushed many Japanese manufacturers to American shores. The desire to avoid transportation costs from Japan and to get closer to the American market motivated investments as well. Low rates of return at home, coupled with firm-specific assets that enabled Japanese companies to cash in on these competitive advantages in

the United States, also drove many investment decisions.

Significantly, though, foreign direct investment in the United States has not been a high-return activity. That is especially true for Japanese investors. On average, it takes 10 years for foreign-owned ventures just to earn a positive return and even longer — if ever — to break even. Two case studies highlight this fact of business life.

Japan's Overseas Investments In Context

Japanese investors have accumulated approximately $2.8 trillion in assets abroad. Almost 10 percent of this total — $274 billion — is in the form of direct investments, defined as ownership of a sufficient share of a foreign company to presume some degree of managerial control.[1]

Foreign direct investment, however, does not represent the principal method of Japanese investment abroad. The single largest share, more than one-third of the roughly $2.8 trillion total, is in portfolio investment — equities and debt instruments, such as government or corporate bonds. These investments simply establish a claim on an asset for the purpose of realizing a return without managerial control.[2] Bonds dominate this portion of overseas funds, accounting for 84 percent of Japan's portfolio investment (see Figure 1).

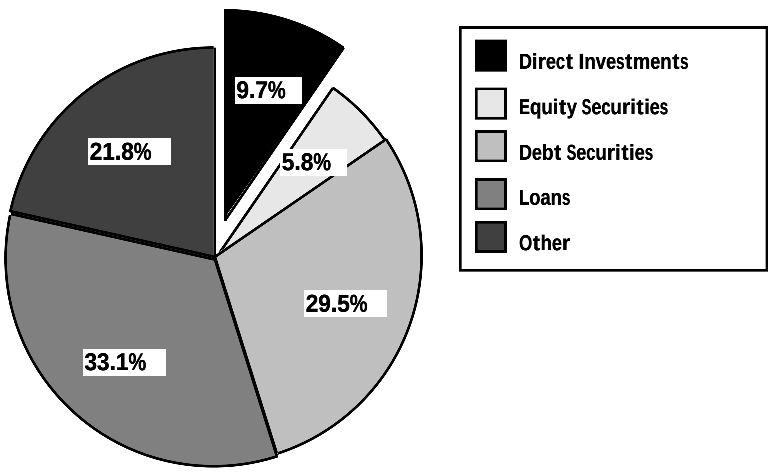
For comparison, American foreign assets at the end of 1996 totaled $3.7 trillion at current cost (adjusting for exchange rate and price changes).[3] In contrast to Japan's allocation of overseas assets, 26 percent of U.S. foreign capital represented direct investments (at current cost) and only 34 percent was in stocks and bonds. The latter category presented an even more striking difference with Japan. A whopping 69 percent of U.S. portfolio investment was in corporate stocks

[1]Bank of Japan, *Balance of Payments Monthly*, April 1997, Table 15 (International Investment Position of Japan). Yen figures for 1996 were converted into dollars at an exchange rate of ¥108.8=$1.00.

[2]The asset categories comprising the ¥307.7 trillion of Japan's international investment position at yearend 1996 included: foreign direct investment (9.7 percent), portfolio investment (35.3 percent), long-term loans (15.1 percent), short-term loans (18.1 percent), trade credits (2.1 percent), currency and deposits (5.1 percent), reserve assets (8.2 percent) and "other assets" (6.4 percent).

[3]Russell B. Scholl, "The International Investment Position of the United States in 1996," *Survey of Current Business*, July 1997, Table 1, p. 31.

Figure 1: Composition of Japan's International Investment Position, Yearend 1996



Source: Bank of Japan, Balance of Payments Monthly, April 1997.

compared with only 16 percent for the more timid Japanese investor. Although Japan's foreign asset position as a share of gross domestic product is almost identical to that of the United States at 61.5 percent (at current cost), FDI is equivalent to just 6 percent of Japanese GDP versus a U.S. figure of 13 percent.

FDI and investments in equities depend on business profits for their returns. Since profits are more volatile and less predictable than the fixed returns of debt instruments, they generally yield higher paybacks accompanied by higher risks. At the end of 1996 American investors had 56 percent of their foreign holdings in such relatively risky investments, whereas only 15.5 percent of Japan's total was in similar assets.

The 1996 investment flow figures for Japan reinforce the big picture. FDI accounted for 17.5 percent of the total movement of assets abroad. Portfolio investment climbed to almost 86 percent, with debt securities absorbing fully 92 percent of that category.

Japan's U.S. Direct Investments

All investments expose the investor to risk. In addition to exchange rate risks, FDI incorporates the prospect of business risk or the chance that future profits will not measure up to forecasts. Forays into foreign markets, which are likely to be less familiar to an investor than the domestic scene, are especially vulnerable to business risk.

Not surprisingly, the main destination for Japanese FDI is the United States — the country that businesspeople know best. At yearend 1996 the United States accounted for 47 percent of the net stock of Japan's direct investment abroad. Together with Western Europe, Canada, Australia and New Zealand, advanced developed economies were the location of 64 percent of Japanese FDI. Almost all of the rest was in Asia. Japanese companies had nearly 10 percent of their FDI in the People's Republic of China and another 31 percent elsewhere in Asia at 1996's close (see Figure 2).[4]

The Department of Commerce placed Japan's yearend 1996 stock of direct investment in the United States at $118.1 billion. That represented 18.7 percent of the total for all countries. However, it was second to the United Kingdom with its 22.6 percent share (see Figure 3). In 1980 Japan ranked seventh as a direct investor in the United States. In subsequent years it quickly moved up the standings, reaching third in 1984 and second in 1988. A surge in Japanese investment activity in the second half of the 1980s was responsible for this rapid ascent. However, an equally sharp slowdown in FDI in the post-1990 period, combined with strong investment inflows into the United States from other countries, gradually has eroded Japan's relative position. Nonetheless, the world's second-biggest economy still has a firm hold on the number-two position.

Figure 4 shows the inflow of Japanese direct investment using two of the three measures developed by the Department of Commerce to track this activity: total capital inflows and outlays for acquisitions and new business establishments (see Technical Note). The latter is somewhat more sensitive to changing economic

[4]These shares are based on net FDI, which includes reductions in FDI in some areas. The percentages add up to more than 100 percent because Japanese investors sold off assets in Africa and Central and South America.

<u>Technical Note</u>

Surveys and analyses from the Department of Commerce yield three ways of measuring FDI flows into the United States.

1. *Outlays for the acquisition or the establishment of U.S. businesses* span investments made by foreigners and those made through their existing U.S. affiliates. They include financing other than that from foreign parents, such as local borrowing by existing U.S. affiliates. This measure does not cover new money going into existing foreign-owned businesses. For 1996 total outlays to acquire or establish U.S. businesses were $80.5 billion.[1]

2. *Capital inflows* include net equity investments, changes in intercompany debt and reinvested earnings. This measure incorporates outlays for the acquisition or the establishment of new businesses but adds to that figure additional investments in existing businesses. However, this measure only includes transactions with foreign parents or other members of foreign parent groups. In 1996 total FDI capital inflows into the United States of $78.8 billion comprised $53 billion in equity capital, $11.7 billion in intercompany debt and $14.1 billion of reinvested earnings.[2]

3. *Change in the historical-cost position* includes the capital inflow figure just noted, plus several valuation adjustments. One reflects changes in exchange rates that alter the value of a U.S. affiliate's foreign assets and liabilities. This adjustment typically is quite small; in 1996 it came to a negative $0.4 billion. The other main adjustment reflects capital gains or losses on assets that are sold during a year as well as other write-offs. The 1996 value of this item was a negative $9.2 billion.[3] The total change in the historical-cost position was $69.2 billion in 1996.

The cumulative sum of this figure over time yields the stock of foreign direct investment in the United States on a historical-cost basis — the most commonly cited value of FDI. Last year it came to $630.1 trillion. Country data are not available to account for changes in the replacement costs of assets or for changes in market value. On an aggregate basis, 1996 FDI in the United States was $729.1 trillion on a current-cost basis and $1,253.6 trillion when calculated at market value.[4]

All three measures of foreign direct investment flows are highly correlated, even though they are based on different concepts and evolve from different surveys and methods.

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[1]Sylvia E. Bargas, "Direct Investment Positions for 1996: Country and Industry Detail," *Survey of Current Business*, July 1997, p. 40.

[2]*Ibid.*

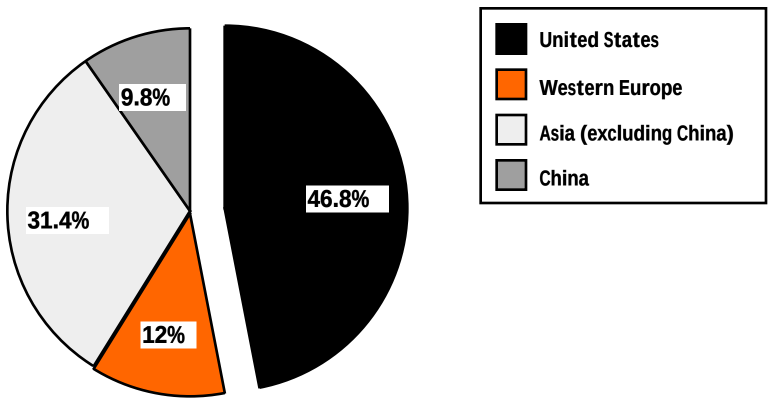
[3]*Ibid.*

[4]"Foreign Direct Investment in the United States: Detail for Historical-Cost Position and Related Capital and Income Flows, 1996," *Survey of Current Business*, September 1997, Table 1, p. 79.

conditions because it only covers initial activities; in other words, additional investments in existing operations and reinvested earnings are excluded. These Japan-financed outlays rose very sharply starting in 1986. They hit a peak of $20 billion in 1990 but then fell off just as quickly in 1991 to $5 billion-plus.

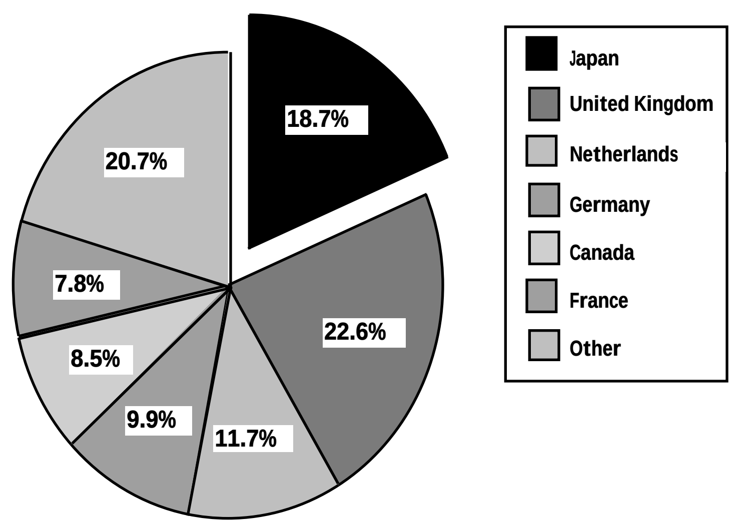
The decline of Japanese direct investment inflows into this country was conditioned by economic conditions here as well as at home, a point that will be developed below. In fact, direct investments from other countries, which had peaked in the 1988-89 period, also fell abruptly, mainly due to the U.S. recession at the start of the 1990s. The bottom of this trough in 1992 was followed by a rush of new investments that outpaced the flows of the 1980s. As shown in Figure 5, the recovery of Japanese direct investment outlays appeared weak in comparison with inflows from other countries, led by the traditional foreign participants in the American market — the United Kingdom, Germany, Canada and Switzerland.

Figure 2: Country or Regional Breakdown of Japan's Foreign Direct Investment Position, Yearend 1996



Source: Bank of Japan, Balance of Payments Monthly, April 1997.

Figure 3: Country Breakdown of Foreign Direct Investment Position in the United States, Historical-Cost Basis, Yearend 1996



Source: Department of Commerce, *Survey of Current Business*, September 1997.

The jump in capital flows from Japan to the United States during the second half of the 1980s made Japanese investors a permanent part of the American economic scene. From a position of only 5.7 percent of all FDI in 1980, the stock of Japanese direct investment capital doubled to 10.5 percent in 1985 and doubled again to 21.8 percent in 1990. The subsequent collapse of new flows, plus the resumption of strong activity by other countries, reduced the Japanese share to 18.7 percent at yearend 1996. The erosion in the proportional weight of Japanese companies in the U.S. economy is likely to continue as their FDI position adjusts to long-term forces. However, the figure is unlikely to fall back to the levels seen in the early 1980s because Japan itself is now a major player in international trade, production and finance.

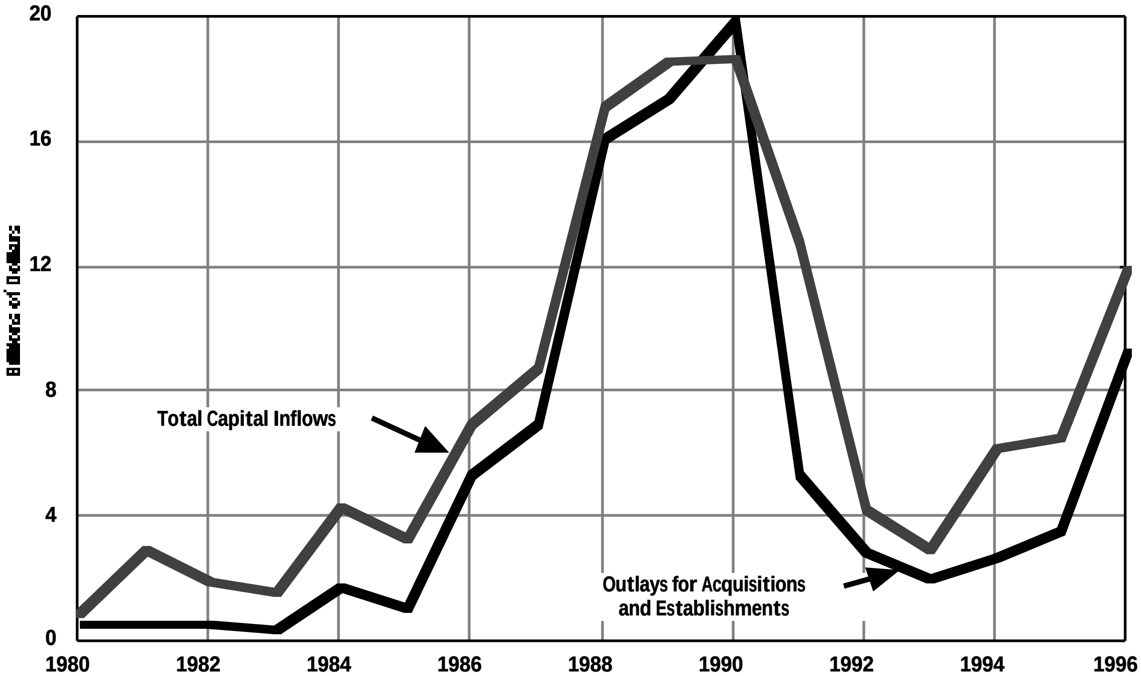
Allocation Of Japan's FDI

Not only has the pace of Japanese direct investment in the United States changed dramatically over the past 10 years, but the sectors favored by investors also have shifted. When Japanese companies first started to expand into the American market, they did so largely through exports of intermediate products and consumer and capital goods. The marketing of these products was supported by sales subsidiaries as well as warehouse and service facilities.

This early experience still shows up in Commerce Department statistics as the dominance of wholesale trade. Although the published data do not break down the country wholesale trade figures into product groups, the aggregate numbers indicate that motor vehicles and electrical goods are the largest; these are among the product groups in which corporate Japan first made its presence felt in the American market. As shown in Figure 6, wholesale trade accounted for two-thirds of the stock of Japanese direct investment in the United States in the early 1980s. Manufacturing was around 15 percent of the total until 1987.

Manufacturing assumed greater importance in

Figure 4: Japanese Direct Investment in the United States Measured by Capital Inflows and Outlays for Acquisitions and Establishments, 1980-96



Source: Department of Commerce, Survey of Current Business, various years.

the post-1985 period, as Japanese exporters were forced to cope with the yen's rapid appreciation, actual or threatened U.S. trade protection as well as a long list of other pushes and pulls. However, manufacturing establishments of Japanese companies that originally were designated in the wholesale trade category continued to be counted as wholesale activities. Despite this anomaly in the data collection process, wholesale trade fell to the 30 percent level in the 1990s, and the manufacturing share increased to more than 20 percent.[5]

By the middle of the 1980s banking and other financial companies in Japan were exploring opportunities in the U.S. market, mainly to support fellow members of corporate Japan already here or headed in this direction but also to capitalize on the vast potential of the American economy. Figure 6 shows that over the course of a decade nonbank financial companies, mainly securities brokers, came to represent almost 20 percent of the Japanese money in this country. In absolute terms, nonbank financial companies had a $20 billion investment position by 1995. Banking (not shown in the figure) declined slowly in relative importance from about 14 percent of the total in 1980 to 6 percent, even while the dollar value of this investment surged from less than $1 billion to more than $6 billion.

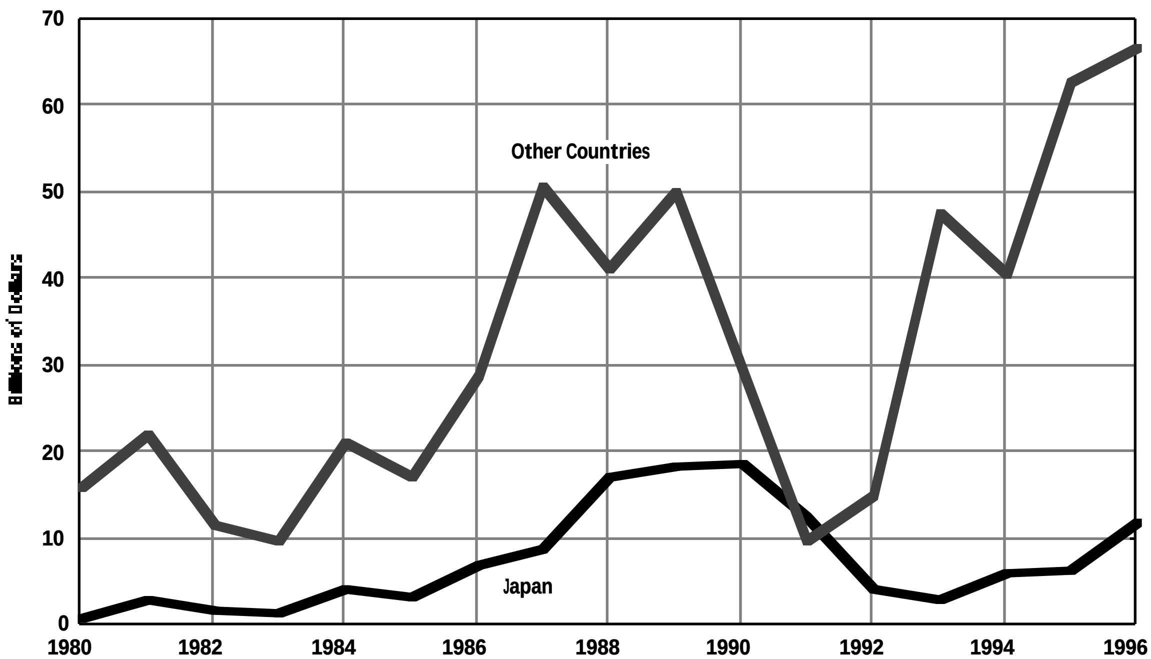
Real estate jumped in importance as the "bubble economy" perked along in Japan. However, Japan's U.S. real estate position peaked in 1990 and then began a period of long-term decline. By 1996 this once high-profile type of investment represented only about 7 percent of the total.

The Image Of The Japanese Invader

The surge in Japanese direct investment in the United States conveyed by Figure 4 is the one that fed the widespread American suspicion at the start of the 1990s that corporate Japan was about to take over the U.S. business community. Coming from virtually nowhere in 1985, Japanese firms

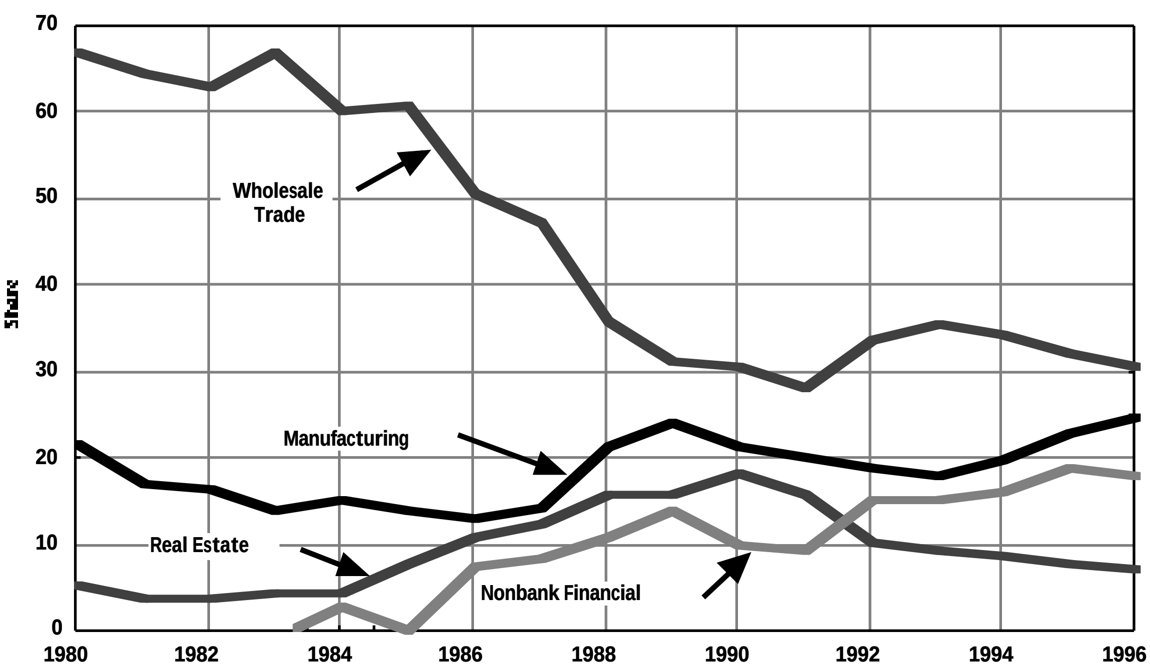
[5] See Susan MacKnight, "Japanese Investment In The American Manufacturing Sector: The Second Phase," *JEI Report* No. 1A, January 12, 1996.

Figure 5: Direct Investment Capital Inflows into the United States from Japan and Elsewhere, 1980-96



Source: Department of Commerce, *Survey of Current Business*, various years.

Figure 6: Sectoral Breakdown of Japan's Direct Investment Position in the United States, Yearend 1980-96



Source: Department of Commerce, *Survey of Current Business*, various years.

pumped $20 billion in direct investments into the U.S. economy a scant five years later. Largely overlooked by the public and some otherwise informed observers is the reality of the 1990s — the almost as quick shrinkage of these inflows and the retrenchment of Japanese investors in some fields, mainly real estate.

The comparison of Japan with other countries in Figure 5 is more revealing of longer-term trends, although the conventional wisdom has not necessarily adjusted to this picture. With the recovery of the U.S. economy starting in 1992 and its subsequent sustained, strong performance, direct investments by companies headquartered in other countries have far surpassed Japanese inflows except for the single year of 1992.

A closer look at the 1988-90 boom years for Japanese direct investment in the United States reveals that the U.S. image of an unstoppable marauder with the deepest of pockets was the product of a few huge acquisitions. Table 1 shows the largest of the megadeals included by the Department of Commerce on its annual list of publicly identified FDI transactions.

To many people Bridgestone Corp.'s 1988 acquisition of Firestone Tire & Rubber Co. for $2.6 billion typified a strong Japanese industrial company's takeover of a formerly strong but ailing American industrial icon. The 1989 buyout of Columbia Pictures Entertainment Inc. by electronics giant Sony Corp. for $5 billion marked the entry of corporate Japan into the quintessential American movie industry. The purchase the same year of a controlling share of the Rockefeller Group's Rockefeller Center in the heart of Manhattan by Mitsubishi Estate Co., Ltd. was another indicator of the vulnerability of the American myth. (Ironically, British investment money originally financed a large share of Rockefeller Center.) Then, in 1990, the $7.5 billion purchase of MCA Inc. by Matsushita Electric Industrial Co., Ltd. confirmed the "Japanese invasion of Hollywood," as it was portrayed in the press. Japanese interests also acquired the Pebble Beach golf club in California, the home of major American golf tournaments.

Mainly because they perceived Japan as the only real competitive threat to the future health of the U.S. economy, people worried about the

Table 1: **Total Japanese Outlays for Acquisitions and New Establishments and Megadeals Over $750 million, 1988-90**

(in millions of dollars)

Year	Outlays	Purchaser	Target	Value
1988	$16,200	Bridgestone Corp.	Firestone Tire & Rubber Co.	$2,600
		Nippon Mining Co., Ltd.	Gould Inc.	1,100
		Paloma Industries Ltd.	Rheem Manufacturing Co.	850
		Bank of Tokyo, Ltd.	Union Bank of California	750
1989	17,400	Sony Corp.	Columbia Pictures Entertainment Inc.	5,000
		Dai-Ichi Kangyo Bank, Ltd.	CIT Group, Inc.	1,280
		Mitsubishi Estate Co., Ltd.	Rockefeller Group	846
		Fujisawa Pharmaceutical Co., Ltd.	LyphoMed Inc.	798
1990	19,900	Matsushita Electrical Industrial Co., Ltd.	MCA Inc.	7,500
		Mitsubishi Corp.	Aristech Chemical Corp.	875
		Minoru Isutant	Pebble Beach Co.	800

Source: Department of Commerce, International Trade Administration, *Foreign Direct Investment in the United States: Transactions*, various issues.

"buying of America" ignored the fact that 12 megadeals in the $750 million-plus category occurred in 1988 that involved non-Japanese parents, followed by 11 in 1989 and 10 in 1990.[6] For example, 1989 saw Great Britain's Grand Metropolitan PLC acquire Pillsbury Co. for $5 billion. That deal placed the Burger King fast-food chain under foreign ownership. The hamburger (though named after a German city) is probably even more symbolic of America than is Hollywood.

The megadeals listed in Table 1 — those that made the headlines as well as the ones that escaped the glare of public attention — constituted a large share of new outlays during the boom in Japan's U.S. direct investments: 32.6 percent in 1988, 45.5 percent in 1989 and 46.1 percent in 1990 (the result of just three transactions). As the big deals declined in number, so did the overall volume of Japanese direct investment here. The extraordinary wave of investments in a few years of the late 1980s, spotlighted and given high visibility by megadeals, camouflaged the rather conservative nature of most Japanese foreign investments, direct or otherwise.

Why Is There FDI?

What accounted for the surge of Japanese foreign direct investment worldwide in the second half of the 1980s and its subsequent decline? Addressing these questions requires an examination of several subsidiary issues. Why invest abroad at all? Why invest overseas rather than export goods and services from a domestic base?

A thorough discussion of these issues is beyond the scope of this report, but a few summary responses are possible. Why invest abroad? The simple answer is to earn higher returns than are possible domestically or to diversify an investment portfolio to reduce risk. An investor can expect to earn more abroad than at home if returns in a foreign country generally are higher than domestic returns or, less obviously, if a company possesses a firm-specific asset that enables it to earn adequate profits in a foreign market even if paybacks in general are not higher there. They can be adequate, in turn, either because the foreign firm expects higher returns or because it requires lower returns.

Why put capital into direct investments abroad rather than in other assets? In fact, most foreign assets take the form of portfolio investments. In the United States only 15.7 percent of foreign assets (at current cost) represent direct investments. In general, the relative cost of capital fails to explain why direct investments are chosen over investments in financial assets, especially since FDI involves more risks and greater costs because companies are operating in distant, unfamiliar territory. This argument does not rule out comparative returns as an explanation for FDI. It does suggest, however, a more challenging route to profits. Foreign firms might be no better at production in another country than domestic firms there and have no other special advantage, yet they might be willing to pay more for an offshore property because they apply a lower return requirement to expected profits.[7]

Firm-Specific Assets - The bulk of the evidence suggests that, regardless of the nationality of the investor, the main determinant of FDI is the possession of firm-specific assets. Companies often have experience, technology, know-how or other assets like organizational or marketing skills that are difficult to transfer or sell to others and that can generate returns beyond those available in alternative investments. If the firm-specific asset were transferable at a competitive price, a company would not have to invest overseas and incur the subsequent risk; instead, it could license the asset or sell it to another party. Where contracting is not a problem and technology is transferable, other methods of selling abroad are feasible. Coca-Cola Co., for instance, franchises the right to produce and market its products in many areas around the world where contracts are enforceable.[8]

Why not export rather than invest abroad? The nature of firm-specific assets may indicate

[6]The sharp post-1990 falloff of direct investment in the United States is highlighted by the fact that only six megadeals occurred in 1991 (three by Japanese parents) and two in 1992 (one French and the other German).

[7]This argument is called the cost-of-capital explanation of FDI. See Edward M. Graham and Paul R. Krugman, *Foreign Direct Investment in the United States* (2nd edition) (Washington, D.C.: Institute for International Economics, 1991), p. 36.

[8]*Ibid*., p. 178.

why a company chooses not to license or sell its expertise to another business. However, it does not address the issue of why it is profitable to be on the scene rather than export.

A traditional explanation for direct investment abroad is the factor proportion hypothesis. It states that manufacturers integrate production vertically across borders to take advantage of input factor price differences associated with varying relative factor supplies. This explanation was adequate in the years following World War II when the majority of multinational firms were American and much of their investment went to countries with significantly lower costs.

However, an emergent feature of the modern global economy — namely, that the United States was well on its way to becoming both the world's largest direct investor abroad as well as the largest destination for foreign direct investment by other countries — forced attention to alternative theories. By 1988 some 70 percent of all direct investment flows occurred among the five biggest industrialized countries.[9] It is difficult to explain such two-way flows on relative cost grounds.

An alternative explanation suggests that manufacturers are more likely to expand production horizontally abroad the higher are transport costs and trade barriers and the lower are investment barriers and plant scale economies. Firms should expand across borders when the advantages of access to the destination market outweigh the disadvantages of reduced scale economies. In addition to avoiding transportation costs as an incentive for FDI, being physically close to a market often enhances the feedback of essential demand information and allows the producer to respond more flexibly and quickly than if it were an ocean away.

Another kind of localization advantage is access to specialized skills that are not captured by the traditional factor proportion theory. These skills can be as broad as general engineering capabilities or as narrow as a specific scientific field. The location of many international bioengineering firms in Bethesda, Maryland near the research campus of the National Institutes of Health testifies to the importance of highly specialized local skills.

Empirical studies find support for all of the cited theories. However, the single most important factor promoting FDI is the existence of firm-specific assets.[10] As noted by Edward M. Graham of the Institute for International Economics and Paul R. Krugman of the Massachusetts Institute of Technology, "When U.S. production is undertaken by foreign firms it is typically because the foreigners have firm-specific assets that give them an advantage in management and technology."[11] The two economists go on to say, however, that, within this broad story, "shifts in exchange rates, taxation, and protection all probably play an important role in explaining the timing of this investment." For Japan, exchange rates and the cost of capital played especially important roles in the late 1980s.

Many Japanese companies possess firm-specific assets that allow them to earn higher profits in the United States than U.S. rivals. Even though productivity throughout the Japanese economy in general is considerably below comparable American levels, this situation is not true across the board. In particular, Japan's motor vehicle, steel and electronics industries are estimated to be more efficient than their U.S. counterparts. Japanese automotive makers, for example, pioneered just-in-time production methods that yielded greater productivity as well as high quality at low cost. Such knowledge enabled automotive, steel and electronics manufacturers to establish competitive operations in the United States and to transfer their in-house efficiency to their American subsidiaries.

Rate of Return Differentials - Rates of return to capital in Japan are especially low in comparison with other industrialized countries. Estimates of economywide returns for 1990 indicated that Japan earned 3.9 percent on its domestic capital stock versus 5.9 percent for the United States, 7.9 percent for the United Kingdom, 5.3 percent for Germany and 6 percent for

[9] Cited by S. Lael Brainard, "An Empirical Assessment of the Proximity-Concentration Trade-off Between Multinational Sales and Trade," *American Economic Review*, September 1997, p. 520.

[10] Richard E. Caves, *Multinational Enterprise and Economic Analysis* (New York, New York: Cambridge University Press, 1996), p. 3.

[11] Graham and Krugman, *op. cit*., p. 3.

France.[12] At a minimum, corporate Japan could earn 36 percent more through broad investments in Germany or 50 percent more by putting its money into the United States.

The gap between returns in Japan and those available elsewhere appeared in the early 1980s. That was when the current account moved into long-term surplus, implying that Japan was a net supplier of capital to the rest of the world. The relatively low home returns facing Japanese investors had two sources: high levels of capital stock relative to output because of the vigorous rate of investment in the 1950s and the 1960s, plus low efficiency in the use of that capital. By the 1990s capital intensity in Japan was some 50 percent greater than in the United States, but Japanese capital efficiency was estimated at only two-thirds of the American level. Given the opportunity to earn higher returns abroad, it is not surprising to find a substantial outflow of assets from Japan. Even if Japan-based businesses earn lower profit rates in the United States than American investors, it still could be economically rational for Japanese companies to be in this market.

A Japanese Corporate Purchasing Power Index - In a world of imperfect capital markets, anything that lowers the cost of financial capital for foreign firms compared with U.S. companies increases the purchasing power of the outsiders. Three separate phenomena combined to produce such an effect in Japan in the late 1980s. Between 1985 and 1989 average share prices on the Tokyo Stock Exchange (as represented by the Nikkei index of 225 stocks listed on the exchange's first section) more than tripled. As prices rose, the number of yen that could be raised by floating a share went up at the same rate. Price/earnings ratios also took off, meaning that purchasers of equities were willing to pay more for the same amount of corporate profits.

The easy availability of financial capital was only part of the story. Yen raised in Tokyo had to be converted into dollars to establish or acquire American assets. The yen appreciated sharply in the wake of the fall 1985 Plaza Accord. That enabled Japanese investors to exchange their currency for more dollars, leveraging rising Tokyo stock prices. Moreover, the costs of American assets, as represented by equity prices on the New York Stock Exchange, were not rising as fast as in Tokyo. In addition, the October 1987 stock market crash in New York created buying opportunities for foreigners whose own markets had not fallen by similar amounts.

An index number using January 1985 as the base was created to reflect these three links. By dividing the Nikkei price index by the yen-dollar exchange rate and the NYSE composite price index, the resulting figure can be interpreted as the number of shares in New York that can be purchased with the proceeds from floating 100 shares in Tokyo.

This Japanese corporate purchasing power index tracks outlays for acquisitions and new establishments in the United States remarkably well (see Figure 7). Purchasing power rose rapidly from 1985 through 1988, held fairly steady for a year and then collapsed in 1990. The outflow of money for U.S. direct investments followed suit with a short lag. As the Tokyo stock market took a dive in the 1990s while the yen leveled off and the NYSE began to outpace the TSE, the feasibility of overseas investments as well as their attractiveness went into a tailspin. Only in the last year or two has Japanese offshore business begun to recover from these developments.[13]

Other Exchange Rate Considerations - Not all industries will be affected to the same degree by the corporate purchasing power index. A depreciating dollar that makes U.S. assets less expensive for foreigners to buy also raises the dollar costs of parts and other products imported into the United States. Automotive wholesale trade, in particular, suffered a sharp decline in profitability in the first half of the 1990s owing to the weaker dollar.[14]

At the same time, investors expecting the dollar's long-term depreciation might find an

[12] For an explanation of this calculation, see Arthur J. Alexander, "The Role Of Investment In The Japanese Economy: Past, Present And Future," *JEI Report* No. 4A, January 31, 1997.

[13] A recent study also found that exchange rates and Tokyo stock prices strongly influenced Japanese direct investment in the United States. See Bruce A. Blonigen, "Firm-Specific Assets and the Link Between Exchange Rates and Foreign Direct Investment," *American Economic Review*, June 1997, Table 2, p. 456.

[14] David S. Laster and Robert N. McCauley, "Making Sense of the Profits of Foreign Firms in the United States," *Federal Reserve Bank of New York Quarterly Review*, Summer-Fall 1994, pp. 54-55.

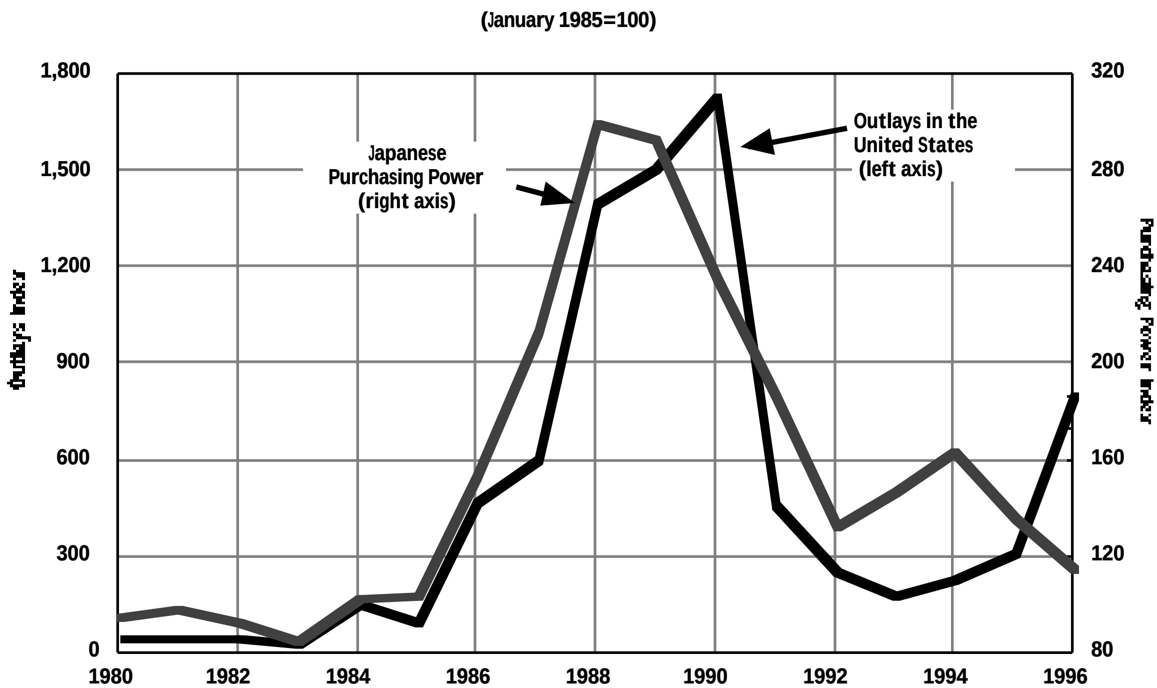


Figure 7: Japanese Outlays for U.S. Acquisitions and New Establishments and Japanese Corporate Purchasing Power, 1980-96

Source: Department of Commerce, *Survey of Current Business*, various years, and calculations by author.

incentive to produce in the United States in order to avoid or minimize the expected rise in import costs. Dollar depreciation would be even more important if foreign producers in this country planned on exporting the output of their factories back home or to third countries. On balance, though, the profitability of foreign affiliates in the United States seems to be little affected by exchange rates. A study conducted by two economists at the Federal Reserve Bank of New York found that positive effects balanced negative ones.[15]

Economists sometimes argue that exchange rate considerations should not influence FDI decisions because returns are earned in the same currency in which an investment was made. The price of U.S. assets should not matter in this view, only their rate of return. This argument, which refers mainly to such assets as bonds, is reinforced by reference to the well-known observation that exchange rates behave like random walks. The implication is that exchange rate changes are unpredictable at least over periods of up to two years or so. Since neither depreciation nor appreciation can be predicted, the prudent response for companies weighing direct investments abroad is to assume that exchange rates will continue at current levels.

This argument breaks down, however, if products made offshore are exported or production inputs imported or if long-run forces appear to be moving exchange rates in a predictable direction. It also fails if capital markets are imperfect and considerations like the availability of funds influence investment decisions.

Imperfections in product markets also bring exchange rates back into consideration. If a foreign manufacturer has a better chance of selling the output of an acquired company in its home market or in a third country where it holds an advantage, a depreciating currency in the target economy for FDI produces an investment incentive. Specifically, it permits the foreign firm to offer a higher price to acquire a domestic company than another locally headquartered business could afford. In fact, this argument provides a strong explanation for Japanese acquisitions in the United States, especially of manufacturing

[15] *Ibid.*, p. 55.

companies in industries with substantial research and development expenditures.[16]

Low Profitability Of Japanese FDI

Japanese firms presumably faced lower "hurdle rates" in their investment decisions at home in the late 1980s because of economywide weak returns and the easy availability of funds during the bubble years. It might follow then that corporate Japan would be satisfied with lower returns on its U.S. investments. That is just what happened. Returns on FDI in the United States as a whole are lower than on American investments abroad. As shown in Table 2, U.S. multinationals earned double-digit returns, even in Japan, in recent years, whereas foreigners made only half those rates in this country. Moreover, Japanese companies were only half as profitable as other foreign firms operating in the United States.

The two economists at the New York Fed attributed the depressed earnings of foreign firms operating in the United States to their rapid buildup in the late 1970s and the 1980s. "These companies paid top dollar for underperforming U.S. firms, borrowed heavily, and then spent freely on investment and marketing. As the share of recently acquired firms in the United States rose in the 1980s, aggregate returns deteriorated."[18]

Analyzing IRS data, the New York Fed economists noted that many foreign ventures do not move out of the red for up to a decade and take longer to break even on their investments. This information is summarized in Table 3, which shows that manufacturing firms broke even after eight years but that companies in the wholesale and retail industries were not earning positive returns even after 10 years.

Japanese firms, however, have fared worse than the typical foreign company doing business in the United States. The IRS analyzed foreign-owned firms based on the 1994 tax returns of large companies, defined as concerns having either $250 million in assets or $50 million in sales. These big businesses did somewhat better than the aggregate of all foreign-owned firms. A summary of these data is shown in Table 4. They indicate that foreign companies performed more poorly than domestic counterparts of the same age and that Japanese companies did even worse.

Table 2: **Rates of Return on Foreign Direct Investment on a Historical-Cost Basis, 1994-96**

Source and Location of Investment	1994	1995	1996
All FDI in the United States	4.5%	6.1%	5.7%
Japanese Direct Investment in the United States	1.0	3.2	2.6
All U.S. Direct Investment Abroad	11.6	13.1	12.8
U.S. Direct Investment in Japan	6.5	10.7	10.0

Sources: "U.S. Direct Investment Abroad: Detail for Historical-Cost Position and Related Capital and Income Flows," *Survey of Current Business*, September 1997, pp. 120 and 145; "Foreign Direct Position in the United States: Detail for Historical-Cost Position," *Survey of Current Business*, September 1997, pp. 79 and 115.

A major reason for the comparatively low profitability of foreign firms doing business in the United States is that they are newer than American firms operating abroad. It takes many years to overcome the initial problems of a new overseas venture, and U.S. multinationals got a big head start on their foreign counterparts in the postwar period. Internal Revenue Service data for large American-based firms in 1988 and 1989 showed that returns on assets rose steadily from 2.1 percent for companies that were a year old or less to 16.1 percent for concerns that had been in business for 29 to 33 years.[17]

The same study reported 1994 information for all foreign-controlled companies in the United States but without an age analysis. On average, a $10 million investment by a Japanese parent

[16] Blonigen, *op. cit*., p. 452.

[17] John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988," *Statistics of Income Bulletin*, Fall 1992, Table 4, p. 86.

[18] Laster and McCauley, *op. cit*., p. 41.

Table 3: **Profitability (Return on Equity) of Foreign Firms in the United States, 1990**

	All Industries		Wholesale and Retail		Manufacturing	
Years After Incorporation	Annual Return	Cumulative Return	Annual Return	Cumulative Return	Annual Return	Cumulative Return
0	-4.8%	-4.8%	-22.0%	-22.0%	-4.7%	-4.7%
1	-4.8	-9.6	-22.0	-44.0	-4.7	-9.3
2	-4.8	-14.4	-22.0	-66.0	-4.7	-14.0
3	-4.8	-19.2	-22.0	-88.0	-4.7	-18.6
4	1.1	-18.1	-11.0	-99.0	3.7	-15.0
5	1.1	-17.0	-11.0	-110.0	3.7	-11.3
6	1.1	-15.9	-11.0	-121.0	3.7	-7.7
7	0.9	-15.0	-6.0	-127.0	4.7	-3.0
8	0.9	-14.1	-6.0	-133.0	4.7	1.7
9	0.9	-13.2	-6.0	-139.0	4.7	6.3
10+	4.3	-8.9	-3.0	-142.0	8.3	14.6

Source: David S. Laster and Robert N. McCauley, "Making Sense of the Profits of Foreign Firms in the United States," *Federal Reserve Bank of New York Quarterly Review,* Summer-Fall 1995, Chart 9, p. 51.

yielded $7.2 million in receipts and $37,000 in profits that year. Focusing on the services sector, the same $10 million investment produced revenues of $3.5 million and a loss of $32,000.[19] Japanese-owned manufacturing firms did considerably better; the average company in 1994 earned 2.9 percent on its assets or $291,000 on $10 million. The bottom line (literally) of this analysis is that even the most successful Japanese investors in the United States have made little money.

Case Studies Of Two Firms

The recitation of facts and numbers and the scanning of figures and tables obscure the individual actions of thousands of Japanese companies in their American adventures. These investments were driven by a myriad of influences — the potential for the yen's appreciation, the prospect of Washington-imposed trade barriers, the desire to service longtime Japanese customers operating in the United States, the easy availability of credit at home, the higher returns available in the U.S. market, the high costs and inflexibilities imposed by operating at a distance as well as the opportunity to cash in on a company's special knowledge and expertise. All these motivations and more drove the wave of Japan's U.S. direct investments. But behind each one was a unique story of individuals and special situations. Two case studies put a little flesh on the bare statistical bones.

One involves NKK Corp., an industrial giant that built its American entry on its financial, managerial and technological assets. The other case study is drawn from the opposite type of industry, women's lingerie. Wacoal Corp. was a rash entrant into Japanese business in the postwar era. It went on to dominate the market at home and then established an international reputation.

NKK Corp. - NKK, among the world's five largest integrated steel producers, was a technology leader when it acquired 50 percent of the fourth-biggest American steel company, National Steel Corp., in 1984 for $322 million. The two companies had a relationship dating back 30 years to when National Steel supplied leading-edge technology to NKK. By the mid-1980s NKK and Japan's other major steelmakers were beginning to eye onshore U.S. operations. Such a presence would give them a way around the trade restrictions that by then had become a

[19] James Hobbs, "Foreign-Controlled Domestic Corporations, 1994," *Statistics of Income Bulletin*, Summer 1997, Table 1, p. 94.

Table 4: **Profitability of Large Domestic and Foreign-Controlled Firms in the United States, 1994**

	Net Income / Assets			Net Income / Sales		
Years Since Incorporation	U.S. Firms	Foreign Firms	Japanese Firms	U.S. Firms	Foreign Firms	Japanese Firms
0-2	2.3%	0.8%	0.3%	5.8%	1.4%	0.7%
3+	2.5	1.2	0.9	6.3	2.1	1.2

Source: James Hobbs, "Foreign-Controlled Domestic Corporations, 1994," *Statistics of Income Bulletin*, Summer 1997, p. 110.

fixture so that they could service the automotive and other Japanese manufacturers that were setting up plants in this country.

Close inspection of its new acquisition revealed low efficiency, an inability to meet the quality requirements of potential U.S.-based Japanese customers, rigid personnel practices and the absence of any recent investment in plant and equipment. Almost immediately, NKK began to put money into new equipment to raise productivity and quality to the needed levels. Over the past 13 years these investments have added up to more than $2 billion, with an estimated half coming from Tokyo along with loan guarantees that peaked at $330 million in 1993.[20] In 1990 NKK upped its stake in National Steel by acquiring another 20 percent of the steelmaker's shares for $147 million.

The monetary side of the investment was only part of the problem. The steelmaking culture at National Steel had to change before NKK could even contemplate a semblance of profits. Industry observers note that head office management and control issues are vital to the success of a foreign investment, but getting the mix of tightness and looseness right is difficult. For 10 years NKK executives deferred to National Steel's domestic managers. Although quality and efficiency improved, largely due to the parent's massive investments in equipment and the introduction of NKK production methods, National Steel still did not perform to the desired standards. In 1994 NKK's chairman moved himself and his family to National Steel's new headquarters in Mishawaka, Indiana to personally oversee operations.

[20] Nigel Holloway, "School of Steel," *Far Eastern Economic Review*, October 9, 1997, p. 70.

In the meantime, personnel practices had been transformed by guaranteeing employment to workers in exchange for workplace flexibility. Since workers no longer could be laid off to cope with business downturns, sales had to be increased. That, in turn, demanded a closer working relationship between the sales force and the plant — something that National Steel's Japanese managers had done instinctively at home without realizing the cultural change that this type of cooperation required in the American context.

Eventually, NKK's investments and production changes began to have an impact. The number of man-hours per ton of steel produced at National Steel has come down 50 percent since 1985, and the proportion of finished steel in the highest quality category has more than doubled since the new Japanese chief operating officer took over. National Steel has been profitable since 1994, 10 years after NKK bought into it. However, it is doubtful whether NKK ever will break even on the money it has plowed into National Steel, especially with minimills entering the integrated mills' best automotive markets.[21]

NKK's experience with National Steel is not unique, as a glance at the profitability figures in Table 3 confirms. Money, technology and operating proficiency are insufficient by themselves to guarantee profitability.

Wacoal Corp. - Wacoal is Japan's largest manufacturer and marketer of women's lingerie and undergarments. Established in Kyoto in 1949 by brash, entrepreneurial Koichi Tsukamoto, then 29 years old and three years out of the military,

[21] *Ibid.*, pp. 69-70.

Wacoal, just as much as better-known names like Sony Corp., typifies the group of companies started in the postwar period when Japan's old structures and long-standing business relationships were breaking down. Within a few years of its founding, the upstart signed deals to market and jointly produce American brands entering the Japanese market. Through his U.S. connections, Mr. Tsukamoto gained entree to the big domestic department stores that previously had refused to talk to the newcomer. Although these ties soon unraveled, they gave Wacoal the legitimacy needed to succeed in Japan's business world.

As production and sales grew, Wacoal drafted a long-range plan for expanding internationally. First it opened production facilities in Asia. In 1969 the company signed technical and trademark agreements with Teen Form Group, the largest maker of brassieres for American teenagers, and began selling Teen Form products in Japan. It opened a New York branch office in 1977 and issued American Depository Rights to enable its shares to be traded in the United States. One of the main reasons for doing this was to demonstrate the seriousness of its interest in the U.S. market. Being publicly traded meant that Wacoal had to adhere to American accounting and disclosure practices, which are stricter than in Japan. A wholly owned subsidiary, Wacoal America, Inc., was established in 1981.

As part of its long-term strategy for developing the American market, Wacoal sought to acquire Olga Co., a producer of high-end intimate apparel. The two agreed that the Japanese firm would purchase 30 percent of Olga's shares and that the remaining 70 percent would be transferred in seven years if business relations between them had deepened sufficiently. Olga's greatest attraction was its 3,000 department store and other outlets around the country.

Wacoal produced products in its Southeast Asian plants to support this venture. However, in 1982 Olga requested that the deal be terminated. With this setback to its marketing efforts, Wacoal continued its long-standing discussions with Teen Form, finally acquiring it in 1983. Wacoal America constructed a factory in Puerto Rico in 1985 that complemented the one it had acquired there with its purchase of Teen Form.

Wacoal's product strategy at this time was to aim for the midrange of the bra market, which it saw as an unfilled niche between American-made mass-market products and high-quality European imports. It established in-store boutiques at 15 major department stores across the country to support its quality image and improve distribution.

However, Wacoal's products did not appeal to American women. Company designers discovered that the physical proportions of the American female varied considerably more than those of Japanese women. In Japan, for example, the A-cup bra has the largest market share, whereas in the United States, C, D and DD cups together make up a comparably sized segment.[22] It took Wacoal two years of trial and error as well as a study of U.S. styling methods to work out a line of American products.

Wacoal moved into a new part of the market in 1991 when it signed a licensing agreement with Donna Karan to produce and sell her designer lingerie. Sales began a year later — but not until after considerable internal debate about the company's ability to produce and market a high-end product. Nevertheless, back in Kyoto, Mr. Tsukamoto felt that such an opportunity should not be passed up.

Profits had remained elusive throughout the 1980s. Sales were booming, but costs always seemed to outstrip revenues. Part of the problem arose from the fact that Wacoal imported 70 percent of its merchandise from Japan during a period when the yen constantly was rising in value. As a company report noted, "It is not an exaggeration to say that the more products Wacoal America sold, the higher its deficit became."[23]

Another problem was the choice of leadership. Should it be Japanese or American? Executives in New York and Kyoto debated this issue; finally, an American was chosen as Wacoal America's chief executive officer. In 1991, however, a Japanese executive took over the U.S. subsidiary as chairman, with authority to control costs and achieve profitability. He chose as the president an American executive with a financial rather than a production or a marketing

[22] Wacoal America, Inc., *Tenth Anniversary* pamphlet, p. 17.
[23] *Ibid*., p. 26.

background. By the mid-1990s, almost 20 years after establishing an American branch office and 15 years after opening a U.S. subsidiary, Wacoal finally managed to earn positive returns.[24]

By 1994 Wacoal America had sales of more than $40 million and did business with 1,500 department stores nationwide. It had 640 employees and produced in Puerto Rico, Domenica and Barbados. Its experience conforms to the broad statistical story of Japanese direct investment in the United States, but the characters and the details reflect the personality of a single individual. That is as much a part of the picture of Japanese investment in America as are automotive, steel or electronics producers.

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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.

[24] Wacoal America does not publish separate financial results, but company officials have said that the last few years have been profitable.