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4 Japan's Low Levels of Inward Investment: The Role of Inhibitions on Acquisitions

Robert Z. Lawrence

The 1980s have seen a dramatic increase in global foreign direct investment (FDI) within the Center on Transnational Corporations triad (UN 1991). In particular, both Japanese and European firms have rapidly increased their holdings in the United States, while U.S. and Japanese investments in Western Europe have expanded considerably. Foreign direct investment into Japan, however, remains the weakest link, with flows much smaller than those into the United States and Europe, even when the relatively smaller size of the Japanese economy is accounted for (Transnational Corporations and Management Division 1992, 20, table I.4). The result is that foreign firms play an unusually small role in the Japanese economy. As noted by Edward Graham and Paul Krugman (1991, 33), compared with other major economies such as Germany, France and the United States, in which between 14 percent and 26 percent of industrial assets are controlled by foreigners, the 1 percent share controlled by foreigners in Japan is minuscule. Other data indicate a similarly low share of FDI in Japanese employment, sales, and domestic capital formation.

Should one be surprised at these low levels of FDI in Japan? What do they tell us about the nature of the Japanese market? The official Japanese interpretation is that foreigners can readily succeed in Japan, although it takes considerable effort. Indeed, publications of government agencies (e.g., JETRO 1989) proclaim the success of firms such as IBM, Texas Instruments, Procter and Gamble, and Coca-Cola. According to the *Japan Economic Journal* (1990, 1), "As numerous examples of successful foreign ventures testify, [Japan] may not be an easy market, but it certainly is an open one."

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But the success stories seem to be the exception rather than the rule. The relatively low FDI stock in Japan is partly the result of a history of official inhibitions on FDI. As Dennis Encarnation (1992) and Mark Mason (1992) describe, inward FDI was heavily restricted for much of the postwar period. Officially, however, at least since the early 1980s, the Japanese market has been open to FDI.[1] Indeed, JETRO (1989, 1) disseminates reports by the American Chamber of Commerce in Japan and by the European Business Community which state that "government regulations are no longer an obstacle to foreign investment in Japan."[2]

4.1 Recent Foreign Direct Investment in Japan

One might have expected that FDI would surge in the 1980s as firms compensated for their previous exclusion from Japan. According to Japan's Ministry of Finance, which records notifications rather than actual transactions, the pace of inward FDI has accelerated. The Japan Economic Institute (1991a, 3) reports that between 1980 and 1990 the Ministry of Finance was notified of $12.6 billion as additions to equity capital. This raised the total of postwar FDI from 8,826 cases valued at $3 billion at the end of 1980 to 42,900 cases valued at $15.5 billion at the end of 1990.

Ministry of Finance data, however, overstate FDI since they refer to notifications and not to actual investments and do not include loan repayments or liquidations of assets. In fact, in recent years, major withdrawals, particularly from minority-owned ventures, have been significant. These include the much publicized sales of equity by General Motors, Chrysler, Honeywell, Avon, and Southland Corporation (7-Eleven). According to estimates made by the United States Department of Commerce using balance-of-payments data reported by the Bank of Japan, the value of the total stock of inward FDI (valued at historical cost) in Japan at the end of 1989 was a mere $9.2 billion (to be sure, a threefold increase over the value in 1980), an amount that implied no increase in the global share of inward FDI of Japan over the decade.[3]

The estimates of the Bank of Japan understate FDI in Japan because they exclude reinvested earnings. An indication of the importance of this omission

1. In 1980, the Foreign Exchange and Foreign Trade Control Law allowed FDI in all but four industries (petroleum, leather, mining, and agriculture). Notification of investments was still required, and the government retained the right to object to any investment deemed a threat to national security or to "the smooth performance of the Japanese economy." Japan also retained the right to reject investments "from the viewpoint of reciprocity." Nonetheless, in principle, such objections were supposed to be rare. In 1992, the diet enacted provisions to remove the government's authority to block FDI deemed a threat to the smooth performance of the economy (Mason, forthcoming).

2. The U.S. government argued in the Structural Impediments Initiative talks that the notification process involved delays. In 1991, the Japanese diet shifted to ex post facto reports; in March 1992, the government of Japan actually passed a law designed to encourage FDI.

3. It is striking that just two acquisitions, one of MCA Inc. by Matsushita Electric Industrial Co. Ltd. in late 1990 ($6 billion) and the other of Columbia Pictures by Sony Corporation ($3.4 billion), are roughly equal to the entire value of the stock of inward FDI in Japan.

can be gleaned from the data reported by the United States, which is the largest foreign investor in Japan. (On a cumulative basis, Minister of Finance data suggest that, as of March 1991, United States investors held 47 percent of the total book value of reported FDI.) U.S. balance-of-payments data show a significant increase in the value of the FDI position of the United States in Japan, valued at historical cost. Between 1982 and 1990, for example, this position tripled, from $6.4 billion to $21 billion. This represents a considerably faster rise than the twofold increase in the global stock of U.S. FDI valued at historical cost over the same period. However, the data also reveal that the growth was dominated by the activities of enterprises that were already in Japan. Valuation adjustments (which occur, for example, when a U.S. affiliate is sold to another U.S. owner), reinvested earnings, and intercompany debt flows more than account for the growth. On balance, changes in equity capital were actually negative. Apparently, liquidations outweighed new injections of capital.[4] In sum, therefore, it appears that the foreign stake in Japan is growing, but primarily through the reinvested earnings of the firms already resident in Japan. New inflows have been offset by increased exit. As a result, compared with that of other economies, the overall FDI stock in Japan remains unusually low. In 1990, assets held by U.S. foreign affiliates in Japan accounted for 12.8 percent of the total assets held by all U.S. foreign affiliates abroad. However, these data include U.S. minority stakes in firms such as Mazda, Mitsubishi Motors, and Isuzu. Japan accounted for only 5.7 percent of the assets in United States majority-owned foreign affiliates worldwide and only 5.5 percent of the majority-owned manufacturing affiliates.

This paper argues that the difficulties of acquiring existing Japanese firms help explain the low level of FDI in Japan. Indeed, the distribution system and other unusual entry barriers to the Japanese market suggest that the demand for acquisitions by foreigners contemplating FDI should be unusually high. In fact, however, most foreign entry into Japan occurs through greenfield operations. Obstacles to acquisition on the supply side, therefore, dominate entry patterns. The low levels of FDI in Japan reflect the need to rely on greenfield entry in a market in which entry barriers would normally induce entry through acquisition. One of the major barriers to foreign acquisitions of Japanese firms are the stock cross-holdings of Japanese corporate groups. Statistically significant evidence suggests, indeed, that *keiretsu* linkages inhibit FDI in Japan. The final section of the paper considers some implications of this finding.

4.2 The Demand for Acquisitions

Foreign firms may face higher market entry costs than their domestic counterparts. Some of these simply reflect a lack of familiarity with the domestic

4. New inflows of equity capital were not a major source of the overall growth of the United States FDI position worldwide. Between 1982 and 1990, only 4 percent of the growth in the historical-cost position reflects net equity flows.

economy; others may be permanent and reflect official and/or private discrimination against foreign-owned firms. Much of FDI theory rests on the recognition of these disadvantages and the insight that, to compete abroad, a firm must have compensating advantages in the form of specialized product, process, or marketing assets. But establishing a majority-owned foreign operation is not necessarily the optimal means of exploiting firm-specific assets. One alternative is to service the foreign market through exports. If foreign production is advantageous (e.g., because of trade barriers, transportation or production costs, or the benefits of market proximity), then licensing, franchising, and joint ventures could be attractive alternatives to majority-owned FDI. Of course, these methods of market entry could be complementary. However, it is instructive to consider the factors that determine choices between them, since it helps to evaluate the characteristics of FDI in Japan.

4.2.1 Foreign Direct Investment versus Licensing

Consider first the choice between FDI and licensing without equity. Licensing has the advantage of saving the firm the costs of manufacture and market entry. On the other hand, licensing requires formulating and monitoring a contract relating to the foreign use of the specific assets of the licensing firm. As Edward John Ray (1989, 59) points out, the licenser faces risks of opportunistic behavior by the licensee and difficulties of assessing the value of the assets being licensed. In addition, where specific assets of a firm are not easily reduced to a formula or a blueprint, the licensee faces the risk that the know-how will not be readily assimilated. Foreign direct investment, by contrast, allows a firm to internalize these contracting, informational, and transference difficulties, although it requires incurring the costs associated with foreign entry and operation. As Ray notes, the desire to invest directly is positively related to these licensing contract costs and negatively related to the market entry and operating costs of the investing firm. A reliance on licensing suggests the dominance of entry and marketing costs over contracting costs.

The propensity to license could also rise with the presence of domestic monopolies.[5] Foreign firms could prefer to take advantage of domestic monopoly power of a local firm rather than enter into head-to-head competition with it. Indeed, a domestic firm with existing market power may be prepared to pay more for a license than would firms that are forced to compete.

The government of Japan has historically induced foreign firms to grant licenses by placing severe restrictions on FDI. Officially, the Ministry of International Trade and Industry (MITI) is no longer engaged in such activities. Nonetheless, it is clear that, compared with other nations, a disproportionate amount of United States know-how continues to be exploited in Japan through licensing rather than through export sales or FDI. In 1990, for example, the $1.2 billion U.S. companies earned from royalties and licensed fees from Japan

5. I thank Kenneth Froot for this point.

accounted for 35 percent of U.S. receipts from royalties and fees from unaffiliated foreigners worldwide.[6] By contrast, in 1990, U.S. receipts from Japan from foreign affiliates in the form of income and royalties and license fees were only 5.5 percent of total U.S. receipts from affiliates worldwide. Indeed, U.S. earnings from royalties and license fees from unaffiliated Japanese firms were 33 percent of all U.S. receipts from their foreign affiliates in Japan in the form of income and royalty fees. By contrast, worldwide, total U.S. receipts from payments of royalties and fees by unaffiliated foreigners amounted to just 5.2 percent of total U.S. receipts (income plus royalties) from affiliates.

Over the 1980s, as restrictions on FDI were removed, the role of licensing might have been expected to diminish. Yet, in 1980, the $354 million paid by unaffiliated Japanese firms to the United States in the form of fees and royalties equaled 40 percent of FDI income—considerably smaller than the corresponding ratio of 61 percent in 1990. In 1980, Japan accounted for 30 percent of all U.S. income from fees and royalties; in 1990, its share was 35 percent. To be sure, more research is required to determine how much of the rapid growth in Japanese fees and royalties reflects recent licensing and how much simply reflects a historical legacy.

4.2.2 Joint Ventures

Consider next the choice between minority positions in joint ventures and majority-owned FDI. Joint ventures represent a compromise between licensing and full control. They may be more advantageous to foreign firms than licensing is, because they permit a foreign firm to exploit its specific assets while economizing on the costs of operation in a foreign environment and avoiding some of the contract costs associated with licensing; they may be more advantageous to the domestic firm in ensuring an effective transfer of the specific foreign assets. Joint ventures, nonetheless, retain the risks associated with the loss of know-how to foreign partners and with the lack of complete operating control. Both partners in joint ventures may fear the creation of formidable future competitors. In general, one would expect joint ventures to predominate over FDI in those cases in which operating in a foreign environment presented unusually large problems for foreign-owned firms, because of entry barriers and/or operating difficulties (e.g., nationalistic discrimination against foreign-owned firms). Indeed, often sanctioned by law, joint ventures predominate in FDI in developing countries following protectionist policies. Joint ventures could also be a means of collusion when ventures have monopoly potential.

Generally, however, U.S. firms prefer to invest abroad in majority-owned ventures. In 1990, majority-owned companies accounted for about 78 percent of the FDI assets of U.S. firms. By contrast, only 34 percent of the FDI assets in Japan and only 26 percent of the assets in manufacturing were in majority-

6. In 1990, Japanese firms earned only $185 million in payments from unaffiliated U.S. firms for royalties and license fees. This is less than one-sixth of the corresponding receipts from unaffiliated Japanese firms earned by U.S. firms.

owned companies. Indeed, there is a relationship between countries that have generally discriminated against FDI and the share of majority-owned firms in FDI assets. While in developed countries that ratio averaged 76 percent, the conspicuous outliers are the Republic of Korea (18 percent), India (14 percent) and Japan (34 percent).

There is evidence, however, that the U.S. FDI position in Japan is becoming more concentrated in majority-owned firms. In 1977, for example, majority-owned U.S. affiliates accounted for only 16 percent of the assets of U.S.-affiliated firms in Japan. One source of that shift is the actual decline in the activity associated with minority-interest U.S. affiliates in that country. Indeed, as reported in table 4.1, employment and sales (adjusted for exchange rates and inflation) in minority-interest U.S. affiliates in Japan actually declined by 28 percent and 36 percent, respectively, between 1977 and 1990. The second source of the shift is the rapid growth in real assets (increasing by 91 percent) and real employment (increasing by 70 percent) of majority-owned ventures. Thus, while the U.S. stake in majority-owned affiliates in Japan remains unusually small, it is a growing component of the overall U.S. FDI position.

4.2.3 Investment in Wholesale Trade

As emphasized in particular by Encarnation (1992), U.S. majority-owned investment in Japan has been heavily directed toward wholesale trade. Valued at historical cost, worldwide U.S. investment in wholesale trade accounted for just 11 percent of the U.S. global FDI position in 1990. A similar valuation of the U.S. position in Japan indicates that wholesale trade has an 18 percent share in the U.S. position. Similarly, the value of assets in majority-owned affiliates involved in wholesale trade account for 18 percent of all assets held by majority-owned U.S. Japanese affiliates. By contrast, only 10 percent of majority-owned affiliate assets worldwide are in wholesale trade. Also, unlike other forms of investment in Japan, U.S. FDI in wholesale trade is predominantly majority owned. Indeed, in 1990, 49 percent of all U.S. assets in wholesale trade were in majority-owned firms. These data strongly suggest either unusual profit opportunities in this industry or the importance of such investment for making sales.

In sum, the continued dependence on licensing, the heavy reliance on minority-interest ventures, and the relatively large investments in majority-owned wholesale trade ventures support the argument that the marketing and distribution of foreign products in Japan are unusually difficult or that current inflows have been too small to offset the impact of earlier policies. (The data on U.S. licensing and wholesale trade investment could also indicate a lack of competition.)

A study conducted by the U.S. International Trade Commission (1990) singled out:

- Legal restrictions on retailing, wholesaling, and investment as limiting entry. These include a weak enforcement of the antimonopoly law of Japan, the

Table 4.1 U.S. FDI: Japan versus Developed Countries in 1977 and 1990

Type of Affiliate	1977	1990	Percentage Change
Japan			
Majority owned (%)			
Employment	16.8	32.4	70.4
Sales	25.5	37.4	12.3*
Assets	16.1	33.8	91.4*
Minority interest (%)			
Employment	83.2	67.6	−28.1
Sales	74.5	62.6	−35.8*
Assets	83.9	66.1	−28.4*
Total			
Employment (number)	389,123	344,300	−11.5%
Sales ($ billions)	$51.9	113.4	−23.5%*
Assets ($ billions)	$41.8	108.3	− 9.2%*
Developed countries			
Majority owned (%)			
Employment	76.7	75.1	
Sales	75.4	77.5	
Assets	71.3	76.2	
Minority interest (%)			
Employment	23.3	24.9	
Sales	24.6	22.5	
Assets	28.7	23.8	
Total			
Employment (number)	4,980,691	4,308,500	
Sales ($ billions)	$449.0	$871.1	
Assets ($ billions)	$359.6	$843.2	

Sources: International Monetary Fund, *International Financial Statistics,* various issues; U.S. Department of Commerce, National Trade Data Bank; U.S. Department of Commerce (1981).
Note: In 1977, $1 in U.S. = 268.5 yen. In 1990, $1 U.S. = 144.8 yen.
*Real sales/assets adjusted for inflation and exchange rate changes. The consumer price index in Japan rose by 54 percent during the period 1977–1990.

Large Retail Store Law (which limits expansion of large retailers), and other regulations and entry fees.

- Business practices used by manufacturers to exert vertical control over distribution channels and to reduce horizontal competition.
- The high costs associated with setting up independent distribution systems (land rent, warehousing, transportation), partly as a result of government tax and land use policies.
- Social customs that emphasize long-term relations, resulting in less willingness by purchasers to switch suppliers or retailers.

4.2.4 Greenfield versus Acquisitions

Once the decision to invest has been made, a firm has the choice of either starting a greenfield operation or acquiring an existing operation. In equilib-

rium, one would expect to see firms priced at their replacement cost—that is, for Tobin's q (the ratio of the firm's market value to its replacement costs) to equal unity. However, when $q = 1$ for domestic entrants, foreigners, if their costs of entry are systematically higher, should be prepared to pay more than domestic firms do for existing firms. Indeed, except in cases where the specific assets can only be transferred to new ventures, one would expect to see acquisition as a more common means of entry in FDI than in domestic investment. In general, the foreign preference for acquisitions over greenfield investments reflects the disadvantages faced by foreigners in establishing domestic operations. The more costly it is for foreigners, as compared with domestic firms, to enter new markets, the higher the demand for acquisition over greenfield entry.

In terms of our theoretical analysis, the evidence on licensing, joint ventures, and investment in majority-owned wholesale trade operations is strongly suggestive of unusual barriers to entry, operation, and marketing in Japan. This evidence suggests that, ceteris paribus, foreign demand for acquiring existing Japanese firms as a means of entry should be unusually high. Ex post, however, the share of entry accounted for by foreign acquisitions also reflects the relative supply of acquirable assets to foreigners. This supply is related to the overall level of economic development. In addition, however, it reflects the market for corporate control in general, as well as official and unofficial discrimination against foreigners. Indeed, it will be argued below that all factors limiting the supply of acquirable assets have played a role in constraining FDI in Japan.

4.3 The Supply of Acquirable Assets to Foreigners

Data gathered by the Japan Economic Institute (1990) show that the number of mergers and acquisitions in Japan is actually quite similar to that in the United States, but the typical Japanese deal appears to be smaller (table 4.2). However, this finding could simply reflect a bias in the samples; the Japanese data, which are based on reports to the Fair Trade Commission, are comprehensive, while the U.S. data may not be. In both countries, merger and acquisition activity has increased rapidly in recent years. Although megadeals appear to be more rare in Japan, they are not unknown. In fact, the Mitsui Bank merger with Taiyo Bank in 1990 was actually the largest in the world in terms of market capitalization (Holloway 1990, 41).

4.3.1 Hostile Takeovers

The more striking differences between Japan and the United States, however, relate to the feasibility of hostile takeovers and of takeovers involving foreign firms. In part, hostile takeovers are rare because the Japanese concept of a firm places less emphasis on the role of stockholders and more emphasis on the rights of other stakeholders—in particular, employees and management. According to the Japan Economic Institute (1990, 13), the Japanese word for "takeover bid" (*nottori*) can also mean "hijack." Moreover, the loyalty felt by

Table 4.2 U.S. and Japanese Merger and Acquisition Activity, 1981–1988

	Number		Value ($ billions)		Average Value ($ billions)		Number of Large Deals	
Year	U.S.	Japan	U.S.	Japan*	U.S.	Japan*	U.S.†	Japan‡
1981	2,395	1,815	$ 82.6	$ 10.1	$ 34.49	$ 5.58	113	50
1982	2,346	919	53.8	13.3	22.93	14.50	116	47
1983	2,533	1,722	73.1	8.9	28.86	5.14	138	63
1984	2,543	1,886	122.2	10.4	48.05	5.52	200	81
1985	3,001	1,920	179.8	15.0	59.91	7.80	270	79
1986	3,336	2,083	173.1	27.2	51.89	13.06	346	112
1987	2,032	2,299	163.7	24.0	80.56	10.42	301	131
1988		2,364		27.2		11.49		

Sources: Japan Economic Institute (1990).

*The dollar values of Japanese deals were calculated using current exchange rates from the International Monetary Fund, *International Financial Statistics* (various issues); Japanese data are for fiscal years.

†Deal of $100 million–plus.

‡Deals of ¥50 billion–plus; ¥50 billion = $220 million, $210 million, and $346 million in 1980, 1985, and 1987, respectively.

employees and management to large firms in a system (often characterized by lifetime employment) stands in the way of even friendly mergers in which companies lose their identity.

In part, however, hostile takeovers are more difficult because many Japanese firms have large percentages of their stock held either by stable shareholders (such as insurance companies and trust and pension funds), who have close relations with the management of the company, or by *keiretsu* members (that is, members of a corporate group characterized by extensive cross-shareholdings). In many cases, these two groups account for two-thirds of all outstanding shares of a company and therefore can prevent hostile takeovers.

The practice of cross-shareholdings was originally a response to the prohibition on holding companies that was implemented in Japan in the early 1950s to prevent the reconstitution of the large prewar zaibatsu conglomerates. Despite these strictures, the three former zaibatsu groups—Mitsubishi, Mitsui and Sumitomo—and other large groups of diverse companies (horizontal *keiretsu*) centered on major banks have developed more subtle mechanisms of collaboration, a feature of which is extensive cross-holdings of stock. In addition, other groups, centered on such large manufacturing companies as Nippon Steel and Toyota (vertical *keiretsu*), have developed close links that involve an exchange of equity. For the six largest horizontal groups, the average percentage of stock of a group held by other group members ranged from 7 percent to 14.3 percent in 1963 and had risen to between 12.2 percent and 26.9 percent in 1988 (fiscal year).

Nonetheless, hostile takeovers are not unknown in Japan. For example,

Aaron Viner (1988, 89–90) noted that Takami Takahashi (president of the Minebea ball bearing company) has masterminded takeovers in both Japan and the United States. Minebea was also the object of a takeover attempt by foreigners, who acquired stocks through convertible bonds and warrants that are traded anonymously in the Euromarket. However, a foreign participant in the effort, Charles Knapp (a Los Angeles financier), "could not find a single Japanese bank or securities house to help in any capacity with his bid" (p. 90), and Takahasi successfully fought off the bid by merging his company with another and thereby diluting Knapp's stake.

Some suggest that possibilities for hostile mergers have increased recently. In part, this reflects increased experience of Japanese firms with acquisitions abroad. In addition, Japanese courts that formerly frowned upon hostile takeovers have modified their stance in recent rulings. In a particularly noteworthy case in 1989 (Shuwa versus Chujitsuya), the court found that efforts to dilute Shuwa's shares by an exchange of stocks at low prices between two targets was unfair. This was the first time a court declared antitakeover practices unfair.

In addition, Japan has seen a nascent debate over shareholders' rights, sparked in part by the ill-fated efforts of T. Boone Pickens, who tried to claim a seat on the board of Koito Manufacturing Company.[7]

4.3.2 Foreign Acquisitions

Japan's other striking difference from the United States relates to its treatment of foreign investors. As mentioned above, FDI in Japan was severely restricted during the 1950s and 1960s (Encarnation 1992, chap. 2). By 1973, however, Japan was officially complying with the Organization for Economic Cooperation and Development (OECD) Code of Liberalization of Capital movements. However, although the official policy was that Japan was open, less formal policies undermined this commitment.

Mason (1992, 205–7) described how a revision of the Commercial Code of Japan in 1966 made it easier for Japanese firms to issue shares to third parties of their choice. He detailed how firms belonging to industrial groups took advantage of these regulations over the following decade to insulate themselves from foreign companies. In addition, an amendment of the Securities Exchange Law in 1971 introduced a system of notification of takeover bids. In 1972, as described by Viner (1988, 88), the Bendix Corporation made a tender offer for some of the equity in the small firm Jidosha Kiki. This created concerns and prompted a deliberate effort to prevent foreign firms from initiating takeovers of domestic companies. To render foreign takeovers virtually impossible,

7. According to the Japan Economic Institute (1991b), on 13 June 1991, a study group of the Ministry of International Trade and Industry urged the ministry to promote mergers and acquisitions through various regulatory and legal changes. However, the report also called on the ministry to provide legal aid to firms facing hostile buyouts.

> hundreds of corporations (with unofficial Ministry of Finance encouragement) which were not members of *keiretsu* systematically expanded their mutual shareholdings. Companies within *keiretsu* increased mutual shareholding to the legal limit. As a direct result . . . the total percentage of shares held by corporations rose 12.7 percent in just one year, 1971/2. [Indeed] the redistribution was so effective that between 1978–84, the number of foreign acquisitions of Japanese companies numbered just 20. Of these only two were of substantial size (BOC takeover of Osaka Gas and Banyu-Merck). (Viner 1988, 88)

In general, foreign firms contemplating Japanese acquisitions do not enjoy national treatment. As of mid-1989, as noted in "Mergers and acquisitions" (1989), takeover bids from foreigners had to be carried out through a domestic securities house, which gave the Ministry of Finance ten days notice of its intentions—"i.e., enough time to organize a rescue operation to be mounted to keep the target in Japanese hands" (p. 68). If a foreign firm managed to clear that obstacle, it was allowed just twenty to thirty days to complete the acquisition. Japanese firms were not subject to these rules.

Recent data confirm that foreign involvement in merger and acquisition activity within Japan, though increasing, remains rare. According to data collected by Yamaichi Securities (table 4.3), between 1985 and 1989, foreign purchases of Japanese firms were in the range of about twenty per year; however, these data include purchases outside of Japan. By contrast, there was a dramatic increase in Japanese purchases of foreign firms and Japanese purchases of Japanese firms. Data on foreign sellers collected by Merrill Lynch (table 4.4) confirm the paucity of sales of Japanese companies to foreign firms; these averaged about 3 per year. By comparison, averages were 52, 15, 14, and 6 per year for British, West German, French, and Swiss firms, respectively.

Table 4.3 Number of Mergers and Acquisitions Involving Japanese Firms: 1981, 1985–1990

Year	Japanese Firms Acquire Japanese Firms	Japanese Firms Acquire Foreign Firms	Foreign Firms Acquire Japanese Firms	Total
1981	122	48	6	176
1985	163	100	26	289
1986	226	204	21	451
1987	219	228	22	469
1988	223	315	17	555
1989	240	405	15	660
1990	293	440	18	751

Source: Yamaichi Securities Co., Ltd., cited in Japan Economic Institute (1991a).

Table 4.4 Foreign Sellers: Number of Transactions, by Country, 1982–1991*

Country of seller	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	Ten-year Cumulative
Australia	6	3	6	7	7	5	4	13	19	10	80
Austria	1	1	0	0	0	0	1	0	0	1	4
Belgium	2	1	3	3	6	2	1	1	2	4	25
Canada	30	35	24	42	54	31	32	41	41	49	379
Denmark	0	1	2	0	0	2	0	1	2	1	9
Finland	0	1	0	0	0	1	0	0	2	1	5
France	8	8	15	16	12	9	14	16	21	18	137
Greece	1	0	0	0	0	0	0	0	2	1	4
Ireland	0	0	0	0	2	1	1	0	3	1	8
Italy	2	6	6	13	4	10	7	15	10	6	79
Japan	3	3	7	7	2	0	1	2	4	3	32
Luxembourg	1	0	0	0	0	0	0	0	0	0	1
Netherlands	3	8	3	7	5	7	5	4	11	17	70
New Zealand	0	0	2	1	0	1	0	3	7	3	17
Norway	0	0	1	0	0	1	2	0	1	3	8
Portugal	0	0	0	0	0	0	0	1	1	0	2
Spain	0	3	6	3	4	2	2	3	5	2	30
Sweden	0	1	3	3	2	5	2	8	7	2	33
Switzerland	10	11	3	5	5	2	2	7	7	3	55
Turkey	0	0	0	1	0	0	0	1	1	0	3
United Kingdom	30	39	45	44	50	41	48	71	80	72	520
West Germany	12	13	13	15	13	11	12	17	25	16	147

Sources: Mergstat Review 1991; Merrill Lynch Business Brokerage and Valuation, Shaumberg, Ill.
*Foreign sellers reflect nationality of ownership, not necessarily location of company. Transaction measures reflect announced transactions only and include acquisitions of both controlling and minority interest in a company.

4.4 Acquisition versus Greenfield Entry

It was established earlier that, ceteris paribus, one would expect that in general the foreign demand for entry via acquisition would tend to be high. Indeed, this is confirmed by the data compiled by James W. Vaupel and Joan P. Curhan (1973) on the ways used by affiliates of U.S.-owned manufacturing firms to enter foreign markets between 1900 and 1968 (table 4.5). More specifically they found that, on average, direct acquisitions dominated newly formed ventures in entries into foreign markets of subsidiaries in which U.S. firms had at least a 5 percent stake. In countries in which acquisitions are made with relatively ease (such as Canada and the United Kingdom), only 35 percent of entries involved newly established operations. In France and West Germany, newly established ventures accounted for 39 percent and 42 percent of all new entries, respectively. Weighted by the number of firms entering, newly formed entrants accounted for 43 percent of all new entries in the sample.

As might be expected, entry into developing countries (in which the supply of acquirable assets is limited) is more dependent on new ventures. The share

of new ventures has also been high in some less developed industrialized countries, such as Turkey (86 percent were new establishments), Portugal (81 percent), and Greece (78 percent). Furthermore, data on entry into the United States between 1981 and 1990 indicate, as in the earlier cases of Canada and the United Kingdom, a high dependence on acquisitions rather than greenfield operations. For these years, acquisitions accounted for 79 percent of all entries. While Japanese firms have tended to prefer greenfield entry and plant expansions more so than firms from other countries have, they have not been reluc-

Table 4.5 Manufacturing Foreign Affiliates of U.S.-based Companies, 1900–1968*

A. By Method of Entry into Foreign Country

Country	Newly Formed	Reorganization	Acquired Directly
Australia	47.0%	2.1%	50.0%
Austria	59.0	0.0	41.0
Belgium	49.0	0.0	51.0
Canada	35.0	2.8	62.0
Denmark	48.0	0.0	52.0
Finland	60.0	0.0	40.0
France	39.0	3.5	57.0
Greece	78.0	0.0	22.0
Ireland	45.0	3.2	52.0
Italy	50.0	0.5	50.0
Japan	64.0	0.7	35.0
Luxembourg	49.0	0.0	51.0
Netherlands	53.0	1.1	46.0
New Zealand	58.0	2.3	30.0
Norway	50.0	0.0	50.0
Portugal	81.0	0.0	19.0
Spain	43.0	0.8	57.0
Sweden	62.0	0.0	38.0
Switzerland	48.0	0.0	52.0
Turkey	86.0	0.0	14.0
United Kingdom	35.0	3.3	62.0
West Germany	42.0	2.3	56.0
Weighted average	43.3	2.1	54.5

B. By Time Period When U.S. Firms Entered into the Japanese Market

	Pre-1946	1946–1957	1958–1967
Percentage of total	6.4	16.7	76.9

Source: Vaupel and Curhan (1973), chap. 4, 256.

*Data cover foreign affiliates formed between 1900 and 1968. the study covers approximately 40 percent of the total number of all foreign manufacturing affiliates of U.S. companies and approximately 70 percent of the value of U.S. manufacturing investment in foreign affiliates. Data include minority-interest and majority-owned affiliates.

Table 4.6 **Foreign Direct Investment in the United States: Method of Investment by Source Country, 1989* (percentage)**

Method	All Countries	Canada	France	United Kingdom	Japan	Netherlands	Switzerland	West Germany
Mergers and acquisitions	79.21%	86.85%	90.53%	97.53%	56.20%	99.07%	91.68%	86.72%
Equity increases	3.98	0.51	0.00	0.02	5.45	0.00	8.11	0.00
Joint ventures	3.13	4.33	1.50	0.66	6.47	0.00	0.21	0.00
New plants	4.94	4.47	6.32	1.20	10.23	0.18	0.00	5.24
Plant expansion	3.57	0.89	0.00	0.29	9.28	0.00	0.00	7.94
Real estate	4.59	2.94	1.44	0.24	11.34	0.74	0.00	0.00
Other	0.57	0.00	0.21	0.04	1.03	0.00	0.00	0.10
Total value known ($ million)	$74,715.4	$3,691.3	$3,324.8	$24,955.1	$22,977.7	$3,824.1	$4,306.8	$2,381

Source: U.S. Department of Commerce (1991).

*The data include only investments for which the value of the transaction is known. Foreign direct investment is defined as ownership of 10 percent or more of a company.

tant to engage in acquisitions. In 1989, for example, 56 percent of Japanese FDI involved acquisitions, and 11 percent involved purchases of real estate (table 4.6).

Uniquely among developed countries, entry into Japan historically also involved a relatively large number of greenfield investments. For the entire sample, the ratio was 64 percent. For the period 1957 to 1968, the ratio was 68 percent. Thus, while a priori reasoning suggests that the demand for acquisitions as a mode of entry should be high in the case of Japan, ex post acquisitions appear to be unusually low. The foreign direct investment entry data confirm that there are obstacles on the supply side.

The *24th Survey of Foreign Affiliates in Japan,* undertaken by MITI in 1991, provides an even more overwhelming impression of the degree to which entry into majority-owned firms in Japan has occurred through greenfield operations. As reported in table 4.7, only 7 percent of the firms in which foreigners have more than a 50 percent equity stake started through the acquisition of Japanese firms. Some 49 percent started with new establishments, and the remainder began as joint ventures.

The ex post data on the share of new entry taking the form of greenfield operations can be used to explore whether there is a relationship between the overall quantity of FDI and the mode of entry. These regressions are reported in table 4.8. Regression 1 shows that the level of assets in majority-controlled U.S. affiliates in Japan is 41 logarithmic percentage points lower than one would expect on the basis of Japanese population and per capita purchasing power parity (GDP) gross domestic product. Despite the large standard errors of the equation, the coefficient on the Japanese dummy is almost insignificant. However, as shown in regression 2, inserting the variable GREEN in the regression confirms a negative association between greenfield operations and FDI that is significant at the 90 percent level. The addition of this variable has a large impact on the Japanese dummy variable: it is reduced by 60 logarithmic percentage points. As might be expected, the measure of tariff and nontariff barriers is not significant in explaining overall FDI (equations 4 and 5). It is, however, more significant in manufacturing (equations 6 and 7) and confirms that trade barriers can induce FDI. These regressions, which explain assets in majority-controlled manufacturing FDI, also suggest the importance of mergers and acquisitions for FDI. In this case, the dummy variable on Japan in equation 6 run without GREEN is -103 logarithmic percentage points. However, when GREEN is introduced into the regressions, the coefficient of the Japanese dummy falls to only -16 logarithmic percentage points. The coefficient on the greenfield variable, which is almost significantly different from zero, confirms the negative relationship between reliance on greenfield investment as a mode of entry and overall FDI. Ex post, therefore, the supply of acquirable assets appears to be an important factor in encouraging FDI. Conversely, the lack of such supplies inhibits FDI.

Table 4.7 **Majority-owned Foreign Direct Investment in Japan, by Industry and Method of Entry, 1991 (percentage of total number of firms)**

Industry	Creation of Joint Venture	Creation of New Company (greenfield)	Capital Participation (M&A activity)	Total Number of Firms that Responded
Total investment	43.7%	49.3%	7.1%	1,234
Manufacturing	51.0	40.3	8.7	576
Manufacturing, except oil	51.5	40.7	8.2	562
Food processing	52.4	33.3	14.3	21
Textiles	57.1	42.9	0.0	7
Wood products	42.9	57.1	0.0	7
Pulp and paper	20.0	80.0	0.0	5
Publishing and printing	33.3	66.7	0.0	12
Chemicals	62.3	29.8	7.9	114
Pharmaceuticals	44.4	44.4	11.1	45
Oil	50.0	21.4	28.6	14
Rubber	50.0	41.7	8.3	12
Leather	50.0	50.0	0.0	2
Clay and ceramics	50.0	50.0	0.0	14
Steel and iron	0.0	0.0	0.0	0
Nonferrous metals	35.7	50.0	14.3	14
Processed steel	40.0	50.0	10.0	10
General machinery	52.4	37.8	9.8	82
Electric machinery	50.5	45.9	3.7	109
Transportation machinery	59.1	22.7	18.2	22
Precision machinery	38.3	51.7	10.0	60
Weapons	0.0	0.0	0.0	0
Other manufactured	61.5	26.9	11.5	26
Commerce	38.0	56.0	6.0	502
Oil sales	0.0	0.0	0.0	0
Services	34.3	61.1	4.6	108
Other	35.4	60.4	4.2	48
Oil-related services	50.0	21.4	28.6	14

Source: Ministry of International Trade and Industry (1991). The survey was sent to all business enterprises that had a foreign capital ratio of 50 percent or more as of 31 March 1991. The survey was sent to 2,463 companies.

4.5 *Keiretsu,* FDI, and Mergers in Japan

Few issues in U.S.-Japanese relations are more controversial than the *keiretsu* relationships among Japanese firms. For many firms in the United States, *keiretsu* are the best example of the invisible barriers that make U.S.-Japanese investment and trade unfair. Japanese investors can buy any U.S. firm they choose, but it is almost impossible for U.S. investors to obtain control of most major Japanese firms because of substantial cross-holdings of stock held by *keiretsu* members. Similarly, Japanese exporters can readily sell their goods in the United States, but U.S. exporters find extraordinary barriers in Japan created by the close links between suppliers and assemblers and between manu-

facturers and distributors. Some believe that these asymmetries in access make free trade with Japan undesirable; thus, they advocate managed trade. Others are calling for antitrust measures and changes in rules that will make *keiretsu* relationships more transparent and Japanese markets more open to foreign exporters and investors.

In the recent Structural Impediments Initiative between Japan and the United States, particular attention was paid to the role of *keiretsu.* The government of the United States argued that *keiretsu* linkages made foreign entry into Japan especially difficult. The Structural Impediments Initiative talks ended with an agreement by the government of Japan to strengthen the monitoring of transactions among *keiretsu* firms by its Fair Trade Commission and to take steps to eliminate any restraints on competition that might arise from their business practices. The United States called for, among other things, streamlined rules for mergers and acquisitions, stronger rights of shareholders, and disclosure requirements against management. However, the relevance of *keiretsu* remains hotly contested, and the Japanese defend it with two diametrically opposed arguments (Yoshitomi 1990).

One argument is that *keiretsu* do not actually have significant economic ef-

Table 4.8 Foreign Direct Investment in OECD Countries, 1990 (*t*-statistics in parentheses)

FDI	ln(POP)	ln(GDP/C)	BAR	JPN	GREEN	Corr. R^2	Standard Error
1. ln(MAJDFI)	0.84	3.05		−1.4		0.70	0.94
	(5.00)	(5.87)		(1.32)			
2. ln(MAJDFI)	0.81	2.4		−0.81	−0.032	0.78	0.88
	(5.10)	(4.00)		(0.77)	(1.90)		
3. ln(MAJDFI)	0.76	2.24			−0.036	0.74	0.88
	(5.30)	(4.00)			(2.20)		
4. ln(MAJDFI)	0.86	3.06	0.02	−1.26		0.69	0.95
	(5.00)	(5.83)	(0.79)	(1.15)			
5. ln(MAJDFI)	0.82	2.44	0.01	−0.074	−0.03	0.65	0.90
	(5.05)	(3.95)	(0.54)	(0.69)	(1.72)		
6. ln(MAJMAN)	0.94	4.85	0.07	−1.03		0.65	1.49
	(3.63)	(5.92)	(1.89)	(0.61)			
7. ln(MAJMAN)	0.88	3.79	0.06	−0.16	−0.05	0.70	1.39
	(3.53)	(4.01)	(1.69)	(0.10)	(1.89)		

Sources: (1) U.S. Department of Commerce, Bureau of Economic Analysis.
(2) OECD main economic indicators.
(3) Saxonhouse and Stern (1989).
(4) Vaupet and Curhan (1973).

Notes: Constant term not reported. Definitions (source number in parentheses): MAJDFI (1) = Assets of U.S. majority-owned affiliates. MAJMAN (1) = Assets of U.S. majority-owned affiliates in manufacturing. POP (2) = Population in 1990. GDP/C (2) = 1991 purchasing power parity per capita gross domestic product. BAR (3) = Sum of tariff rates and tariff equivalents of nontariff barriers. JPN = Dummy = 1 for Japan. GREEN = Percentage of U.S. FDI entries in greenfield establishments.

fects. Foreign concerns about *keiretsu* simply reflect "misunderstandings." *Keiretsu* are really no different from arrangements in other countries, such as vertical integration, conglomerates, and close links between firms and banks. There is no need for new policies, because the Japanese economy is highly competitive. If firms actually made decisions based on *keiretsu* loyalties rather than on economic grounds, they would lose money and soon be driven from the market. Often cited in support of this view is evidence gathered by the Japanese Fair Trade Commission, which indicated that intragroup transactions account for only a small share of total transactions by *keiretsu* members, as well as evidence that *keiretsu* firms are not particularly profitable (Yoshitomi 1990, 13).

The other argument is that *keiretsu* linkages are very important—indeed they are the heart of Japanese success. It is no coincidence that the best firms in Japan are typically members of *keiretsu. Keiretsu* provide members with benefits through sharing risk and information. Close links between assemblers and suppliers enhance the transfer of technology. *Keiretsu* linkages are more efficient than vertical integration, because they permit reliable supply while preserving corporate flexibility. Stock cross-holding permits *keiretsu* managers to concentrate on long-term investment decisions. It frees them from pressures of the stock market and fears of takeovers, which have made U.S. managers short-sighted (Yoshitomi 1990, 12).

Proponents of the second argument acknowledge that *keiretsu* create problems for new foreign entrants, but they still defend it on efficiency grounds. According to their view, Japan is confronted with a painful dilemma: if it becomes more open, it will be less efficient. In other words, those who want Japan to become more open are asking it to be less successful.

Robert Lawrence (1991) evaluated these views by examining Japanese trade, using a model developed by Peter Petri (1992). Trade by industry was explained on the basis of such variables as factor intensity, tariffs, transportation costs, and concentration. In addition, variables were used that were drawn from data developed by Dodwell Marketing Associates, which measured the share of sales accounted for by firms belonging to *keiretsu,* by industry. Statistically significant evidence that *keiretsu* were associated with reduced imports was found. The analysis of Japanese exports, however, gave mixed results. The vertical *keiretsu* of major producers and suppliers in a single industry had a positive effect on exports, although it was not statistically significant. However, *keiretsu* of firms drawn from the former zaibatsu groups and those from other horizontal groups had no beneficial effect on exports. It was concluded that the results provided some support for the claim that vertical ties enhance efficiency. On the other hand, no support was found for claims that horizontal *keiretsu* improve performance, and it was therefore concluded that the efficiency benefits from cross-holdings may be exaggerated.

This work on *keiretsu* can now be expanded to explore, in a preliminary fashion, the relationship between *keiretsu* and the activities of majority-owned

foreign affiliates in Japan. The dependent variable is the share of industry sales in 1991 accounted for by majority-owned foreign affiliates, as indicated by the data collected for the twenty-fifth annual survey of MITI. The independent variables are taken from the Petri model. In particular, variables have been used that measure concentration (Herfindahl index) and technological intensity (share of scientists and engineers in sectoral employment). Foreign direct investment is expected to be positively associated with both variables. A variable was added to indicate capital intensity and the share of industry sales by *keiretsu* firms in 1987. In a second specification, that variable was separated into the share in sales of firms in horizontal and in vertical *keiretsu.* The results, reported in table 4.9, suggest that *keiretsu* are indeed negatively associated with FDI. As indicated in equation 1, the *keiretsu* variable is statistically significant and negatively signed. The coefficients on concentration and technological intensity are both positive. When separate variables measuring vertical and horizontal *keiretsu* are introduced, they are insignificant and with negative coefficients. While not significantly different from each other, the coefficient of horizontal *keiretsu* is larger than that of vertical *keiretsu.* This suggests that each percentage increase in sales by horizontal *keiretsu* firms is associated with a relatively larger restraining impact than a percentage increase by firms in vertical *keiretsu.*

It should be stressed that the data sample is inordinately small; observations are available for only ten industries. In addition, one cannot be sure that the classification schemes used for measuring sales by industry are all consistent. Moreover, questions have been raised about the classification scheme used by

Table 4.9 **Sales and Mergers and Acquisitions by Industry (*t*-statistics in parentheses)**

Dependent Variable	CAPINT	HERF	TECH	KRETS	VERT9	HORIZ8	Corr. R^2
1. SALESMOF	0.03	0.002	0.42	−0.09			0.77
	(0.39)	(1.79)	(2.31)	(3.45)			
2. SALESMOF	0.097	0.002	0.327		−0.08	−0.12	0.79
	(1.11)	(2.24)	(1.75)		(3.29)	(3.31)	
3. JPNMERG	−15.34	−0.15	113.85	6.82			0.17
	(0.65)	(0.53)	(1.89)	(0.90)			
4. JPNMERG	−28.17	−0.23	123.82		6.19	13.04	0.03
	(0.87)	(0.71)	(1.86)		(0.75)	(1.04)	

Sources: (1) Japanese Ministry of Finance, corporate business statistical annual report; Ministry of International Trade and Industry. (2) Japan Economic Institute (1990). (3) Petrie (1992). (4) Dodwell Marketing Consultants (1986).

Notes: Constant term not reported. Definitions (source number in parentheses): SALESMOF = Share of foreign affiliates in industry sales, FY1991. JPNMERG (2) = Value of mergers and acquisitions, by industry, 1984–88. CAPINT (3) = Capital intensity. HERF (3) = Herfindahl index. TECH (3) = Technology intensity. KRETS (4) = percentage sales by all *keiretsu.* VERT9 (4) = Percentage sales by vertical *keiretsu.* HORIZ8 (4) = Percentage sales by horizontal *keiretsu.*

Dodwell. Nonetheless, there is no reason to believe that the data are particularly biased toward finding significantly negative relationships between *keiretsu* and foreign sales by industry.

To be sure, it is quite possible that *keiretsu* and low FDI are both correlated with an omitted variable that has a causal link with both. However, this variable must operate separately from the effects of both capital intensity and concentration, which were controlled for in the regressions. One argument worth considering, for example, is that *keiretsu* enjoy a lower cost of capital, have lower hurdle rates of return and can therefore outbid foreigners interested in acquiring Japanese companies. It may also be the case that, if exports and FDI are complements, the difficulties experienced by foreign firms in entering industries in which *keiretsu* predominate help to explain the finding in Lawrence (1991) that *keiretsu* have a negative impact on imports.

Finally, the data have also been used to explore whether the existence of *keiretsu* constitutes a barrier to domestic mergers and acquisitions. Indeed, while *keiretsu* may inhibit mergers outside the group, they may actually help to promote such activities between members. Data on mergers and acquisitions (most of which were relatively small) reported to the Japan Free Trade Commission for nine industries over the period 1988 and 1989, showed that merger and acquisition activity is more prevalent in technology-intensive industries (table 4.9, equations 3 and 4). However, no effects associated with the *keiretsu* variables could be found. Apparently, *keiretsu* do not inhibit domestic merger and acquisition activity. Indeed, the coefficients of the *keiretsu* variables are positive (although not statistically significant). The effects of *keiretsu* appear to operate on FDI but not on domestic merger and acquisition activity.

4.6 Conclusions and Policy Implications

During the 1980s, inward FDI in Japan grew primarily through the reinvested earnings of existing firms. In fact, foreign withdrawals, particularly of minority-interest positions, have outweighed new equity capital investments. Apparently, the high values on the Tokyo stock market during the late 1980s not only discouraged new entrants but also encouraged existing foreign participants to liquidate some of their positions.

Several features of foreign activity in Japan support the anecdotal accounts of barriers to foreign entry and operation. These include the high share of U.S. receipts from Japan that take the form of license payments from unaffiliated Japanese firms, the high share of FDI accounted for by joint ventures, and the high share of majority-owned FDI in wholesale trade. Given these entry barriers, one would expect the ex ante demand for acquisitions as a mode of entering Japan to be relatively high.

Mergers and acquisitions in Japan, even under friendly conditions, are difficult. Acquisitions involving foreign firms and/or hostile takeovers are rare. In other developed countries, by contrast, the majority of FDI entries occur

through acquisitions. However, a disproportionate share of entries in Japan involves joint ventures and greenfield versus acquisition) and the level of FDI internationally helps to explain the low levels of FDI in Japan.

The expansion of stock cross-holdings among *keiretsu* members and other Japanese firms during the 1970s was an explicit device to prevent foreigners from buying Japanese companies. It appears to have worked. The presence of *keiretsu,* whether horizontal or vertical, is associated with particularly low levels of FDI. Market entry could be hindered by practices that are explicitly collusive (situations in which long-term relationships are the norm), by difficulties associated with making acquisitions of *keiretsu*-related firms because of stock cross-holdings, or by inherent cost-of-capital advantages enjoyed by *keiretsu* members. Additional research is needed to determine the precise mechanism that brings about this negative association. While one cannot be clear on precisely which mechanism is at work, the results represent additional evidence refuting the claim that *keiretsu* linkages are economically insignificant. Although *keiretsu* do not appear to discourage domestic merger and acquisition activity, they are associated with less FDI.

Is the environment for FDI in Japan changing? The 1992 recession in Japan, combined with significant declines in stock and land prices, could herald a change in the environment for merger and acquisition activity in Japan in general and for acquisitions of Japanese firms by foreign companies in particular. Foreigners are likely to find deals more attractive as prices fall. *The Economist* ("Biter Bitten" 1992) noted that though present economic conditions will require considerable restructuring through mergers, most deals are likely to occur between firms within the same *keiretsu.* However,

> Japanese banks are increasingly unwilling to play their traditional role of arranging marriages with healthier Japanese companies. Many just want to get their money back as soon as possible, even if that means selling to a foreign company. [Nonetheless], there is still a huge cultural divide that deters many outsiders from acquisitions in Japan. (p. 85)

The major differences in the ease with which foreigners can acquire domestic companies in Japan and in other developed economies are likely to persist for the time being.

As the world economy becomes increasingly integrated, institutional differences, such as those that exist between Japan and other countries, are coming under particular scrutiny. One view holds that pluralism and diversity are beneficial to the global economy and that, as long as border barriers are removed, a high degree of national sovereignty is warranted. Certainly, since no global investment code exists, Japanese practices do not represent a violation of its international legal obligations. On the other hand, there is a growing recognition that globalization requires mechanisms for deeper integration than that achieved by the removal of border barriers and the adherence to the formal legal obligations of national treatment. At certain times, as the preparation for

the single European market has made clear, this may require harmonization; at other times, mutual recognition may suffice. Regardless, efforts to negotiate measures to reconcile institutional differences are likely to continue.

A cost-benefit analysis of these institutional practices is beyond the scope of this article. Foreign direct investment will generally confer benefits on both the host and home countries. The relatively closed Japanese market for corporate control reduces foreign profits. It also reduces domestic competition and may reduce technology transfer to Japan. However, restrictions on FDI could also increase Japanese welfare (and reduce foreign welfare) if it shifts rents from foreign to Japanese-owned firms by forcing foreign firms to license their products rather than to enter the Japanese market directly.

Increasingly, firms recognize that effective global strategies require a major presence in each region of the triad (UN Center on Transnational Corporations 1991). Since access to Japan is more difficult than access to the United States or Europe, Japanese firms could gain a strategic advantage. Indeed, in the long run, firms headquartered in Japan could become more competitive than those headquartered in the European Community or in the United States. As Japanese companies become more important rivals and as they avail themselves of the opportunities to invest in other nations, these asymmetries in market access between Japan and other countries are likely to become an increasing source of friction. It is unclear whether the asymmetries will be closed by a Japanese movement toward foreign practices or by restraints that seek to give Japanese firms investing abroad access that is equivalent to that granted foreign firms in Japan. It is hard, however, to imagine that the current asymmetries will be maintained.

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Comment

Richard C. Marston

In his essay, Robert Lawrence provides an interesting and provocative look at foreign direct investment in Japan. He argues that, because of informal and

formal barriers, all forms of foreign direct investment (FDI) in Japan are much lower than in other comparable countries. When FDI occurs, moreover, it typically takes the form of joint ventures or greenfield investments rather than the acquisition of existing firms, because foreign corporations are discouraged by Japanese practices from acquiring majority control of Japanese firms.

Lawrence marshalls a variety of evidence to support these two propositions. The evidence on the first point is strong. Graham and Krugman (1991) show that the share of foreign-owned firms in total sales is 1 percent in Japan, but 10 percent in the United States and 18 percent or higher in Britain, France, and Germany. The Bank of Japan's (BOJ) balance-of-payments data indicate that in 1989 the stock of inward FDI is only $9.2 billion in Japan, in contrast to $400 billion in the United States and $100 billion in Canada. U.S. data on direct investment in Japan, which unlike the BOJ data take into account reinvested earnings, show that FDI in Japan in 1989 was $21 billion, still a remarkably low figure.

Lawrence also presents interesting evidence on the importance of licensing as an alternative to FDI. In 1990, 33 percent of U.S. receipts of direct investment income and royalties from Japan were in the form of royalties and fees from licensing. In contrast, only 5.2 percent of U.S. receipts worldwide were in the form of royalties and fees. So a disproportionate amount of U.S. activity in Japan is in the form of licensing rather than direct investment. This evidence is consistent with the view that the Japanese market is difficult to penetrate (for example, because the distribution system is complex), although it does not indicate necessarily that Japanese companies deliberately excluded foreigners.

One piece of evidence is difficult to reconcile with the rest. Table 4.8 examines FDI in countries belonging to the Organization for Economic Cooperation and Development (OECD). In an equation explaining FDI as a function of variables such as population and GDP per capita, a dummy variable representing Japan has no significant effect on FDI (at conventional levels of significance). That's a little surprising, given the other evidence showing that Japan is an outlier.

Lawrence's second proposition is more provocative: that the Japanese system blocks acquisitions by foreign firms. Much of FDI, when undertaken, takes the form of joint ventures or greenfield investments, not acquisitions of majority ownership in Japanese firms. According to Lawrence, FDI does not take the form of acquisitions because the Japanese system actively discourages acquisitions by keeping shares in friendly hands (with stable shareholdings by insurance companies and pension funds and with cross-holding of shares by other corporations). In industries dominated by *keiretsu*, any attempt to buy into the industry will induce defensive reactions in which firms within the *keiretsu* buy the shares of the targeted company. Ministry of Finance rules further thwart potential acquirers by requiring that takeover bids by foreigners be delayed by ten days—time enough to mount a rescue effort. Domestic firms are not subject to these rules.

I will review the evidence Lawrence provides to support his view that foreign acquisitions are restricted in Japan. Then I will offer an alternative explanation for the same phenomena.

What evidence can be marshalled about foreign acquisitions? Table 4.7 presents the results of a MITI survey of foreign-owned firms completed in 1991. This survey shows that only 7.1 percent of these firms were the result of acquisition. In contrast, 49.3 percent were established through greenfield investments, while 43.7 percent were joint ventures between foreign and Japanese firms. So it is true that foreign acquisitions constitute a remarkably low percentage of FDI in Japan. Table 4.2, however, shows that overall merger and acquisition activity, by Japanese as well as foreign firms, is much smaller in value in Japan than in the United States (one-sixth as large). So it may truly be difficult for any firm, Japanese or foreign, to acquire a Japanese firm. Table 4.3, on the other hand, shows that in the last half of the 1980s there was a large surge in acquisition activity by Japanese firms acquiring both Japanese and foreign firms. Japanese acquisition of other Japanese firms almost doubles between 1985 and 1990. And Japanese acquisitions of foreign firms increases fourfold during this same period. Yet there is no increase in foreign firms' acquisitions of Japanese firms.

Let me suggest an explanation of these facts that does not rely on a conspiracy theory involving Japanese firms systematically shutting out foreign acquisitions. The boom in FDI across the world occurred in the last half of the 1980s. That was also a period of unparalleled increases in real estate values and stock market values in Japan—increases which exceeded those in other countries by a considerable amount. Is it possible that Japanese firms were able to outbid foreign firms in acquisitions of Japanese firms during this period?

In a perfectly functioning capital market, of course, all firms should bid the same amount for any given anticipated cash flow. But if firms are *capital constrained,* then firms with large real estate holdings in Japan and cross-holdings of Japanese equity will be able to outbid other firms—including those firms from abroad who are not sharing in the Japanese boom. This is a variation on Froot and Stein's (1991) analysis in which FDI in the United States was driven by the rise in foreign currencies relative to the dollar. Here it is the Japanese real estate and stock markets that raise the wealth of Japanese firms.

In studying FDI in Japan, it is well to keep in mind that we are examining a country that liberalized FDI only in 1980. We really want to know how the liberalized regime of the 1980s works, not the MITI-dominated regime of the 1960s and 1970s. The Japanese real estate and stock market booms of the last half of the decade may well be enough to explain why the stock of foreign acquisitions was so low at the end of the decade. By this reasoning, the recent collapse of the Nikkei should lead to more acquisitions by foreign firms and thus a reversal of present patterns.

Having introduced an alternative explanation for the low level of foreign acquisitions in Japan, let me review the strongest piece of evidence in favor of

Lawrence's explanation. Table 4.9 presents equations explaining the share of 1991 industry sales in Japan that is accounted for by majority-owned foreign affiliates. Lawrence explains the share with conventional variables such as concentration ratios and technological intensity. But he also adds a variable representing the share of sales by keiretsu in that industry. He finds statistically significant effects of these sales. That is, FDI sales are significantly lower in industries where *keiretsu* are important. This is important evidence.

There are some possible explanations for this finding which do not rely on conspiracy theories. It could be, for example, that *keiretsu* are concentrated in industries where foreign investment is undesirable for reasons unrelated to the *keiretsu* per se. (Lawrence mentions the possibility that some omitted factor explains these results). Or suppose that we take the statistical results at face value. It could be that industries where *keiretsu* dominate are less attractive targets for direct investment because acquisition might jeopardize beneficial ties among firms within the *keiretsu.* If so, then the existence of the *keiretsu* discourages acquisitions but not necessarily because firms in the *keiretsu* mount defensive operations to keep shares out of foreign hands. In any case, the statistical evidence buttresses Lawrence's case that it is Japanese behavior, whether intentionally designed to exclude foreigners or not, that discourages acquisitions.

Overall, Lawrence's paper provides a convincing case that FDI in Japan is different than elsewhere. Whether this is due to deliberate exclusionary practices or to other causes is still subject to debate.

References

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Graham, Edward M., and Paul R. Krugman. 1991. *Foreign direct investment in the United States.* Washington, D.C.: Institute for International Economics.

Discussion Summary

Kenneth Froot began the discussion by suggesting that differences in language and culture, rather than actual discrimination, may explain why there is so little FDI into Japan; geographic isolation may be a further explanation. Also, the *keiretsu* groups can marshall liquidity to defend against a hostile takeover of any member by an outsider.

Martin Feldstein observed that the high Japanese share prices have been a barrier to foreign acquisitions in recent years. Foreigners could not get the same price-earnings ratios and therefore could not justify the acquisition of a

Japanese firm. He suggested that a majority-owned wholesale trade company is likely to be just a marketing subsidiary of a U.S. manufacturer, and he pointed out that direct investment is fundamentally different from licensing. The latter is essentially static; the licensee obtains what is known at a point in time but does not share in the dynamic of change and does not get future products.

Raymond Vernon began his comments with a general statistical point about cross-country data sets. Because there is no "universe" of which the current observations are a sample, there is no meaning to the standard errors. It is appropriate therefore to look at the coefficients as descriptive material but to ignore the t-statistics. Since there are many individual cases of barriers to foreign investment that are known, the statistical estimates confirm the existence of these barriers. Any other finding would not have been believable. Also, there is a data problem associated with licensing fees for intrafirm transactions.

James Hines suggested expanding the sample beyond the OECD. He noted that Japanese tax rules would discourage foreign investment in Japan.

Deborah Swenson mentioned that acquisitions are frequently spin-offs that are not doing well, but there are not many of these in Japan. *Robert Lawrence* noted in response that this is not true in Japan, where the *keiretsu* takes over sick spin-offs.

Michael Adler asked what the welfare consequences are of FDI. *Lawrence* named three in response: japanese welfare is reduced by a reduction in FDI, rent shifting may benefit Japan, and asymmetry of bilateral pattern of FDI creates tension.

Karl Sauvant pointed out that if *global* production is key to a firm's ability to compete, closing a market to foreign firms hurts their ability to compete worldwide.

Peter Petri offered a further explanation of why U.S. firms do not invest in Japan: that U.S. firms may not have a comparative advantage in manufacturing. Japanese firms come to the United States because they have such a comparative advantage. *Richard Caves* added that there are a variety of other factors that may explain why there is so little FDI in Japan: distance, language, and so on.

Said *Geoffrey Carliner,* "There was a time when General Motors could have bought Toyota for less than it spent on direct investment in plant and equipment."

Robert Feenstra ended the discussion by commenting that *keiretsu* firms are a market for other members of the group. A foreign investor would not have this advantage. This also serves as a barrier.

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