



European Business Council (EBC) Review of the Japanese Investment Environment

May 14, 2008

Introduction

The past decade has been an important transitional period for the Japanese economy, and foreign direct investment (FDI) is one area in which changes are readily visible. Until the mid-1990s, the amount of FDI that Japan used to receive was miniscule and the role of foreign firms in the Japanese economy remained accordingly small (*Table 1*). Since then, however, Japan has experienced by the country's own standards, a veritable boom in inward FDI. In the five years from 1998 to 2002 alone, Japan increased FDI inflows more than in the entire post-war period. And although inflows have receded in recent years, they still continue to be much larger than before.

At the same time, however, the recent wave of inward FDI appears to be large only because inflows in the past have been so small. In fact, inflows and the stock of inward FDI in Japan remain at levels much lower than those in comparable advanced economies. (*Table 1 and Table 2*)

Globally, FDI increased significantly between 1980 - 2000, almost tripling between 1980 and 1990 and then again between 1990 and 2000, before slowing in the first part of this decade. Virtually all regions experienced substantial FDI inflows, which were particularly pronounced in Europe, the United States and developing countries. FDI into Japan surged from 1995 to 2000 by some 54%, while more than doubling in the EU, U.S., and developing economies, particularly China. Thus, despite talk of an "FDI boom" in Japan in the late 1990s, FDI increased at a slower rate relative to other major economies at a time when it expanded rapidly on a global basis. FDI increased in Japan as well, particularly in relative or percentage terms, but by any measure Japan ranks at the bottom of the major industrial economies, or G-7. (*Table 2*)

Table 1: FDI Stock 1980-2005, Selected Countries (Percentage)

	1980	1990	2000	2005
Developed economies	75.6	79.3	68.5	70.3
European Union	42.5	42.9	37.6	44.4
Japan	0.6	0.6	0.9	1.0
United States	14.8	22.1	21.7	16.0
Developing economies	24.4	20.7	30.3	27.2
West Asia	1.4	2.2	1.1	1.5
South, East, and South East Asia	8.8	8.5	17.2	13.8
World	100.00	100.00	100.00	100.00

Source: UNCTAD, World Investment Report 2007.

Table 2: FDI Inflows 1980-2005, Selected Countries (Percentage)

	1978-1980	1988-1990	1998-2000	2003-2005
Developed economies	79.7	82.5	77.3	59.4

European Union	39.1	40.3	46.0	40.7
Japan	0.4	0.04	0.8	0.8
United States	23.8	31.5	24.0	12.6
Developing economies	20.3	17.5	21.7	35.9
West Asia	-1.6	0.3	0.3	3.0
South, East, and South East Asia	6.7	10.0	10.7	18.4
World	100.00	100.00	100.00	100.00

Source: UNCTAD, World Investment Report 2006.

Measured on a stock basis (the cumulative value of investments over time), at \$4.4 trillion the stock of FDI in the European Union is over 40 times greater than Japan's \$89 billion, while FDI in Italy alone is more than twice as much. The stock of FDI in Japan is also substantially lower than that in emerging economies such as China and Singapore.

When seen as a percentage of GDP, FDI in Japan is much lower than in other OECD countries. Whereas Japan's FDI/GDP ratio more than doubled from 0.6% in 1995 to 2.1% in 2003, FDI/GDP ratios for the other G-7 economies now range from 10% to 40% (Table 3). While the gap narrowed in the last decade, the stock of Japanese direct investment abroad still greatly exceeds the stock of inward FDI. In 2002, Japanese companies invested 5.6 times more abroad than foreign companies invested in Japan. This is a dramatic improvement from 1990, when Japan's outward-inward ratio was 20:1, but is still much higher than ratios for the United States (1.1) or the EU (1.3), where companies from the host country invested abroad at about the same rate as companies from other countries invested in that country.

Table 3: Inward FDI Stock/GDP Ratio (%)1990-2006

	1990	1995	2000	2002	2003	2004	2005	2006
Developed Economies	8.2	8.9	16.5	20.5	20.7	22	21.4	24
European Union	10.9	13.2	28.5	34.6	32.8	34	33	38
United States	6.9	7.3	12.4	14.4	14.1	13	13	13
Japan	0.3	0.6	1.1	2.0	2.1	2	2	2

Source: UNCTAD, World Investment Report 2007.

Measured on a "flow" basis, FDI in Japan rose sharply from 1997 to 1999 before falling in line with global trends (Table 2). Even in the peak year of 1999, FDI in Japan measured only \$12.7 billion, far below levels in the G-7 economies. From 1997 to 2004, foreign companies invested \$1.2 trillion in the U.S., \$464 billion in the U.K., \$384 billion in China, \$141 billion in Ireland, and \$99 billion in Singapore. FDI in Japan totalled \$56 billion in the most active period in history for FDI.

To better understand FDI in Japan, it is useful to look in more detail at recent trends. Prior to FY1998, European and U.S. companies – the leading investors in Japan – made relatively small investments. Starting in FY1998, the value of investments increased substantially while the number of cases for both Europe and the U.S. peaked in 2000 before falling back to, or below, pre-FY1998 levels (Table 4).

Table 4: Inward FDI Flows in Japan by Source Country (US \$ million)

	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
World												
E.U	84	1,429	527	9,102	3,913	2,732	5,217	5,377	5,492	1,858	-4274	642
U.S.A												1327
Canada	294	512	2,064	628	-1,052	3,492	2,451	-641	1,407	308	105	0
ASEAN	-710	-82	49	62	1,048	776	569	25	890	-944	-2771	-561
China	6	276	107	75	76	-164	-16	354	392	592	1063	1283
India	-22	-22	-12	3	0	2	1	-2	-9	11	12	15
Latin America	n.a.	0	3	0	0	0	-1	0	0	1	-1	3
World												
America	n.a.	395	-49	1,026	2,895	-1,013	-176	1,376	-1114	1278	566	2831

Source: JETRO 2008

By industry, FDI in service sectors (“non-manufacturing”) has far exceeded that in the manufacturing sector (*Tables 5a and b*). The so-called Big Bang financial reforms initiated by Prime Minister Hashimoto created new business opportunities for foreign firms in Japan and spurred a sharp increase in FDI in finance and insurance in 1997-2000. During the global telecom/Internet boom of the late 1990s, foreign investment in Japan’s telecommunications industry increased in the quest for a possible crack in the market domination of NTT following new technologies and partial liberalisation. Foreign investment in real estate has increased substantially since 1997 as foreign firms have acquired more golf courses, hotels, and commercial and residential buildings.

In manufacturing, FDI has been concentrated primarily in chemicals and machinery, with most of it taking place via acquisitions. Most notable is the foreign investment in Japan’s automotive industry, in which Renault and Daimler Chrysler acquired controlling stakes in Nissan and Mitsubishi Motors, respectively, while GM increased its ownership stake in Fuji Heavy Industries and Suzuki Motors. Renault acquired a controlling 44% stake in Nissan for \$5.4 billion in 1999, GM acquired a 20% equity stake in Fuji Heavy Industries for \$1.4 billion in 1999 and doubled its 10% stake in Suzuki in 2000, and DaimlerChrysler acquired a controlling 37% stake in Mitsubishi Motors in 2000. FDI in the food sector is noticeably low. (*Tables 5a and b*)

Table 5a: Japan’s Inward FDI by Industry in value 1995-2004 (US \$million)

	1995	1997	1998	1999	2000	2002	2003	2004
<u>Manufacturing</u>								
Total	1,464	2,179	2,442	8,783	7,155	6,749	4,310	952
Food	42	18	201	13	0	68	448	32
Textile	24	15	28	2	22	33	10	83
Lumber&Pulp	22	153	38	63	10	-	-	-
Chemical	1,136	603	310	540	1,618	3,416	970	199
Metal	1	2	16	160	17	136	25	7
Machinery	189	1,184	1,663	7,757	3,184	2,220	2,489	402
Petroleum	21	47	65	121	2,292	508	114	166
Glass&Ceramics	0	6	-	51	0	3	7	-
Others	30	151	120	76	11	365	248	63

<u>Non-manufacturing</u> total	2,368	3,348	8,029	12,727	21,122	11,186	14,412	36,507
Telecommunication	55	27	131	2,959	6,793	1,412	535	4,338
Construction	1	3	11	20	0	19	10	31
Trading	704	812	1,374	3,124	2,498	2,118	3,265	999
Finance&Insurance	1,038	1,317	3,569	4,586	9,313	5,306	9,005	27,693
Service	509	723	2,485	1,845	2,140	2,025	955	1,263
Transportation	13	3	48	19	52	22	15	1,947
Real Estate	16	392	325	151	313	239	609	213
Others	33	71	87	23	12	45	18	24
TOTAL	3,833	5,527	10,470	21,510	28,276	17,935	18,722	37,459

Table 5b: Japan's Inward FDI by Industry in value 2005-2007 (US \$million)

	2005	2006	2007
<u>Manufacturing</u> (total)	-2,191	254	1,381
Food	-211	-717	365
Textile	188	58	109
Lumber and pulp	-22	-23	3
Chemicals	-1,168	1,538	-1,010
Pharmaceuticals	-44	37	935
Petroleum	1	35	35
Rubber and leather	103	193	663
Glass and ceramics	-34	60	230
Iron,non-ferrous, metals	164	-24	-22
General machinery	-1,195	32	-391
Electric machinery	32	-1,408	331
Transportation equipment	-59	598	20
Precision machinery	5,414	-7,043	20,800
<u>Non-manufacturing</u> (total)	-1	11	41
Farming forestry	0	-39	-33
Fishery,marine products	0	1	.
Mining	41	37	19
Construction	2,108	28	-288
Transportation	912	-9,715	-633
Communications	1,157	-387	1,660
Wholesale and retail	645	2,265	17,661
<u>Finance and insurance</u>	15	72	1,413
Real estate	178	122	295
Services	3223	6789	22181
TOTAL			

Source: JETRO 2008.

Academics examining FDI patterns in Japan suggest that the overriding objective for investing in Japan in the majority of cases has been to gain access to the huge Japanese market (see Paprycki 2007).

One indication of this is that the service sector accounted for almost four-fifths of FDI inflows during the period 1998–2004. In the case of services, not only is establishing a local presence often the only way in which a market can be served, but Japan’s productivity and international competitiveness in this area are generally low. A case in point is finance and insurance, which alone made up half of the service sector FDI during that period. Many of the transactions in the financial field involved the acquisition of local companies, not primarily based on the quality of these assets (many of the companies were on the brink of bankruptcy), or the contribution they could make to regional or global operations, but rather the instant access to the local market they provided. Other major service sectors that attracted FDI during this period were wholesale & retail trade— where the market-orientation is quite clear – and telecommunication. With regard to the latter, the dominant case, the acquisition of J-Phone by Vodafone, again primarily served to provide the British company with a presence in the Japanese market.

In 2006, Japan’s economic expansion was still hampered by deflationary pressures and low productivity growth in non-tradable goods and services (Moody’s, 2007). Also for the first time since 1989, FDI inflows to Japan turned negative largely due to some large sell-offs of foreign affiliates to Japanese companies (See UNCTAD World Investment Report 2007).

The decline in FDI inflows made it impossible to achieve the ambitious target to double Japan’s inward FDI stock by the end of 2006 (*Table 7*). However, in 2007, JETRO reports that FDI rose to new levels making a rebound from 2006 (*Table 4, Table 5b, Table 7*) which is still at much lower levels than in the early 2000s.

Table 7: Annual new FDI in Japan fell dramatically in 2006, but rebounded in 2007:

Year	Inward FDI flow (US\$ millions)
2002	9239
2003	6324
2004	7816
2005	2775
2006	- 6500
2007	2888

Source: UNCTAD World Investment Report 2006

Whereas scholars point out that the general economic outlook is the single most important factor determining if Japan is regarded as an interesting country in which to invest, the short history of foreign investments in Japan shows that regulatory reforms, or the perception that reforms are underway, are really the driving factor. In other words, foreign companies invest in sectors where regulatory reform has been undertaken and on the hope that such are under way. Only when local regulations have been aligned with global best practices or where access barriers have been eliminated by recognition in Japan of foreign standards will foreign companies be able to take advantage of their competitive advantages (global expertise and scale of economy). Purchasing or merging with a local company has proved the preferred way for new entrants to ensure access to the huge and often lucrative



market.

FDI promotion policies in Japan

Despite the small increase in FDI in 2007, the level remains extremely low by international comparison. It is equally clear that the major loser is Japan. A declining population and maturation of the economy require improved allocation of resources and efficiency gains. Increased inflow of FDI would mean new jobs, increased productivity and consumer welfare in Japan. It would enrich the Japanese economy as foreign firms bring new management skills, R&D, and marketing methods. New business approaches and, equally important, access to fresh capital to develop new services and/or products, give a novel dimension to competition and stimulate domestic companies to become even more innovative. Given this background, European Business Council in Japan (EBC) has over the past ten years urged the Japanese government to take further steps to facilitate investments and provided practical policy advice on ways to move forward.

In contrast with earlier decades, the Japanese government today recognizes, in principle, the benefits of inward foreign investment. Former Prime Minister Junichiro Koizumi announced in January 2003 that he wanted to double the cumulative FDI stock in five years, from 6.6 trillion yen in 2001 to 13.2 trillion in 2006. Although not achieved in time, when the target was within reach, Koizumi announced in January 2006, that the next goal should be another doubling of FDI, this time to reach 5% of GDP in 2010. His successor Mr. Abe publicly embraced the same policy target and so has current Prime Minister Fukuda, but these post-Koizumi prime ministers have not devoted much energy to the issue. However, following an ever increasing gloomy economic mood with the stock market in free flow, Minister for Economy Ms. Hiroko Ohta announced in January 2008 that she wanted to establish a new Investment Expert Committee to elaborate further policy goals to achieve this target.

The EBC has taken part in this committee and is playing a crucial role as the committee is now about to announce its final conclusions. This is not the first time the advice of the EBC has been sought. EBC was also a key member in the Japan Investment Council, the FDI advisory body to former Prime Minister Koizumi. The EBC has persistently argued that unless: 1) a more business-friendly regulatory environment is put in place, 2) mergers with or acquisitions of Japanese companies become feasible for foreign companies, and 3) the government takes active steps to counter the negative public image of foreign investments, FDI to Japan is unlikely to surge substantially.

This may sound obvious, but remains a controversial premise in Japan even today.

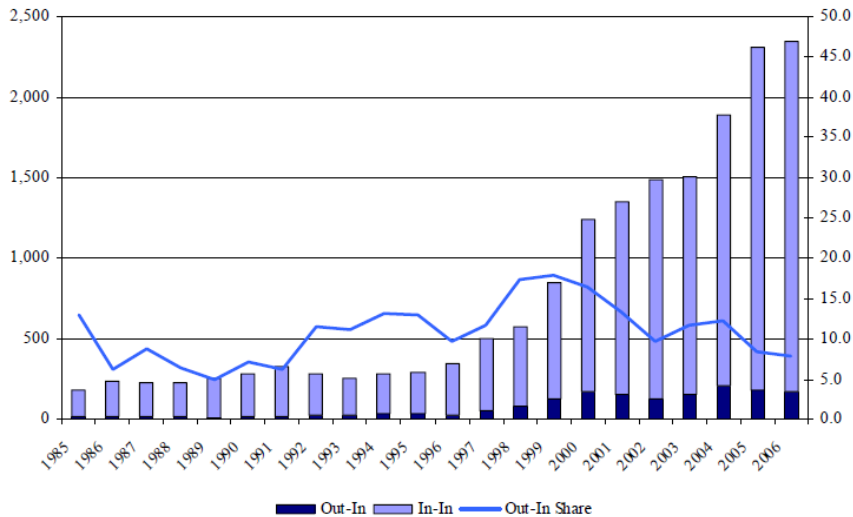
The powerful business federation, Keidanren, has relentlessly argued against any liberalisation of merger rules and for the protection of national companies despite their repeated call on the government to deregulate the economy as a way to encourage foreign investment. Along with the recovery of corporate profits over the past years, old patterns of cross share-holding have reappeared and suspicions of foreign investment, combined with unease over the economic forces unleashed by recent reforms have re-appeared. The mood has changed slightly over the past months as stock markets have fallen and the fear of Japan being forgotten have

re-appeared but this has not yet been translated into any mitigation of the resistance to reforms in the M&A and Corporate governance field, which are keys to increasing investments.

Mergers and Acquisitions (M&As)

The difficulty in creating a more conducive environment for foreign investments is fully discernible in Japan's struggle to open up for foreign mergers and acquisitions. M&A activity in Japan has grown substantially in recent years, reflecting wider changes in the country's economy as well as measures introduced by the government to facilitate corporate restructuring (see below on the new company law replacing the old corporate code). The number of cases involving a Japanese firm as the acquisition target rose from less than 300 during the mid-1990s to over a thousand in 2000 and reached more than 2,300 in 2006.

Figure 6: In-in and out-in M&As in Japan (no. of cases; percent)



Source: RECOF.

In this context, it is important to note that so-called in-in M&As (deals between Japanese companies) make up the large part of these cases. Though the number of out-in M&A cases has climbed from around thirty annually during the mid-1990s to an annual average of around 170 during the 2000s, this does not really signify an impressive gain. In short, M&As are becoming an established feature of the Japanese business landscape, but are predominantly occurring between Japanese companies, and not with foreign firms wanting to enter Japan. Despite – or because of – this trend for ever-increasing activity, concerns about M&As, and especially hostile takeovers, have also been growing.

A key episode in this context concerns the events surrounding the internet and finance firm Livedoor and its owner, Takafumie Horie. In 2005 he launched a hostile

takeover bid for Nippon Broadcasting System (NBS), a radio station, which represented an indirect attempt to gain control of one of the country's private TV stations, Fuji Television.

The bitter battle that followed dominated the news for weeks, and ended with the subsequent arrest of Mr. Horie and other board members in early 2006 following revelations that an affiliate companies had broken disclosure rules and falsified statements. The Livedoor episode is important because it brought to the surface continuing resistance to the changes sweeping Japan and, at least indirectly, played a role in shaping the environment for M&As and FDI in Japan. While to some, Horie, until his arrest, was a model of the new kind of entrepreneur the country desperately needed, to others he and his business practices exemplified the "market fundamentalism" and "excesses" unleashed by economic reforms. Reflecting such fears, the revision of the commercial code implemented in 2006 not only established clearer rules for mergers and acquisitions, but also introduced provisions allowing firms to adopt a variety of anti-takeover measures so-called poison pills.

Moreover, citing concern over an imminent wave of foreign hostile takeovers, parliament postponed the introduction of the triangular merger scheme for one year, from May 2006 to May 2007. During this time, when the scheme was again "under examination", the Keidanren launched a campaign to undermine the scheme before it was implemented. The business lobby was partially successful with this endeavor. Although the Liberal Democratic Party declined the request from Keidanren to make listing in the Japanese stock market a mandatory requirement for using the scheme, it ordered the Ministry of Finance to forbid tax deferrals for recipients of stocks from foreign companies that are not established and operating in Japan. As a result, foreign stocks can in practice only be used as consideration in mergers with or acquisitions of Japanese companies if the acquirer already has a substantial operation in Japan.

The triangular merger scheme is, furthermore, inherently complicated and has, one year after its introduction, only been used in one case, which was not a true merger, but a squeeze-out of minority shareholder, using foreign stock as consideration. Although triangular mergers cannot be used for hostile takeovers as any transfer of stock will have to be proposed by the board to the shareholders meeting, the two are often mentioned in the same breath and confused, reflecting the apprehension with which Japan's business community and public has viewed the scheme.

The EBC has argued within the foreign direct Investment Expert Committee headed by Minister Ohta that Japan should not be satisfied with the cumbersome triangular merger rule, but allow for tax deferrals also on other cross-border mergers. A forward triangular merger is just one type of M&A transaction. The fact remains that tax-deferral is not available for almost all other types of cross-border M&A transactions. For example, tax deferral is not available for any of the following cross-border investment structures:

- "Reverse" triangular mergers, in which the target, rather than the Japanese subsidiary

of the foreign parent company, is the “surviving” entity. For licensing, regulatory and other valid non- tax business reasons, a reverse triangular merger may be preferable or even essential to an acquirer. Since the resulting structure would be very similar compared with a forward triangular merger, the current requirement that the target corporation cannot be the surviving entity acts as a barrier to FDI;

- “Stock-for-assets” exchanges, in which foreign parent stock consideration is paid in order to acquire substantially all of the assets and assume the liabilities of a Japanese target company. For legal liability and other valid non-tax reasons, a stock for assets structure may be preferable or essential to an acquirer. Again, the resulting structure would be very similar compared with a forward triangular merger;
- Simple “stock-for-stock” exchanges, which would be used either (a) in the acquisition of a Japanese private company by a foreign company, usually one that is publicly listed and traded or (b) in “exchange offer” transactions, in the context of a takeover, bid by a publicly listed foreign company, when certain conditions are met;
- Contribution in kind of the assets of a branch to a new corporation that can be owned by a Japanese holding company or directly by the offshore parent without the requirement of keeping the branch in Japan to hold the shares

If the above transactions were possible under Japanese law and tax-deferred treatment was available under reasonable qualifying conditions, it would substantially reduce costs presently posing a prohibitive obstacle to investment.

Faced with the tax burden before any gains have been capitalised, most of these transactions simply do not occur at present. An additional factor that prevents efficiency-enhancing transactions from occurring is the inflexible nature of the tax rules governing reorganization transactions. This is especially so in the context of cross-border transactions.

Extending the range of tax deferrable transactions remains a high priority on the working program currently being discussed by the Investment Expert Committee and is likely to be included in the priority list to be published in late May 2008. The EBC realises, however, that the wording is likely to be vague, only recommending that the related ministries present concrete proposals before the end of 2008. The weak wording is likely to result in the recommendation being eliminated by the powerful Ministry of Finance which usually resists any measure that would, in the short run, reduce tax revenue.

Realising that more than 60% of Japanese FDI and some 80% of Global FDI flows stem from M&A, the opening up for mergers and acquisitions was the main and only substantial FDI promotion policy developed by the Koizumi government. The subsequent undermining of the scheme by the administration orchestrated by industries fearing a wave of foreign take-overs shows how controversial any relaxation of the merger rules will be.

Corporate Governance



A traditional obstacle to potential M&As in Japan has been the focus on market-share rather than share-holder value among Japanese companies. With banks as the major share holders and companies mainly financed through loans and not equities, Japanese management boards have for a long time been allowed to run companies at low or no profit. Instead, the focus has been on taking market shares from other industry groups (*keiretsu*) and not to maximize investment returns. When given a free hand, management has been prone to resist any challenge, merger or acquisition proposals seen as the most obvious threat.

Whilst the corporate structure has changed radically in the past decade and the introduction of the company law in 2006 clearly modernised the forms of incorporation and re-incorporations available, certain traits of the old system are lingering on, adversely affecting the overall corporate governance standards and obstructing M&A. When comparing Japan's system of corporate governance for listed companies with global standards, Japan's system is lagging behind, and in some respects still does not provide sufficient accountability to shareholders. For instance, in 2005 the FTSE-ISS Corporate Governance Indices gave the Nikkei 225 companies the lowest average score among six major international stock markets, with 80% of companies clustered with a rating of 2 on the 1-5 scale.

Despite over a decade of government and private initiatives to improve the financial system and enhance corporate productivity, the post-war system of insider-dominated boards and manager-centric governance is still a major hurdle for shareholders when they try to exert influence to urge efficient business practices and to invigorate initiative and creativity. At the same time, firms with inbound M&A transactions experienced higher productivity, return on capital, and labor efficiency than firms acquired in purely domestic M&A transactions, yet management is more prone to resist a take-over by foreign companies than by Japanese.

This illiquid cross-border M&A market is a major problem which could be rectified by strengthening the numbers and roles of independent directors at company boards. Being less constrained by personal employment considerations, independent directors are more likely to pursue an M&A buying or selling opportunity if it is in the best interests of shareholders.

Because of the scarcity of independent outside directors, almost all listed Japanese companies have no effective and credible mechanism to protect shareholder value – or maximize - in the event of hostile M&A, the exercise of takeover defenses or take-private MBO transactions proposed by internal management. This is such an important aspect that many foreign fund managers have come to view the reform of insider-led board structures in Japan as an important litmus test for whether Japan is serious about corporate governance reform, a necessity for Japan to re-take its position as leading financial centre in Asia. Legitimate shareholder interests are those which seek the optimal use of corporate assets and resources to produce the strongest possible business and financial performance.

The most powerful single measure available to Japan to better align the interests of management is to introduce independent directors to boards, directors who constitute a sufficient proportion of the board's membership, who are charged with representing shareholder interests, and are not motivated by their own self interests in corporate

decision-making. OECD Principles of Corporate Governance issued in 2004 stipulate that the “[b]oard should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment.” Also the Combined Code on Corporate Governance issued in June 2006 and applicable to London Stock Exchange-listed companies stipulates that “[e]xcept for smaller companies, at least half the board, excluding chairman, should comprise non-executive directors determined by the board to be independent.”

The EBC believes that Japan needs to incorporate specific standards that go beyond current requirements, guidelines that define “independent directors” in a manner generally consistent with global best practices. This is particularly crucial as Japan allowed for a large array of defensive measures, so-called poison pills, in the revision of the commercial code (now called company law) in 2006. Japan has seen a number of cases where defensive measures have been abused only to entrench the position of current management. The Ministry of Economy Trade and Industry issued in 2006 very sensible guidelines on what would constitute an abuse of defensive measures and situations when the application of defensive measures could be considered appropriate.

The problem is that none of these guidelines are legally binding and though courts this far have thwarted some abuses, they also seem to take the larger social and political situation into account. The introduction of defensive measures into the company law necessitate a counterbalance - a requirement that listed companies must have a certain proportion of independent directors on the management board so as to ensure share holder value priority. Japan has not addressed these issues in previous FDI promotion programs and the report from the Investment Expert Committee will discuss this only in general terms, recommending measures to ensure that the interest of shareholders are taken into “proper account”. The report of the Investment Expert Committee is likely to lead to a re-convening of the corporate value study group with the view to producing further guidelines before the end of 2008.

Corporate tax rate

Moving on from policies on the functioning and structure of markets, another instrument the government could use to promote inward FDI is tax policy. Reflecting the increasing mobility of multinationals, countries around the world have been lowering corporate tax rates to keep domestic firms from moving abroad and to attract foreign firms. Although this trend has raised concerns about a “race to the bottom,” failing to follow suit would clearly put Japan at a disadvantage. Against this background, effective corporate tax rates were cut in 1999 from 46 percent to 40 percent. However, since then, countries in Europe and East Asia have continued to lower or were in the process of lowering corporate tax rates further. In Europe, the Netherlands reduced the effective corporate tax burden to 20 percent in 2007, Germany decided to lower rates from 2008 from around 38 to 29 percent, and France was considering to cut rates from roughly 34 to 20 percent over a five year period. Similarly, in Asia, Malaysia and Singapore were in the process of lowering, or were planning to lower, corporate taxes. Consequently, at around 40 percent, the level of corporate taxes in Japan seems increasingly out of tune with tax rates of 20 to 30 percent in other parts of the world and there has been a growing debate on



lowering corporate taxes to enhance the country's international competitiveness. Given that Japan continues to have large budget deficits, the Ministry of Finance has been cautious to lower taxes, especially as raising taxes is politically close to impossible. The Investment Expert Committee will recommend lowering the tax-rate to attract more foreign investments, one of few statements that are likely to get any public attention although the prospect of a direct corporate tax rate cut is gloomy at best.

Regulatory transparency

Another generic area where the government must take steps to facilitate foreign investments is in the field of regulatory transparency and predictability. Traditionally, the regulator has in Japan preferred a one-to-one dialogue with individual firms, rather than drafting explicit rules valid for the whole industry. By doing so, the administration has been able to ensure complete political flexibility, unchallengeable power of interpretation, and freedom from responsibility as the dialogues are informal and hence advice deniable at a later stage. Though much has improved and the government is realizing the difficulty for foreign firms in conducting business under these circumstances, a lack of transparency and consistency in the application of regulations continues to be one of the factors most frequently cited by European businesses as inhibiting the development of a truly open environment for trade and investment in Japan, especially in areas with complex regulatory environments, such as financial services and taxation.

It is still common for rule interpretation and enforcement to vary substantially, depending on the officer in charge and the current political situation. Judicial recourse is often not a realistic option, especially for tax-related matters, as the overwhelming majority of rulings favour the regulators irrespective of the merits of the case.

In particular, the EBC is recommending that the no-action letter system is revised with the view to making it usable from a business perspective. The system is currently non-functional as indicated by the fact that the Financial Services Agency, the regulator from which the demand for no-action letters is highest, only issues on average a mere four letters per year. The administration clearly prefers a more flexible approach and threatens the regulated body with an answer they do not wish for, should they be pressed to go-ahead with sending the letter.

The EBC has for a long time also urged the Government of Japan to reinvigorate its efforts to improve transparency and consistency in development of new regulations, in order to facilitate business in Japan for both foreign and domestic firms.

The Administrative Procedures Law (APL) should be revised in order to ensure that:

- All proposed laws, regulations, guidelines and agency recommendations are made available for public comment, by enforcing and monitoring compliance with existing public comment requirements.
- Complete draft laws are made available for public comment, rather than mere summaries, before bills are submitted to the Diet for deliberation.

- A 30-day waiting period is implemented between the expiration of the public comment period and the submission or release of the final law, regulation, guideline or agency recommendation, in order to give officials time to consider the comments received.

Specific attention also needs to be given to the area of taxation, where European firms continue to report cases of arbitrary and inconsistent treatment from the tax authorities. The National Tax Agency (NTA) should provide rulings and clarifications, such as the rationale for additional assessments, in writing as a matter of course and not only in response to specific requests received under the formal *Bunsho Kaito* system. Rulings and clarifications should be made available to the public on a routine basis, in a format that safeguards the anonymity of the taxpayers involved.

The Investment Expert Committee report will contain recommendations for improving the non-action letter system but, again, the text is likely to be very vague.

The EBC believes that a bilateral agreement, such as an economic integration agreement (EIA), with the EU on regulatory transparency and investments would be the best way for Japan to ensure that all administrative bodies are forced to adhere to more transparent practices. With the administration in the position of controlling all transparency enhancing measures, international agreements are likely to be more successful than endless annual recommendations to the authorities from industry and foreign groups..

Regulatory reforms – unfinished

While improvement of the generic investment environment is a precondition, regulatory reform is the best motivator for foreign companies to enter the Japanese market. In the sectors where Japanese rules and regulations are close to global norms and practices such as automotives and machinery, foreign investments are high. By contrast, two sectors where European market shares are substantial, but where investments are low are in the financial and medical fields. Whereas wide-ranging reforms have been undertaken in both sectors, Japan remains simply too different and so much more difficult than the rest of the world to allow for foreign companies to set up any larger operation than what is minimally required to serve the existing client base. Reforming these sectors is crucial for Japan.

Financial Services

Long cosseted by government regulation and structural entry barriers, the banking and insurance sectors provide a vivid illustration both of the substantial changes that have taken place in Japan over the past decade and of the remaining challenges ahead if the country is to develop globally competitive service industries. To be sure, much of the transformation of Japan's financial sector is the result of domestic forces and foreign companies have, at best, played a marginal role. However, to understand foreign direct investment in the sector, it is necessary to make a brief excursion and consider the place of banks and, to a lesser extent, insurance companies in Japan's economic system. Financial institutions have been at the heart of what by the 1980s was often referred to as "Japan Inc.", the monolithic *keiretsu* system with the banks and insurance companies at the center of tightly-knit webs

of cross-shareholdings. A central element of this arrangement, in turn, was the main-bank system, characterized by strong established ties between domestic banks and their corporate clients. Loans from city banks (commercial banks) would typically provide the main source of external funds for most companies, and banks often held significant equity interests in their corporate clients, getting closely involved in the companies' managerial affairs at times of financial distress. Similarly, insurance companies were major long-term shareholders in firms belonging to the same business grouping. Under this arrangement, stringent government regulation of the financial sector and the "convoy system" – meant to guarantee stability by preventing laggards from falling behind and leaders from moving too far ahead – thwarted competition and innovation in products and services, and conventional lending to corporate clients provided the major source of income for Japanese banks. Likewise, insurance companies all tended to offer the same standardized services and products.

However, the traditional system has come under substantial strain as a result of the ongoing economic malaise, financial deregulation, and other economic reforms. In the banking sector, non-performing loans – a hang-over from the bursting of the bubble economy – and failure on the part of the government to decisively deal with the problem meant that by the end of the 1990s, the entire financial system was teetering on the brink of collapse. Between 1997 and 2003, a number of securities firms, including one of the country's Big Four, Yamaichi, two of the three long-term lending banks, Long Term Credit Bank and Nippon Credit Bank, and several regional banks, including Hokkaido Takushoku, Kofuku, and Ashikaga banks, entered bankruptcy and, in most cases, were nationalized.

The life insurance industry was similarly creaking under the burden of negative carrying costs – the shortfall between guaranteed pay-outs to customers on insurance products and the minimal or negative return on assets resulting from the Bank of Japan's zero interest rate policy and slumping stock and real estate markets. All in all, a total of 20 banks, 27 credit unions, 181 credit unions, seven life insurers, two property and casualty insurers, and seven securities companies went bankrupt in the period between 1992 and 2003.

A complete meltdown of the financial system was averted only through the injection of massive government funds, resulting in the quasi-nationalization of a large part of the banking sector and providing the impetus for substantial industry consolidation across traditional *keiretsu* lines. The Industrial Bank of Japan, Fuji Bank, and Dai-ichi Kangyo Bank, for example, merged to form the Mizuho Financial Group, while Sumitomo Bank and Sakura Bank joined forces to become the Sumitomo Mitsui Banking Corporation. The mergers were made possible by a series of financial sector reforms commonly labeled as Japan's "Big Bang". The reforms for the first time since before the Second World War allowed Japanese firms to form holding companies and led to further financial sector consolidation in other areas, such as the securities industry.

But the "Big Bang" reforms were intended to achieve much more than merely facilitate industry consolidation, aiming, as they did, at turning Tokyo into a global financial center on a par with London and New York. To this end, controls on foreign exchange transactions, fixed share-trading commissions, and government-stipulated uniform insurance premiums were abolished. In addition, for the first time, banks were allowed to enter the securities business and barriers between the insurance business and banking,



securities, and trust banking were somewhat lifted. While the reforms did not deserve the “Big Bang” label, they certainly formed part of a long-term transition from a bank-centered to a financial-market centered financial system. The beginnings of this trend date back to the late 1980s, when large Japanese corporations began raising external funds through foreign and domestic bond issues. Since then, bank debt as a source of funding for large, publicly trade firms has declined further in importance.

Foreign direct investment trends reflect the changed conditions in Japan’s financial sector. Until the mid-1990s, banking and insurance accounted for less than 5 percent of total FDI inflows. Since then, however, FDI in the sector has skyrocketed, accounting for 41 percent of total inflows between 1997 and 2004, making banking and insurance by far the leading industry every year, with the sole exception of 1999, when it was eclipsed by the car industry. As a result, financial intermediary services and insurance today are the industries where investments are growing.

The banking and finance sector spans a wide range of services, including retail and commercial banking, investment banking, securities trading, and asset management. It is in the latter areas – investment banking, securities trading and asset management – that foreign financial institutions have made by far the greatest inroads into the Japanese market. What is more, although most of the major international players have been in Japan since the 1980s, it is only since the second half of the 1990s that they have begun to make their presence felt. This success has been based on a combination of deregulation, the transition to capital markets-based financial system, and economic malaise – and foreign investment banks’ expertise, which has allowed them to compensate for what they lack in local knowledge and access, on which traditional relational banking is based, with transactional and technical know-how.

The “Big Bang” reforms broadened the areas in which foreign financial institutions can bring their expertise to bear. The same is true for the insurance sector, where deregulation has allowed life and non-life insurers to enter each others’ business, abolished government-stipulated premium rates, and streamlined the approval of new insurance products. However, even though cross-sector integration of the financial services industry was initially amongst the goals of the programme, little was achieved in this direction. Though the ban on financial holding companies was lifted, the requirement to separate management control between different business entities remained. This effectively undermined any use of the holding company structure by global financial companies since it provided neither for integrated management control nor sharing of risk information.

In 2001, revisions of the ordinances relating to Articles 65 and 45 of the *Securities and Exchange Law* were introduced to permit a larger degree of sharing of internal control functions, such as compliance and risk management, between regulated entities within a financial conglomerate. These revisions were followed by the Financial Conglomerate Guidelines issued in 2005, which attempted to clarify the circumstances and type of information that could be shared between different entities in “related” financial services companies. The decision to leave the regulations themselves unchanged, and only provide guidelines on the circumstances under which they can be circumvented, has unfortunately resulted in more ambiguity and complexity, which means increased risk and costs on the part of the regulated entities. The same holds true for rules allowing the sharing of certain customer information provided prior written consent is received: the general rules are

difficult to apply to specific situations and the prior consent procedure too arduous.

Integrated financial services markets are becoming the norm in countries across the world, having proved to be the most efficient way for financial companies to fulfill their role in society of allocating resources in the economy while dealing with risks for investors. Although Japan has taken small steps in this direction, discussion on reducing firewalls is held back by the prevailing assumption that allowing banks to offer securities services and mutual funds would inevitably lead to conflicts of interest and other risks harmful to customers' interests. This assumption contrasts with the growing consensus in Europe, the U.S. and other parts of Asia (Hongkong and Singapore) that market mechanisms can be relied upon to punish actors who abuse their positions to promote the interests of individual people, departments or clients: "reputation risk" acts as a very substantial deterrent.

In line with these developments, the focus of financial regulators across the world has shifted from simply forbidding companies to engage concurrently in certain types of businesses, to enforcing internal control and corporate governance mechanisms, which ensure that potentially conflicting interests (such as underwriting and brokerage) are kept separate. The trend is for regulators to work together with industry participants to develop clear codes of conduct and rules of enforcement. Rules forbidding insider trading have proved an adequate alternative to economically devastating firewall regulations, with disclosure requirements for investment analysts, credit rating analysts and auditors proving effective in revealing any interests they have in firms they analyse or audit.

The EBC has argued that Japan should profit from the experience of other major markets, where regulators have demonstrated that adequate levels of risk control and supervision can be achieved without resorting to strict separation of each financial services business undertaken within a financial conglomerate. Their approach has been shown to foster efficiency, development of new products and better risk analysis. Both the financial services industry and the economy at large have benefited extensively from integration of businesses at a global level. If Japan wants to attract further investments in the financial sector it must allow for foreign firms to fully integrate their business in Japan with their global operation and, by doing so, enabling foreign financial groups to use Tokyo as a base for their Asian and global operations. The EBC recommends that:

- (1) the ban on concurrent management of banking and securities businesses should be lifted by revising Article 33 of the new Financial Instrument Exchange Law.
- (2) Article 1 of the same Law concerning the concurrent management of trust businesses by financial institutions should be revised to include branches of foreign banks.
- (3) the sale of insurance products through financial institutions should be fully liberalised.
- (4) asset management companies should be allowed to place orders on behalf of overseas affiliates as well as promote off-shore funds for related companies without additional licensing being required.

The EBC has argued for the inclusion of the integration of the Financial Services as a priority subject for the Investment Expert Committee, but this recommendation has been declined on the basis that most of the measures we suggest have already been included in the Financial Services Agency's (FSA) plan to strengthen Tokyo as a global financial center. It is true that the FSA has presented a plan to boost the competitiveness of Tokyo as

financial center

The EBC also believes that an EU–Japan Economic Integration Agreement that includes a concrete time-line for the establishment of mutual acceptance of principles governing the financial services industry and the mutual acceptance of the home regulator as the core regulator would go a long way to improving the investment environment. It would enable the industry to secure the right to invest and to establish financial institutions in the partner’s territory and ensure that regulators do not apply measures that discriminate against the partner’s financial institutions, investors and investment in financial institutions, or cross-border financial service suppliers in favor of domestic counterparts.

Healthcare

Healthcare is a sector of vital importance in any economy. Not only does it account for a significant proportion of economic activity, especially in industrialized countries; it also has an important impact on social welfare. In Japan, total expenditure on health accounts for 7.9 percent of GDP. Although substantial, this figure is in the lower range of comparable OECD countries, indicating that Japan has managed to contain healthcare costs more effectively than other developed nations. What is more, this has been achieved while providing comprehensive health coverage to all citizens and without the rationing seen, for example, in the U.K. And although health care is of course only one contributing factor, the Japanese today enjoy the highest life expectancy in the world.

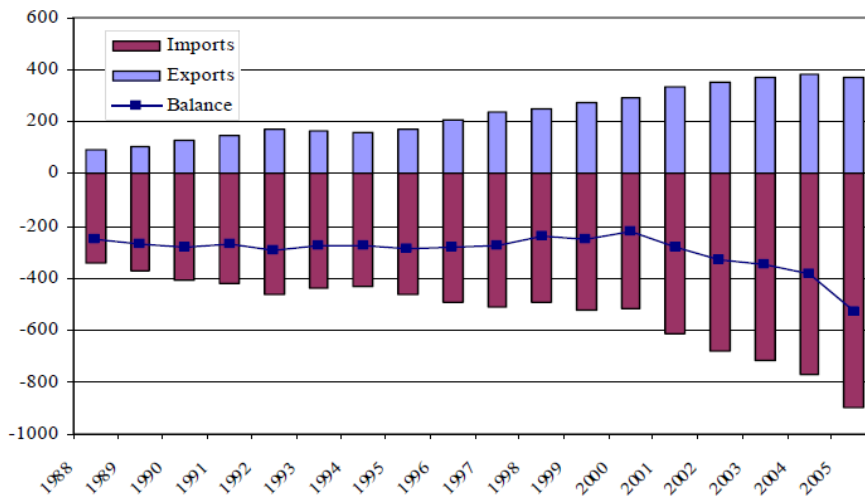
Yet, despite its apparent success, Japan’s healthcare sector has its fair share of problems. Peculiarities in the country’s healthcare system and healthcare regulation have fostered an environment in which competition from foreign firms in the pharmaceutical and medical devices industries has been limited, leading Japan’s manufacturers to fall behind their international rivals. These problems are compounded by the demographic challenge – the aging and shrinking of the population – which is starting to impose a growing burden on the national healthcare system and already put government finances under strain.

Heavy regulation has been responsible for delaying the introduction of new drugs and treatments developed overseas and for fostering pharmaceutical and medical device industries that were largely inward-looking. Regulatory and other changes in the 1990s since have made it much easier for foreign companies to introduce drugs in Japan and the impact has been far-reaching.

At first glance, Japan’s pharmaceutical industry seems to present a paradox. At almost US\$60 billion in 2004, the country’s drug market is the second-largest in the world, behind only that of the United States (ca. US\$230 billion), and about twice as large as third-ranked Germany’s. Japanese firms have long dominated their home market, and given such a strong domestic demand base, one might expect Japan’s drug makers to be among the leading pharmaceutical companies in the world. Yet, not one Japanese firm ranks among the global top 10 in the industry, and the country’s three largest (globally ranked 15th, 16th, and 20th) together account for less than 4 percent of global sales. What is more, this figure obviously includes sales in Japan. The country’s export market share (out of all OECD countries) is smaller still and even shrinking, having fallen from 3.3 percent in 1997 to 2.1 percent in 2003. Thus, unlike the car or electronics industry, a large home market has not

translated into a competitive advantage abroad. In fact, Japan has consistently run a trade deficit in pharmaceuticals, and this deficit has grown rapidly in recent years

Figure 2: Japan's trade in pharmaceuticals (billion yen)



Source Ministry of Finance (From Paprycki 2006)

Furthermore, the dominant position of Japanese firms in their home market has been slipping in recent years: Still controlling 85 percent of the market in 1990, Japanese firms' share shrank to less than two-thirds in 2004. These figures highlight two major features of Japan's pharmaceutical industry: the dominance of domestic firms in their home market despite their lack of international competitiveness; and the inroads by foreign firms into the Japanese market in recent years.

This can only be properly understood only if the re-imbursalment system and the product approval system are considered. When it comes to the re-imbursalment system, the special interests of the medical doctors represented by the Japan Medical Association (JMA) have often taken precedence over other considerations such as economic efficiency or the welfare of society as a whole. A particular feature of the system is that doctors both prescribe and dispense drugs, which they purchase from wholesalers at a discount from the official retail price. Since the Ministry reimburses doctors for all drugs at the official retail price, doctors pocket the difference. This has led to a great demand for pharmaceutical products and, in turn, to a steady cut in the reimbursement prices for drugs by the government as a way to control health care expenses. Drug prices in Japan have since early 1980s fallen by roughly 5 percent a year as a result. Crucially, it is prices for established products that drop rapidly As a result, product life cycles in Japan have been much shorter than in Europe, R&D resources have been fragmented rather than concentrated on a handful of important products, and Japan has produced few drugs with any likelihood of diffusion overseas.

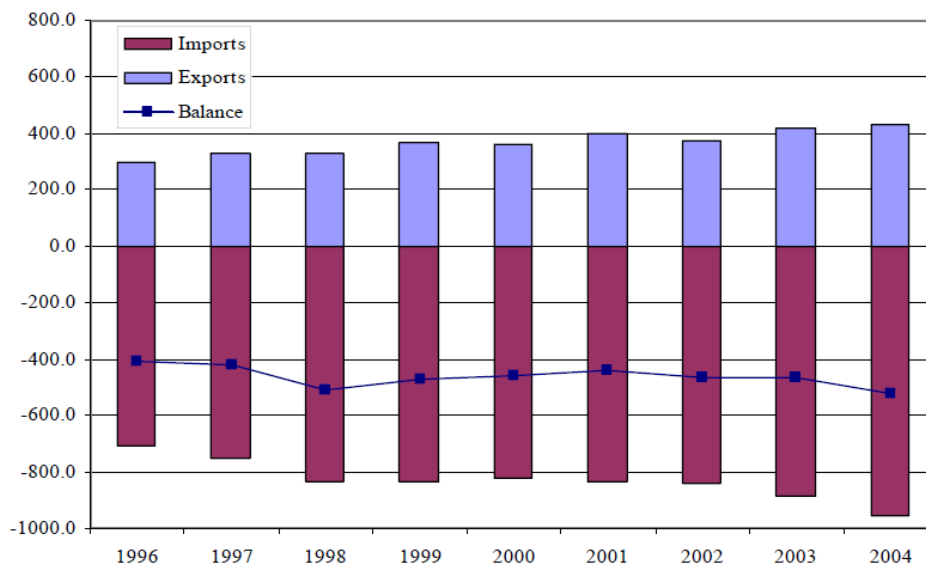
The clinical trial system and drug approval procedures are also to blame for the lack of competitiveness. Japan until recently refused to accept clinical trial results from abroad. Foreign firms wishing to introduce a product already being sold around the world therefore had to spend large sums of money and a lot of time (sometimes years) simply to replicate trials already conducted abroad. The effects have been detrimental both to Japan's drug

firms and to the country's patients: hampered in their ability to compete overseas and largely insulated from international competition at home, Japan's pharmaceutical industry became increasingly disconnected from advances abroad, while patients failed to benefit from many innovative drugs developed overseas.

However, as a result of the regulatory reforms initiated over the past six or seven years, Japan's vast market has become a battleground for the world's foremost pharmaceutical companies, exposing domestic manufacturers for the first time to the full forces of global competition. The presence of foreign companies in Japan thus is a key factor underlying the current transformation of the industry. It is difficult to imagine how the Japanese industry can survive in the long-run without significant further consolidation and partnership with foreign manufacturers.

In many regards, the situation in the medical devices sector resembles that of the pharmaceutical industry. Japanese firms dominate their domestic market, but are relatively weak in the international arena, and their position at home appears to be increasingly vulnerable: Domestic firms account for 60 percent of sales in Japan, but the country's largest medical device makers, Olympus and Terumo, rank only 12th and 13th in the world. Japan also has a large and growing deficit in the trade in medical devices, with imports more than twice as large as exports

Figure 3: Japan's trade in medical devices (billion yen)



Source Ministry of Finance (From Paprycki 2006)

This lack of competitiveness again is the result of the regulatory system under which the industry has had to operate in Japan. Like drugs, medical devices require the approval of the Ministry of Health, Labour and Welfare, and the Japanese environment is very restrictive, conservative, and highly regulated. The need to reduce the time and costs associated with introducing innovative new treatments to the human and animal healthcare markets in Japan and to bring Japanese rules in line with global standards underpinned the Government's decision to revise the Pharmaceutical Affairs Law (PAL). However, three

years after the implementation of the revised Law, it is obvious that a lack of clarity in the guidelines, along with the introduction of new, unique Japanese requirements on top of international standards, have resulted in even longer approval times and less consistency with international practices.

Although the Ministry of Health, Labour and Welfare has introduced a process for improving the clinical trial environment and a new “pharmaceutical industry vision working group” has been considering how to improve the environment for clinical trials and approval review, concrete reforms are still needed in the pharmaceutical sector, including relaxation of GCP regulations and a boost to the numbers and quality of PMDA reviewers at the ministry’s approval body, the Pharmaceutical and Medical Devices Association (PMDA).

The EBC has long called for a reduction in the time and costs associated with introducing innovative new treatments to the Japanese healthcare system. Despite the original intent of using the revision to facilitate procedures and bring Japanese rules in line with global standards, the revised Pharmaceutical Affairs Law (PAL) resulted in the introduction of unique Japanese requirements, longer approval times, and less consistency with international practices. Much hope was pinned on new opportunities for third party testing of low-risk products and for sub-contracted manufacturing, introduced under the revised Pharmaceutical Affairs Law in 2005. However, expectations that this Law might shorten product approval times and streamline application processes have been dashed – the level of bureaucracy and cost has in fact risen.

Foreign Companies will be continuously reluctant to invest in Japan if approval times are not cut so that products manufactured abroad can be taken to the Japanese market. The EBC believes that the government of Japan should:

- Shorten the medical equipment certification process: accepting clinical trial data generated overseas; harmonising Good Clinical Practice (GCP) and Quality Management System (QMS) requirements with international standards; and, following the revision of the Pharmaceutical Affairs Law (PAL) in 2005, establishing objectives and clarifying guidelines that are accessible to all applicants. Foremost, GCP-related requirements need to be modified, since they currently impose an unsustainable burden on applicants in terms of work and application fees.
- Eliminate differences between Japanese GCP and the GCP established by the International Conference on Harmonisation; and increasing the number and quality of staff working on consultation and approval review in the Pharmaceutical and Medical Devices Agency (PMDA).
- Consider Mutual Recognition of Market certifications between Europe and Japan.

The Investment Expert Committee appears to have taken on many of the EBC recommendations and we are hopeful that they will also be included in the work programme to be published later in 2008.