

# THE MIT JAPAN PROGRAM

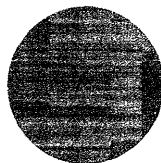
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**FROM BULLYING TO BUYING:  
OPPORTUNITIES FOR FOREIGN INVESTMENT IN JAPAN  
CONFERENCE REPORT**

Report compiled by  
Andrew Tagliabue,  
MIT Department of Political Science

MITJP 99-02

Center for International Studies  
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**From Bullying to Buying: Opportunities for Foreign Investment in Japan**  
Conference Report

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*From Bullying to Buying: Opportunities for Foreign Investment in Japan*

**Conference Report**

**I. Introduction**

From the 1970s until the mid-1990s, the predominant strategy of the United States in its trade relations with Japan has been “bullying” Japan to open its markets. In recent years economic expansion has dampened public pressure over U.S.-Japan trade relations, and the broader financial crises in developing markets and Japan’s prolonged economic slump have drawn the attention of U.S. policymakers. Nonetheless, Japan’s trade surplus with the United States has risen to record levels, and any deterioration in the American economic climate would likely bring a quick return to the tense confrontation over trade issues that characterized the late 1980s and early 1990s.

Yet many features of the Japanese economy have changed during the 1990s. In efforts to bring the economy out of its long-lasting slump, the Japanese government has undertaken various deregulatory and reform measures, and private companies have been changing fundamental aspects of their behavior as well. One effect of these changes has been to open new opportunities for foreign companies to acquire Japanese companies and assets or otherwise establish operations in Japan.

In his introduction to the conference, MIT Professor Richard J. Samuels sketched three alternative views of change in the Japanese political economy. The “**all along**”

**view** is that Japan has always been changing in a gradual but progressive fashion to integrate better with an open international economy. This argument has been heard mostly from Japanese government officials. As such, it was primarily an effort to buy time, to forestall real changes in the Japanese economy and its interactions with the rest of the world. For a time this strategy was effective, but over the long term repeating the mantra that Japan was changing despite contrary evidence had a corrosive effect among Japanese and foreigners alike. Now few outside Japan are willing to accept this view.

The **“at last” view** represents the perspective that Japan’s economy is finally responding to universal economic imperatives in ways that all other economies do. Under the pressure of economic hard times, many features that distinguished the Japanese political economy from others are disappearing. Where Japan’s manufacturing sector remained exceptionally large in comparison to other advanced economies, there is now hollowing out. The lifetime employment system is crumbling and unemployment on the rise. Long-complacent Japanese consumers have demonstrated fierce price sensitivity. Furthermore, protection of Japanese companies is seen to be eroding quickly. The Big Bang is deregulating a whole range of once-protected financial markets, including the large and lucrative business of pension-fund management. Major firms have been allowed to fail, and foreign firms have been able to make large and prominent acquisitions without extraordinary interventions by government. Ford is in effective control of Mazda; GE Capital and Merrill Lynch have made major inroads. To the proponents of an “at last”-type view, economic hard times have unleashed forces of creative destruction to which Japan is not immune.

The “at least” view is conservative in its expectations for change in Japan’s political economy. Historically the Japanese state has never readily relinquished its involvement in the Japanese economy, so it is prudent not to expect it too this time around. Changes in the Japanese economy will take place at least to the extent necessary to bring about recovery, but there will still be much that would have to change before the operation of the Japanese economy would be comparable to that of the United States or even most European countries. Although the economic difficulties of the 1990s have shown that Japan was not, after all, immune to the forces of creative destruction, it does continue to filter them in ways that frustrate attempts of foreign investors to treat Japan as any other market.

Whichever one of these alternative views is closest to characterizing the changes in the Japanese political economy, there is a need to examine U.S. economic and trade policies related to Japan. Has the financial crisis of the 1990s changed the most effective strategy for changing the nature of Japan’s economic relationship with the rest of the world? Where once bullying seemed to be the only way to get Japan to change, is it now more effective to seek to induce change from within by buying Japanese assets and becoming a larger presence in the Japanese economy? These were the central questions animating the presentations of the conference participants.

## **II. Japan’s Economic Outlook**

Japan’s erratic economic performance during the 1990s has created what can at best be called a “lost decade” for the Japanese economy. The first reaction to a weak

economy in the early part of the 1990s was to treat it as an ordinary cyclical downturn. Both official and private economic forecasters predicted recoveries that did not materialize. In the past several years it has been recognized that the economic downturn has significant structural components. The short-term outlook for the Japanese economy is not bright, and many conference speakers believed that the economy still may not have hit bottom. Progress is being made on resolving some of the most serious problem areas in the economy, but on others the outlook remains troubling.

#### *A. Banking*

The weakness of the banking system has constituted one of the greatest problems for the Japanese economy. The collapse of the stock market and real estate prices since 1990 hit banks both in their reserves and on their loan book, but the loan book is the major problem. Acknowledged problem loans now amount to ¥67 trillion, and total high-risk loans are estimated to be about ¥100 trillion.

During the spring of 1998 the government increased the authority of the Bank of Japan to set monetary policy and turned responsibility for banking regulation over to the new Financial Supervisory Agency (FSA). The Economist Intelligence Unit's Robert Madsen noted that the FSA has pursued banking regulation with unexpected vigor. Its disclosures have embarrassed the government and attracted suits from banks for divulging "private" information.

Recognizing that Japanese banks could not simply grow out of their problems, the government by the second half of 1998 took a more active role in promoting

restructuring in the banking sector. The passage by the Diet in the autumn of 1998 of legislation providing ¥60 trillion in public funds for recapitalization and authorizing nationalization of the most troubled institutions was a major step forward. Kurt Tong of the American Embassy in Tokyo<sup>1</sup> said the legislation made a good set of tools available to the government, and resolve may be growing to use them effectively. The passage of the legislation put a floor under the downside for the Japanese economy; the worse that could happen in the banking sector is now much less worse than six months ago.

Banking problems continue to sap the effectiveness of monetary policy. Even though the Bank of Japan has lowered interest rates to near zero, the increase in the monetary base has not flowed on to broader measures of money supply. With such a heavy burden of bad debts, banks are absorbing cheap government credit while simultaneously reducing lending. Jesper Koll, managing director of Tiger Management Japan, dissented from the usual characterization of this as a credit crunch; he said that in reality Japan is experiencing a credit “normalization” as banks fundamentally reevaluate the basis on which they make loans. Madsen added that one should not underestimate the effect of hoarding cash on the circulation of money. Households are holding on to significant amounts of cash as people just do not believe it is safe to save anywhere; sales of safes are at record levels.

However, numerous obstacles to effective clean up of the banking sector remain. David Hale, Chief Global Economist of the Zurich Group, pointed out that the Japanese

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<sup>1</sup> Kurt Tong’s comments at the conference represented his personal opinions, and do not necessarily represent the views of the Department of State, Department of the Treasury, or any other U.S.



equivalent of the U.S. Resolution Trust Corporation has only recovered around 10¢ on the dollar compared to the 50¢ achieved in the U.S. The process of implementing the bank rescue plans, passed in October 1998, has been slow. Madsen believed that it should take a further three to five years to work out the problems in the banking sector.

*B. Real Estate*

The problems in the banking sector are both influenced by and in turn have influence on the prices of all financial assets in the Japanese economy. The collapse in real estate prices has increased the level of bad loans, while at the same time any aggressive clean-up of bank balance sheets at firesale prices would further depress real estate prices.

Koll argued that real estate prices have bottomed, though they will not begin to appreciate for the next three to five years. The Japanese government deserves some credit for changes in zoning and building codes that make it easier to build quality housing and office stock and make sensible real estate investment decisions.

Others were not so sanguine in their views on real estate prices. Madsen said that there could be a further 30 percent fall in real estate prices. In the housing sector especially, the government has been dismantling measures aimed at bolstering consumption faster than alternatives are being introduced. This points to continuing softness in housing sales. Tong also noted that land prices will fall further as banks liquidate assets. From the point of view of foreign investors, increased availability of land is a positive development, because previously many found that their biggest

problem was not the price of land, but the availability.

### *C. Equity and Bond Markets*

The Nikkei average remains around one-third of its peak levels, and several speakers did not exclude the possibility of its falling further. Alexander Kinmont of Morgan Stanley Japan said that retail investors will keep out of the equity market until there is a yen-denominated way to invest in companies and get a true return on capital. However, these investors bailed out of the stock market at the top of the market. They understood that Japanese companies are not in the business of providing returns to investors. Subsequent revelations about favored treatment for big customers by securities firms strengthened small investors' distrust of equity investments.

Koll called attention to the fact that in year 2000 around ¥120 trillion in high interest deposits or about 12 percent of household financial assets will mature. The government is very aware that good opportunities will have to exist to get most of this money put in new investments in Japan and avoid capital flight, which may be one reason the government is jawboning the currency higher and trying to keep confidence up in investing in Japan.

### *D. Overinvestment*

Madsen argued that for at least fifteen years Japan has invested more than appropriate for an economy at its stage of maturity. The impact of investing more than appropriate for the economy's potential growth rate is falling actual utilization. There are numerous indications that this situation is being corrected. Spending on machinery

has been falling at roughly 20 percent a year.

According to Koll, Japan now has to mobilize one unit of capital to make one unit of income, so Japan must focus on putting that excess capital to productive use. If there is too much capital in the economy, the proper government response should be stimulation of new activity through deregulation. However, in Japan, washing out of inefficient producers has not occurred. In fact, the problem of overinvestment has only gotten worse during the 1990s; overall production capacity has increased 8 percent since 1989 (see Table 1). Since 1990 there has actually be the creation of significant additional capacity, not a reduction.

*Table 1: Industrial Capacity and Utilization*

<i>(MITI index, 1995=100)</i>		<b>FY 89</b>	<b>Current</b>	<b>Change</b>
Manufacturing:	Capacity	93.7	101.0	up 7.7%
	Utilization	83.3	69.7	down 16.3%
Electrical machinery	Capacity	87.1	109.0	up 25.1%
	Utilization	77.0	68.9	down 10.6%
Autos	Capacity	94.2	101.0	up 7.2%
	Utilization	98.9	72.0	down 27.2%
Chemicals	Capacity	83.3	105.4	up 26.5%
	Utilization	78.9	67.9	down 13.9%
Steel	Capacity	98.6	98.3	down 0.4%
	Utilization	80.4	66.3	down 16.3%
Textiles	Capacity	118.6	87.5	down 26.2%
	Utilization	77.7	73.0	down 6.0%
Precision	Capacity	108.2	89.7	down 17.0%
	Utilization	83.2	100.5	up 20.8%

Source: Jesper Koll Research, Tokyo

### *E. Unemployment*

Unemployment has reached the record level of 4.4 percent. The decrease in corporate investment and corporate restructuring is translating into rising unemployment. Restructuring has further to go, and unemployment will rise still

further. Unemployment exacerbates the weakness of the economy, as its impact on consumer confidence in a society used to full-employment is great. Falling spending and increased savings rates are in part driven by the high unemployment rate.

Madsen estimated that unemployment was likely to reach six percent in the next few years, while Hale cited a fear that it could rise to seven or eight percent, which would be equivalent to eleven or twelve percent in U.S. terms. The construction sector will be hurt particularly hard, because it should employ around six percent of the workforce, rather than the current 11 percent.

#### *F. Foreign Exchange*

The Japanese trade surplus has grown to record levels in the last year, which according to Madsen, was due to a large fall in imports rather than surging exports. Kinmont warned that Japanese companies and the government have become somewhat complacent about the appreciation of the yen because they have always gotten over it in the past. Yen appreciation would, however, make economic recovery more difficult.

Hale called attention to the problem of the recycling of the Japanese current account surplus. The weak yen had been the only positive aspect of Japan's economic situation, but now the yen will potentially strengthen as in 1995. Japan has been less willing to lend and private yen leverage is reduced. Additionally, the next few months are a period of "seasonal strength" for the yen as companies repatriate funds before the end of the fiscal year. Ironically, Prime Minister Obuchi and top Japanese government officials have been talking up the yen because of fear of the euro, but this misplaced

effort just shows how government officials confuse currency strength with economic strength. Hale noted, however, that in eight to nine months the yen was likely to weaken to a level around 120 to 130 yen to the dollar.

### *G. Government Spending*

Since the first signs of economic weakness the government has repeatedly attempted to restore economic vigor through fiscal stimulus. Although this notably raised GDP growth in 1996 to 3.6 percent, the policy has not had lasting effects, and the April 1997 increase in the consumption tax may have doused any incipient recovery. The cumulative effect of high spending and falling gross tax receipts is ballooning government indebtedness.

No speaker believed that the current government budget deficit is sustainable. Tong warned that dependence on fiscal measures to boost the economy is creating long-term fiscal concerns and Japan will face an "actuarial deadline." Madsen noted that government fiscal straits were exacerbated by the weakening of government influence over the bond prices because of deregulation. Interest rates on government debt have increased from around 0.8 to two percent. This increase will make corporate debt more expensive as well.

Hale too warned that deficit spending is creating an impending fiscal crisis. The central government will run a deficit of 10 to 11 percent of GDP this year. Total government indebtedness could be 140 percent of GDP, which would make Japan's government debt greater than Italy's. This is behind the recent sharp rise in bond yields.

David Asher, a research fellow at the MIT Japan Program, offered the direst picture of Japanese public finances. Including the Fiscal Investment and Loan Program (FILP) and other government obligations excluded from usual accounts, he said that gross government debt could be over 250 percent of GDP. With one-third of government revenue going to local governments, sixty percent of the remaining portion by MOF's figures will go to debt service. Asher argued that the remainder would not even be enough for the Japanese government to meet its payroll without cutting social security spending.

#### *H. Japanese Politics*

Finally, Japanese politics are going through a period of crisis, which has been the backdrop for all the preceding economic problems. The LDP does not have a majority in the upper house, though its majority has grown in the lower house with its alliance with the Liberal Party. The upheaval in the political world may eventually set the stage for a more decisive political leadership to emerge in Japan, but that is still at least two to three election cycles away.

Tong called it a positive change that the Diet is now involved in the formulation of policy. Politicians are involved and overriding the bureaucracy more than in the past. Party alignments now mean nothing. There are cross-party commonalities of opinion, and it is more important to look at who works in what ways with the bureaucracy and other politicians to create support for initiatives.

## *I. Growth Outlook*

Given the significant problems that remain to be worked out, full recovery of the Japanese economy is still a ways off. Hale expects GDP to shrink by 1.0 to 1.2 percent in 1999. Admitting that he was more pessimistic than many, Madsen expected the economy to shrink by two to three percent in 1999, and by somewhat less in 2000.

Taking a longer view, Koll said that it was irrelevant what this year's growth rate in Japan would be, because it is more important to realize that the Japanese economy is undergoing a fundamental adjustment process that is not just cyclical. Although Koll said that a productivity-led upturn in the Japanese economy should occur around 2001-2002, he said that Japan's long-term potential growth rate has decreased and that economic growth will average 1.5-2.0 percent over the next ten years.

## **III. Changes in the Japanese Political Economy**

### *A. Reform and Regulatory Change*

#### The Big Bang

The most eye-catching single reform initiated by the Japanese government in recent years is the so-called Big Bang, named after the "Big Bang" comprehensive deregulation of British financial markets in 1986. Ranging from liberalization of foreign exchange laws to elimination of restrictions on OTC derivatives, the Big Bang reforms are eliminating the walls between banks and securities firms and eliminating specialized niches in the financial industry. Speakers offered different assessments of the significance of the reform measures.

Tong argued that the Big Bang is significant because of the degree to which it surpassed expectations; not only was the content of the reform more than would have been expected, but the plans came out of the Ministry of Finance and introduced a new model of top-down reform initiatives. Unfortunately that pattern has not been much in evidence during the past two years on other issues. With the Big Bang, because MOF itself championed the reforms, the necessary legislation cleared the Diet easily. Tong expressed concern that there is now apparently no sign of other comprehensive reforms coming from any part of the Japanese government. MITI seems too weak to initiate Big-Bang-style top-down reform initiatives.

The effect of the Big Bang on Japanese financial firms is profound, and several speakers expressed reservations about the ability of Japanese firms to compete in the new environment. According to Koll, the main effect of the Big Bang is that the deregulation of the cartels that firms have enjoyed will eliminate barriers between the discrete segments of the financial sector that have limited competition. The key question is whether any Japanese financial institution can compete in a global financial market where generalist financial firms are being replaced by a plethora of specialized service providers.

Eugene Dattel, former managing director of Salomon Brothers Japan, also expressed caution, saying that the consolidations seen so far in the Japanese financial industry are evidence of weakness, not of effective reform. They do not result from restructuring; fundamentally these organizations are more complex and convoluted than ten years ago.



There remains some skepticism that the Japanese government will really stand back and allow the market to make decisions if it really looks like domestic financial firms are in serious danger of extinction. Still, pressure on the government to allow continued reform is great from Japanese firms outside the financial sector. The looming pensions crisis is one reason for this.

Japan faces severely underfunded pension liabilities. According to the OECD, Japan's rate of pension liabilities is 106 percent of GDP. Liberalization of the pension-fund management business has opened the market to foreign firms and is breaking down the informal cartels that have dominated it in the past. Many firms' pension fund problems are so large that the higher returns offered by foreign firms in a deregulated market are irresistible. This makes the pensions business a very good opportunity for foreign firms. Madsen noted that only two percent of household savings is currently invested in mutual funds, and the figure is certain to rise.

### Tax Reform

Tax reform has been one of the most talked about areas for reform. Beyond the tax cuts for individuals announced under some U.S. government pressure last year, a variety of business tax reforms wait to be acted upon.

There has been debate for the past two to three years about corporate tax reform, and the corporate tax rate will be cut from forty-six to forty percent, but Koll noted that the impact of this will be negligible because already sixty-five percent of companies do not pay tax. There has been debate about true reforms that would benefit small firms, but the issue has been repeatedly shelved. The result is that large companies still get

away with paying little tax, while small, profitable firms are hit.

Tong said that one of the most important issues under the headline of tax reform is the creation of a system of consolidated taxation. Although this is essential for the holding company system to yield any benefits, MOF has been resisting it. There has been no movement on changing the system of capital gains taxation, but this is a very important issue for foreign investors. The very controversial issue of introducing taxpayer identification numbers has not even been touched, but is needed to bring fairness to the tax system.

### Obstacles to Reform

Despite the headline reforms in some areas, many speakers offered cautionary notes. Several commented that while the Hashimoto government (January 1996-July 1998) was truly reformist in intention, the Obuchi government does not share the same zeal. Its interest and ability to push through real change is subject to some doubt, and reforms will slow down.

Madsen noted that although the Ministry of Finance has lost some power, it is still very important in party politics. A worrying development is the degree to which MOF bureaucrats have involved themselves deeply in the political process, as evidenced by MOF involvement in the negotiations between the LDP and the Liberal Party on their coalition agreement. The contradiction between the long-term interests of the economy and the short-term interests of politicians is a reason to worry that industrial deregulation will be slow. There are strong incentives for the government to resist enacting tough reforms. Outside observers can watch a few key indicators of how

aggressively the government is acting. These would include the rate of bank closures, the level of construction-sector employment falling towards six percent; new bankruptcy laws that make it easier to foreclose on debts; and weakening the power of the Ministry of Finance.

Tong also agreed that reform is incomplete and that the prospect for future progress is unclear. The most important reform measures are three: tax reform, pension reform, and FILP reform.

Harvard Professor Stephen Vogel offered a rich macro-view of Japanese deregulation. He cautioned that Japan's options do not simply lie on a spectrum from doing nothing to converging on Anglo-American practices. The third option is that Japan will change radically, but according to its own pattern. Cross-national studies reveal that what goes by the name deregulation is re-regulation in a different way, so it may be more appropriate to refer to it as a "profound regulatory change." The Japanese government prefers to manage the process of market entry and tries to prevent market exit, rather than leaving the effects of reform up to free competition. Central government bureaucrats, who perform roles of both promotion of domestic business and regulatory functions, try to design reforms that still allow them some discretion in applying rules or adapting to future circumstances. Bureaucrats thus retain some leverage over market participants.

This distinctive pattern has emerged because of profound reluctance to accept pro-competitive change on the part of bureaucracy, politicians, and business. Most countries have highly regulated, protected sectors as well as open, deregulated,

competitive sectors. Japan diverges from this simple model in three ways: (a) it is particularly biased toward the protected sectors, (b) those who might benefit most from reform are more tied to losers than would be expected, thus they are ambivalent toward reform; and (c) consumers are decidedly uninterested in reform, thus apply no pressure. The Japanese political system is biased toward delicate compromises, not outright victory of reformers.

Nonetheless, Vogel argued, there are some trends that are supportive of greater deregulation. The creation of new opportunities for financial intermediaries through the Big Bang reforms will increase pressure for change in the future. In the last couple of years, there has been a growing divergence between players within sectors, especially in finance, where the pressures are strongest and the delegitimization of the authorities (MOF) has been greatest. As the Japanese political system changes there will also be a softening of resistance to reform. If ongoing reforms do not imply more market access, the political balance will shift, and it will have profound political, not just economic, implications.

The bureaucracy will promote reform on its own terms. Foreign companies need to understand that the bureaucracy can be a friend to outsiders, not just an enemy. Rather than assuming that the bureaucracy will not be sympathetic to a particular case, it is necessary to find out the specific motivations of regulators in that case. Regulators are not always captured by their clients, as in the case of MPT and NTT, for example.

## *B. Changes in Business Practice*

### Corporate Management

Changes in the corporate sector are at least as great as in the regulatory environment, and may be even more important to the operating environment for foreign firms in Japan. The most fundamental change may be in the way Japanese firms view capital and investments. The biggest problem of Japanese companies has been that the cost of capital has been distorted for so long that investment decisions have not been guided by this measure that is fundamental in other countries. Japan's rate of return on capital is far below the U.S. and European Union.

Hale noted that Japanese companies have extremely low profitability. The average return on equity has been two to three percent, compared to 22 percent in the U.S. and 12 percent for foreign companies operating in Japan. Profitability is low for three reasons: (1) Japanese firms have overinvested; (2) there has been a reluctance to restructure employment; and (3) Japanese firms have not been focused on shareholder value, profitability, and corporate governance.

Koll argued that opportunities abound for foreign firms who can take advantage of the fact that the cost of capital is rising sharply for Japanese companies. The cost of debt finance is actually going up despite efforts by the Bank of Japan to keep it low. Over the past year there has been more than a trebling in the cost of corporate borrowing, which is a death knell for many Japanese companies in the highly leveraged corporate sector. This rising cost of capital is driving the bankruptcy rate to record levels for the postwar period.

Kinmont argued forcefully that Japanese companies do not understand that capital has a cost and is not just a consumable resource. He said that the correct parallel for a Japanese company is an aluminum factory in the USSR; it made rather nice aluminum that went into good and inexpensive tanks, but it made absolutely no money. He said that the Japanese economy will recover when companies earn the right return on capital, which is a micro-level change, not a macro-level change. The problem is that most managers were raised in a system where capital was believed to be costless.

Although reform has begun, there is a large establishment in the Japanese private and public sectors that has a commitment to anti-market activities. These days the head of Nomura likes to ask Japanese company managers whether they basically believe that they are a *kabushiki kaisha* (stock company) or a *kosha* (public company); many still have the attitude that they are a public-sector company, a *kosha*. Now, however, the Tokyo stock market is rewarding companies that are acting in a capital-friendly manner with higher valuations. The key line of differentiation among Japanese companies will in the future be between those that are capital-friendly versus capital-unfriendly.

Kinmont noted how at some Japanese companies management is radically altering its approach to capital. The correct conceptualization of a Japanese company is a giant bureaucracy, interested in its own power. Even though there are people in Japanese companies who know that the status quo is unsustainable, they have a hard fight against those who would just as soon have the company exist as a *kosha*. As this mentality changes, Japanese companies will be better targets for foreign investors.

Kinmont advised that although few Japanese companies are ready to be bought tomorrow, it makes sense to begin to look at them.

Kinmont said that the most innovatively managed company in Japan is Sony. It has implemented a system that allows it to see within eight days exactly where and how it is making and losing money. Most Japanese companies simply do not have systems in place that can provided them this ready access to information to know exactly how they are doing. As one simple measure, it is interesting to note that while in the U.S. sales of spreadsheet software are roughly even with word processors, in Japan spreadsheets sell only one-third as much as word processors.

### Cross-Shareholding

The decline in cross-shareholdings is one sign that the lesson of capital cost is being learned. Companies are selling cross-shareholdings to shore up their balance sheets (see Table 2). This is especially true of banks, which have the largest cross-shareholdings. Kinmont noted that there is a clear correlation between the weakness of a group's main bank's balance sheet and the dissolution of cross-shareholdings. According to Koll, from a high of 70 percent at the height of the bubble economy, cross-shareholding now represents around 50 percent of market capitalization. Furthermore, it is currently dropping at around 3 percentage points a year, and that rate is accelerating. This changes the way firms relate with other firms that are nominally members of the same corporate group. It also will have an effect on stockmarket liquidity as a higher share of stocks are actively traded.

Table 2: Cross-Shareholding Ratios (%)

FY	Overall Market		Financial Institution Stocks	
	Stable Shareholder Ratio	Cross Shareholding Ratio	Stable Shareholder Ratio	Cross Shareholding Ratio
1987	41.56	21.23	57.38	33.31
1988	41.67	20.75	57.42	33.02
1989	40.49	20.62	54.14	30.02
1990	41.24	21.58	54.63	31.16
1991	41.19	21.47	54.15	30.07
1992	41.40	21.40	54.10	29.56
1993	40.07	21.10	53.74	31.03
1994	40.65	21.15	52.96	30.19
1995	39.11	20.75	52.73	30.56
1996	37.82	19.63	49.96	28.24
1997	35.69	18.18	48.21	26.51

FY	Industrial Companies			
	Wide Stable Shareholder Ratio	Wide Cross Shareholding Ratio	Narrow Stable Shareholder Ratio	Narrow Cross Shareholding Ratio
1987	23.97	13.90	9.18	9.24
1988	25.16	14.75	9.67	9.66
1989	25.13	15.60	9.89	8.95
1990	26.05	16.29	10.48	9.11
1991	26.51	16.38	10.59	9.37
1992	26.02	16.00	10.39	9.28
1993	25.51	15.84	10.18	9.03
1994	25.33	15.98	10.10	8.78
1995	24.68	15.70	10.09	8.24
1996	24.94	15.63	10.14	8.58
1997	22.60	14.87	9.70	9.15

Source: Nippon Life Research Institute, presented by Alexander Kinmont

Kinmont warned, however, that the proceeds of unwinding cross-shareholdings may not flow directly to a company's shareholders. Sony, for example, has announced that the transfer of its cross-shareholdings to its pension fund, and MITI and MOF are looking at encouraging such an approach.

### Employment

Employment practices of Japanese companies are changing slowly, but they are changing. Workforce reduction at prominent large companies is still mainly by attrition. Kinmont warned that as companies begin to use holding companies, it is essential that



labor standards and wages are applied at the level of the individual operating companies, not to holding-company groups as a whole. If this happens, then it is a sign of fair returns to capital and some concern for shareholder value.

Another new feature of Japanese employment was pointed to by Koll. It is easier now than ever for foreign companies to hire good staff in Japan. The labor market for professionals has become mobile in a way that it has not been before. Foreign companies with a good incentive-based salary plan are now in a good position to attract quality talent both directly out of universities as well as from other companies.

#### IV. Asset Acquisition

##### A. Foreign Investment in Japan

Historically, the stock of foreign direct investment (FDI) in Japan is markedly lower than any other advanced industrial country (see Table 3). Tong said that the data on FDI is very bad, and said that the generally accepted figure for stock of FDI in Japan is closer to one percent, not the U.N.'s 0.4 percent. Even allowing for problems in the data, there is no denying that FDI is low, but increasing.

*Table 3: Selected Comparative Foreign Investment Data*

	FDI Stock (US\$ bil)	FDI/GDP		FDI Stock (US\$ bil)	FDI/GDP
U.S.	644	8.5%	China	169	20.0%
Japan	18	0.4%	Singapore	67	67.0%
Germany	171	7.3%	Malaysia	42	43.0%
			Philippines	8.2	26.0%
France	168	6.2%	Indonesia	59	7.4%
U.K.	345	30.0%	S. Korea	12.5	2.5%
Holland	118	30.0%			
Canada	129	21.4%	Mexico	71.5	25.0%
Australia	124	31.7%	Brazil	108	13.3%
			Chile	19	13.7%

Source: U.N. data presented by Jesper Koll Research, Tokyo

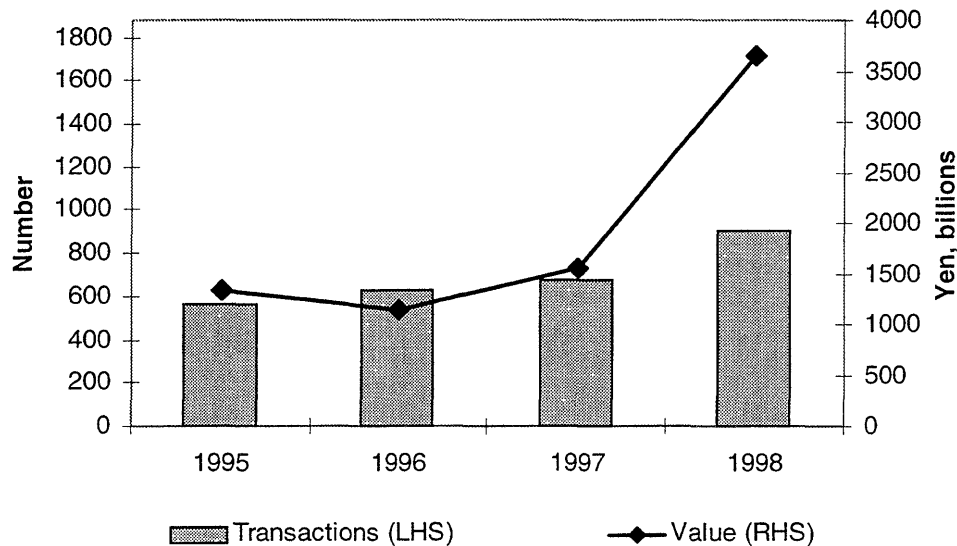
The consensus of conference speakers was that in five years the stock of FDI in Japan was likely to be 3 to 4 percent of GDP. Hale hoped that in a few years FDI stock in Japan could be approaching \$40 billion. Still, FDI in Japan needs to grow by at least \$250 billion to come close to any other large economy in terms of GDP.

#### *B. Mergers & Acquisitions Activity*

Both domestic and inward M&A activity is increasing. The number of transactions increased from 566 in 1995 to 899 in 1998 according to Nikko Securities, and the increase in transaction value has been even sharper (see Figure 1). The value of incoming flows of FDI to Japan has increased from less than ¥400 billion in 1993 to almost ¥1.2 trillion in 1998, and Koll said that the number of transactions increased from 31 to 100 over the same period. Nevertheless, the value of M&A transactions in Japan is still only three percent of the level in the U.S.

Tong noted that thus far the bulk of inward M&A cases have been buy-outs by foreign companies of their Japan agents and partners, but this is also changing.

Figure 1: M&A Activity in Japan



Source: Nikko Securities data, presented by Kiyotaka Fujii

According to Kinmont, a remaining barrier to a real take-off in M&A activity is that stockmarket valuations are still not low enough to make acquisitions a better route to growth than building a business yourself. Good companies in Japan do not need foreign capital, and those that do are not attractive targets. Even if this were to change, the infrastructure for full-scale M&A simply does not exist in Japan.

For one, there have also been significant legal obstacles to M&A. Until last year it was very hard to get a ruling against management even when you owned more than 50 percent of a company, but a court ruling has now affirmed that 50 percent ownership means 50 percent control.

Japan also has a severe shortage of specialist professionals, which is a hindrance to efficient growth of businesses. Professional talent that in countries such as the U.S. is available from outside specialized firms is often handled in-house in Japan. This means

that there are relative few talented professionals for hire. Kinmont showed, for example, that only 16,369 lawyers and 15,494 accountants are members of the respective national professional organizations in Japan, compared to 340,000 members of the American Bar Association and 328,214 members of the American Institute of Certified Public Accountants.

Kiyotaka Fujii, president of Cadence Design Systems, also pointed to several historic deterrents to M&A activity in Japan: corporate governance, limited availability of attractive targets, high prices, equity market behavior, risk averse structure, lengthy decision-making process, legal and regulatory barriers, and tax inefficiencies. The lifetime employment system encouraged diversification and hindered the use of acquisitions to generate operating efficiencies and redundancies. Since the cast of characters in Japanese companies will be there a long time, everybody acts as if they were a debt-holder, not an equity-holder.

A few comments touched on the likelihood of MBOs in Japan. GE Capital's Keith Miller said that MBOs will become possible in Japan, but it will probably happen in the area of non-core assets. Firms have their best people in core assets, so you might sit down to negotiate an MBO with a team from non-core assets and get the sense that these people are adequate, but not the A-team. It will be difficult.

Dattel and MIT Professor Donald Lessard questioned the utility of a concept such as "core assets." Treatment of core/non-core is not fixed across countries. In the U.S., financial companies force the distinction and American firms focus on core activities. In other environments, the distinction might not be drawn if it is not forced.

### *C. Company Cases*

Three speakers shared comments about their own company's experiences and strategies of investment in Japan.

John Cassidy of United Technologies Corporation said that UTC's approach to Japan is equity partnerships. To make these work, it is important to try to walk in your partner's shoes. Even though you will never be able to, it helps to mitigate differing expectations and approaches. Americans and Japanese approach joint-ventures in very different ways. While Americans think the hard part is putting the deal together, Japanese think that it is in making it work.

For companies considering business in Japan, it is important to think broadly about what is offered by the Japanese market. United Technologies has identified numerous advantages to being in Japan: (a) the domestic market opportunities are large; (b) it is a rich location for technology synergies and learning; (c) proximity provides the ability to learn about major competition, (d) the demands of the market lead to the creation of better global platforms; and (e) it provides the ability to leverage areas of excellence in each region and/or each company. The Japanese market has long demanded things that no other market in the world demands in terms of quality and excellence; now it also demands the same in terms of price competitiveness, so if you can succeed in Japan you can do so anywhere.

GE Capital has approximately three percent of its \$90-billion business in Japan. Keith Miller said that in moving into Japan, firms must more often think in terms of liability acquisitions than asset acquisitions. Deregulation is driving much change and

bringing Japanese companies to link with foreign firms. For ventures to succeed, it pays to integrate the existing management in the new business.

In order to overcome cultural biases, you must find congruence of goals between you and your partners. You must understand what you are buying; GE Capital buys in Japan businesses that it has elsewhere, thus things that it knows, not things that are new. You need to have confidence to take decisive actions after the acquisition.

The jury is still out on foreign venture capital investment in Japan. The private equity-venture capital model in which GE Capital is highly knowledgeable is a very foreign idea in Japan. There are no examples yet of going in and successfully exiting. In the case of GE Capital, a joint venture with Toho in insurance has been a success, but there is not yet one in private equity.

Cadence Design Systems' Fujii said that his company brought to Japan a business model that did not exist, and which probably would not exist, because it is came out of the Silicon Valley model, not the Japanese way of operating. While Japan had overcapacity in semiconductor manufacturing, it had undercapacity in design resources. Cadence provides contract design resources, allowing firms to add production to underused, capital-intensive fabrication plants. Cadence's success has come from providing Japanese companies with a way to turn around huge losses on sunk capital investment.

The lesson of Cadence for other firms is that there are ample niches for specialist firms which provide something that Japanese firms do not have the capacity for. As a specialist outsider, Cadence is non-threatening to clients with manufacturing facilities.

Because Cadence was creating a new market in Japan, it did not compete against established domestic players, but rather against other American firms.

#### *D. Potential Backlash*

Most speakers acknowledge the possibility of a backlash against foreign investors, but on the whole they were sanguine about it.

Koll strongly disagreed with the prediction of backlash against foreign investment and foreign “vultures.” Vociferous opposition is a fringe opinion. It is broadly recognized that foreign know-how generates value and jobs in Japan.

Kinmont said that there is certainly great apprehension about foreign acquisition of Japanese companies, but there is also an understanding that it also may be the best option. It is not automatically assumed that a foreign acquisition is antithetical to Japanese interests. In this respect Japan is not unlike other countries, for example, the rejection of Ford’s acquisition of British Leyland/Rover.

#### **V. Effects on US Policy**

Given the difficulties faced by the Japanese economy and the changes going on there, what can the U.S. do? The answer to that question must address both the macro-level concerns about the stagnation of the Japanese economy and its relation to the broader economic crisis in Asia, as well as the micro-level of U.S. trade with and business in Japan.

Edward Lincoln, a Brookings Institution senior fellow and formerly economic advisor to U.S. Ambassador Walter Mondale in Tokyo, noted that the ability of the U.S.

government to directly influence the economic environment and pace of change in Japan is limited, given that Japan is a large, sovereign power with little debt. The main role that the U.S. can play is to speak out and offer advice, and the U.S. government has been doing so, especially from October 1997 through the summer of 1998. This pressure made some difference, and is better than hectoring. Cooperation and quiet friendly talk did not work very well; someone had to speak up and loudly say that things were not right and could not continue as they were. Although the speaking out by the U.S. did have an effect on the size and inclusion of a tax cut in the stimulus package of April 1998, that package was not a magic bullet. Beyond speaking out, the U.S. has relatively little leverage. On macroeconomic issues, the U.S. was able to force Japan to talk in order to get U.S. support on stopping slide of yen. U.S. had less than stellar result in influencing the Bridge Bank Plan of July 1998.

In relation to the business of American companies in Japan, however, Lincoln said that the U.S. government can do more. U.S. trade officials should continue to pursue both structural and sectoral negotiations. Both are necessary, because not all issues can be folded into a single format. For either type of negotiation to succeed, however, the U.S. government needs the support of American companies and their particular issues of doing business in Japan. Not only sectoral negotiations, but also structural talks are unlikely to go anywhere without specific company cases to make the issues salient. The Structural Impediments Initiative, for example, went nowhere until the Toys'R'Us case was used to get changes to the large-scale stores law.

Lincoln said that too few U.S. companies call on the U.S. government when they



have difficulties in Japan. Their preferred solution is to solve its own problems, but that is not always the most effective way. The benefit of involving the U.S. government in problems has been apparent for at least the past thirty years and will continue. No grand overarching agreement is going to solve things, and progress will be issue-specific.

David Asher's prescription for U.S. policy came in the form of a warning that the U.S. must be ready to support Japan through a coming "comprehensive crisis." Based on his prediction that Japan could experience a government fiscal crisis by the end of fiscal year 1999 and a "meltdown" in the broader economy in 2000, Asher argued that the Japanese government would be forced either to radically open the economy to market forces or to retreat into severe protectionism and capital controls. On present trends, retreat from reform seems more likely, so the focus of U.S. policy toward Japan must be on supporting a move towards more openness. This would entail ceasing demands on Japan for fiscal stimulus, which is only a temporary fix, and demanding that Japan be the engine for a wider Asian recovery. The best policy option for the U.S., said Asher, would be to revitalize the U.S.-Japan relationship through a "Comprehensive Security Treaty," that included a U.S.-Japan common market, an expanded mutual security agreement including a commitment by Japan to come to the defense of U.S. forces, and an agreement on international cooperation to defend such common interests as the flow of oil from the Middle East and freedom of navigation in Asia. Not only would this keep Japan from moving towards destabilizing protectionism, but in its boldness it would offer the United States economic and security

benefits that years of negotiations have not achieved.

## **VI. Conclusions**

The conference "From Bullying to Buying: Opportunities for Foreign Investment in Japan" started from the premise that a sea change in Japan during the past decade has brought about historically unprecedented opportunities for foreign companies in Japan. Speakers at the conference presented a wealth of data, some of it tending confirm this premise, some of it contradicting it, and much of it still difficult to read at present.

In support of the change "at last" view outlined by Richard Samuels at the beginning of the conference, there was some positive data. The reforms that have been initiated, especially in finance and telecommunications, are real and are progressing despite opposition. In the corporate world, the dismantling of cross-shareholdings and the rise in M&A activity are indications that acquisitions are becoming easier. The increased mobility in the labor market promises a more efficient economy in the long-term, and in the short-term is providing foreign companies with access to human capital that was out of reach before. In the private sector there are signs of a new generation of bureaucrats and managers who understand that capital has a cost, and management struggles are for the first time visible. New financial accounting, new technologies, and international competition will continue to eliminate rigidities in corporate management.

But ample data supporting the "at least" view was offered during the conference as well. Foremost is the seeming tenuous nature of many reform efforts and uncertainty

about the direction of future reforms. Whereas Hashimoto's reformist zeal was real, the Obuchi government does not show the same convictions. Reform may yet be subverted by the anti-competitive forces identified by numerous speakers. Kinmont spoke of a pervasive ideological hostility to free markets, and Fujii cited opponents of entrepreneurship. Vogel pointed to the strength of inertia in the system and the degree to which even notional beneficiaries of reform are also bound to the interests of continued protection. Lincoln noted that past reforms, such as the NTT agreement, were in danger of coming undone. The persistent need for sectoral and structural talks is reason enough to be pessimistic about the potential for Japanese domestic reform initiatives.

In the final analysis, however, Japan is an important market for foreign companies to be in, and their growing presence there is changing the way the Japanese economy relates to the rest of the world. One thing to remember about Japan is that it is still the second largest economy in the world. It has abundant wealthy consumers and a highly educated workforce. Deregulation is allowing foreigners to break into previously protected sectors. Despite all the political intrigue, Japan is politically stable. The legal system provides protection to investors and is truly accountable. There is more and greater transparency than ever before.

As Madsen pointed out, there is a difference between saying that the macroeconomy has problems and that there are no microeconomic opportunities. Japan remains a promising market even if you assume the worst case of what everyone has said. By investing in the Japanese economy, foreigners have a greater chance of

normalizing the system than by remaining outside.

## VII. Full List of Conference Speakers

### **Introduction & Conclusion**

Richard Samuels                      Ford International Professor, Department of Political Science, M.I.T.; and  
Director, M.I.T. Japan Program

### **Session 1: Japan's Economic Outlook**

Jesper Koll                              Managing Director, Tiger Management Japan, L.L.C.

Robert Madsen                        Visiting Scholar, Stanford University; and  
Economist Intelligence Unit

Clay Chandler                         Staff writer, *The Washington Post*  
(moderator)

### **Session 2: Reform and Regulatory Change**

Kurt Tong                                First Secretary for Finance and Economics, U.S. Embassy Tokyo

Alexander Kinmont                    Equity Strategist, Morgan Stanley Japan, Ltd.

Stephen Vogel                         Assistant Professor of Government, Harvard University; and  
Acting Director, Program on U.S.-Japan Relations, Harvard University

Robert Radin                         Associate Director, Program on International Financial Systems, Harvard  
(moderator)                              Law School

### **Session 3: Asset Acquisition**

Eugene Dattel                         former Managing Director, Salomon Brothers Japan, Ltd.

John Cassidy                         Sr. Vice President for Science and Technology, United Technologies  
Corporation

Kiyotaka Fujii                         President, Cadence Design Systems

Keith Miller                            Senior Vice President, GE Capital Equity Capital Group

Donald Lessard                        Deputy Dean and Epoch Foundation Professor of International  
(moderator)                              Management, M.I.T. Sloan School of Management

### **Session 4: The Effects of Reform on U.S. Policy**

Edward Lincoln                        Senior Fellow, Foreign Policy Studies Program, The Brookings Institution

David Asher                            Research Fellow, MIT Japan Program

Richard Samuels  
(moderator)

### **Conference Dinner (January 11, 1999)**

David Hale                              Chief Global Economist, Zurich Group

### **Conference Lunch (January 12, 1999)**

Frank B. Gibney                        Professor, Department of Political Science, Pomona College; and  
President, Pacific Basin Institute, Pomona College