

**2004 JETRO WHITE PAPER  
ON  
INTERNATIONAL TRADE AND FOREIGN DIRECT INVESTMENT**

**(Summary)**

**JETRO**

**JAPAN EXTERNAL TRADE ORGANIZATION**

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# I. The world economy, trade and foreign direct investment (FDI)

## A. Global economy, trade and FDI

### 1. The world economy grew 3.9% in 2003, fueled by activity in the US and China

- The US and China continue to be the main engines of growth in the world economy, which grew 3.0% in 2002, 3.9% in 2003 and is projected to grow 4.6% in 2004, according to IMF data (Table I-1). Of the 3.9% growth in global GDP in 2003, China contributed 27.7% and the US 16.3%. Broken down by expenditure components, Chinese investment (gross fixed capital formation) accounted for 22.8%, and personal consumption in the US accounted for 12.3%. Investment in China grew 23.0% in nominal terms in 2003, accounting for over 40% of the country's GDP. Consumption in the US, meanwhile, held steady, underpinned by tax cuts introduced by the Bush administration and low interest rates.
- The US and Chinese-led growth of the world economy is not free of risk. The Chinese economy, for example, is overheating, with investment up 43.0% in the first quarter of 2004 (compared to the same period a year earlier), led by growth in the real estate, metal and electric power industries, and a 9.8% overall growth (in real terms) of the economy (of which investment contributed 77.9%). Over-investment in five specific industries—iron and steel, aluminum, cement, real estate and automobiles—and inflows of capital from overseas (in expectation of a revaluation of the yuan), are the two major driving forces behind this high growth in investment. In response, the Chinese government has imposed investment controls, such as suspending fresh financing in four of the above five industries (automobiles being the exception). While these curbs on investment are expected to ease fears of the country overheating, growth in China will remain high, compared with Japan, the US and Europe. China will remain the engine of growth for the world economy and trade in 2004.
- In the US, on the other hand, employment is recovering and the economy is expected to enjoy steady growth of between 3.5% and 5%, provided that a policy of moderate monetary restraint is pursued that does not upset the present virtuous circle of consumption and investment. However, the twin deficits—i.e., the trade deficit, which totaled US\$547.6 billion in 2003 (of which China accounted for 22.7%) and the budget deficit, which stood at US\$375.3 billion in 2003—together with the possibility of simultaneous steep rises in the price of oil and natural gas leave the economy exposed to risk. The world economy thus continues to depend on growth in the US and China, even as these two economies face their own risks.

### 2. The value of world trade grew by an 8-year high of 16.1%

- Growth in world trade (in volume terms) accelerated from 3.2% in 2002 to 5.6% in 2003, while the world export price index rose from 1.6% in 2002 to 10.5% in 2003. As a result, the value of world trade (based on the combined exports of 205 countries and regions, according to JETRO estimates) grew by an 8-year high of 16.1%, to reach US\$7.5 trillion. China was the leading contributor to world trade growth in 2003. Its 10.9% contribution to export growth was second only to Germany (12.8%), while its 11.2% contribution to import growth exceeded even Germany's (10.5%) (Table I-2).
- China registered strong growth in trade in 2003, with growth well in excess of 30% in both imports (up 39.9% to US\$412.8 billion) and exports (up 34.6% to US\$438.4 billion). The two main reasons for this were: (1) a simultaneous growth in exports of both finished IT products and components (up 53.6% to US\$128.7 billion) and imports of IT components (up 43.8% to US\$91.1 billion, due in particular to a 49.2% surge [totaling US\$52.6 billion] in imports of semiconductors and other components, taking China [with US\$ 76.0 billion in 2003] past the US to become the world's largest importer of IT components), as well as the expansion of output in China by Japanese, US and European IT manufacturers of products such as personal computers and cellular phones; and (2) growth in imports of capital goods, iron and steel, and auto parts fueled by the surge in automobile output (Table I-3).

- Behind the rise in the world export price index was the rise in the export price of agricultural and mining products, and the depreciation of the dollar. A breakdown of the index by industry reveals export price rises of 12.0% in agricultural products, 20.0% in mining products (such as fuels), and 10.0% in manufactured products, accounting for 10.0%, 30.0% and 60.0% of the overall rise, respectively (Table I-4). A major factor underlying the rise in the price of manufactured products was the depreciation of the US dollar. Whereas the export price of US agricultural products rose 8.8%, the rate of increase in the export price of manufactured products (i.e., non-agricultural products) was just 1.0%. In line with a weaker dollar, EU trade grew 18% in US dollar terms, but dipped 1.5% in euro terms.
  - Growth in world trade (based on the exports of 29 countries and regions) accelerated at the start of 2004, growing 19.8% from a year earlier in the first quarter.
3. World trade in services (exports) grew 11.7% in 2003
- World trade in services grew by 11.7% in 2003, over the previous year, to reach US\$1,762.6 billion; transportation grew 12.7%, travel 8.8%, and "other services" 13%.
- "Other services" accounted for over 50% of the 2003 trade growth in services. Figures for four key economies (Germany, Japan, Italy and the US) reveal a 14.8% increase in "other business services" (excluding finance, construction and information services, etc.), which make up a little under half of "other services", and a 10.2% increase in "royalties and license fees", which accounts for over 20%.
4. Primary commodity prices rise sharply for the first time in 20 years
- The 20-year slump in the CRB Futures Index – the leading international commodity market index that measures the prices of 17 commodities in six fields – came to an end in March 2004, when it reached 283.8 (its highest level since March 1984), triggering memories of the sharp rise of the late 1970s. Underlying this surge were: (1) the persistence of high oil prices; (2) the increasing flow of capital to the commodities market due to the weak dollar; and (3) the growth in demand for energy and mineral resources in line with China's surge in industrial output. One reason for oil prices remaining high is the existence of varying environmental regulations in different states in the US, resulting in there being over 100 types of gasoline standards. As a consequence, shortages of refining capacity among suppliers act to push up costs.
5. World inward FDI shrank for the third straight year, falling 21.1% in 2003
- World FDI measured in terms of inward FDI on a balance of payments basis shrank for a third year running, falling 21.1% to US\$538.9 billion, according to JETRO estimates of inward FDI for 82 economies (Table I-5). Broken down by country and region, inward FDI declined 44.9% in the US, 23.7% in the EU, and 4.5% in China (the first decrease there since 2000, due mainly to the effect of severe acute respiratory syndrome (SARS)).
  - This three-year decline in world inward FDI is due to a prolonged period of adjustment in investment, which had ballooned to excessive proportions during the so-called IT bubble (US\$1.5 trillion in 2000, with M&As in the same year amounting to US\$1.3 trillion). Cross-border M&As in 2003 are returning to the level seen in 1996-1997, before the start of the IT bubble and the rise in US share prices.
  - The world value of cross-border M&As in 2003 (based on completed deals) declined 21.1% to US\$320.4 billion, while the number of deals fell 0.4% to 5,176 (Table I-6). Playing a large part in the decline were the dramatic falls in M&As by EU acquirers of US companies (down 34.5% to US\$39.3 billion) and cross-border M&As within the EU region (down 55.5% to US\$62.4 billion). Within specific industries, there was a continued decline in the value of M&As in the IT sector (down 30.6% to US\$46.6 billion). Total world cross-border M&As in the first six months of 2004 (also based on completed deals) registered an upturn of 12.9% from the same period a year earlier, to US\$176.2 billion, fueling expectations of a recovery in global FDI in 2004.

**Table I-1 Global economy, trade and investment indices (year-on-year percentage change)**

(Units: US\$ billion, %)

		1998	1999	2000	2001	2002	2003	Q 1 2004	2004 (projected)	Notes
Global economy	% change	2.8	3.7	4.7	2.4	3.0	3.9	-	4.6	The global growth rate calculated by the IMF using PPP weights of the corresponding country and year, except for East Asia for which the 1990 PPP is used. Projected figures are according to the European Commission for EU15 in 2004, and the IMF for other economies.
Japan	% change	-1.1	0.1	2.8	0.4	-0.3	2.5	5.6	3.4	
US	% change	4.2	4.5	3.7	0.8	1.9	3.0	5.0	4.6	
EU15	% change	2.9	2.9	3.6	1.7	1.0	0.8	1.6	2.0	
East Asia	% change	1.8	6.3	7.5	5.3	7.0	7.3	8.4	7.4	
Global industrial production index		2.3	3.8	5.3	-1.7	0.5	1.6	3.7		11 major countries and regions
Global merchandise trade (exports)	Value	5,450.7	5,649.6	6,360.9	6,129.2	6,419.6	7,486.5	1,677.4		} JETRO estimates for 2003 (based on 205 countries and regions) 29 major countries and regions for Q1 2004
	% change	-1.6	3.6	12.6	-3.6	4.7	16.1	19.8		
	Real growth rate	4.2	4.3	10.6	-0.1	3.2	5.6	19.8		
Global merchandise trade price		-5.8	-0.7	2.0	-3.5	1.6	10.5	0.0		
Crude oil price (US\$/barrel)		13.1	18.0	28.2	24.3	25.0	28.9	32.1		Average price of WTI, Dubai and UK Brent
Global service trade (receipts)	Value	1,344.1	1,392.1	1,480.7	1,482.7	1,578.6	1,762.6	147.7		US, UK and Japan only for Q1 2004
	% change	1.4	3.6	6.4	0.1	6.5	11.7	15.8		
Global FDI (inward flow)	Value	705.2	1,094.4	1,509.0	805.1	683.4	538.9	-		JETRO estimates for 2003 (based on 82 countries and regions)
	% change	47.1	55.2	37.9	-46.6	-15.1	-21.1	-		
Global cross-border M&As	Value	632.0	867.9	1,258.6	645.1	406.3	320.4	176.2		First half for 2004
	% change	92.7	37.3	45.0	-48.7	-37.0	-21.1	12.9		

Notes: 1. EU15 includes Austria, Belgium, Denmark, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden, the Netherlands, and the UK.  
2. East Asia includes Asian NIEs (Republic of Korea, Taiwan, Hong Kong and Singapore), ASEAN 4 (Indonesia, Malaysia, Philippines and Thailand), and China.

Sources: Prepared by JETRO from *IFS*, *WEO April 2004* (IMF), WTO, Thomson Financial data and national statistics.

**Table I-2 Trends in global trade by country and region**

(Units: US\$ million, %)

		2001	2002	2003
World	Value of exports (nominal)	6,129,230	6,419,600	7,486,504
	% change	-3.6	4.7	16.1
	Real % change	-0.1	3.2	5.6
EU15	Value of exports	2,317,099	2,461,930	2,904,171
	% change	0.5	6.3	18.0
	% contribution	-4.9	49.9	42.7
	Value of imports	2,265,321	2,360,662	2,817,328
	% change	-2.0	4.2	19.3
	% contribution	20.1	40.2	43.4
Germany	Value of exports	571,394	616,077	749,055
	% change	3.9	7.8	21.6
	% contribution	-9.3	15.4	12.8
	Value of imports	486,001	491,642	602,181
	% change	-1.8	1.2	22.5
	% contribution	3.9	2.4	10.5
East Asia	Value of exports	1,093,769	1,200,543	1,427,343
	% change	-7.0	9.8	18.9
	% contribution	35.7	36.8	21.9
	Value of imports	1,006,491	1,105,452	1,306,105
	% change	-7.1	9.8	18.2
	% contribution	33.1	41.7	19.1
China	Value of exports	266,403	325,596	438,371
	% change	6.9	22.2	34.6
	% contribution	-7.4	20.4	10.9
	Value of imports	243,563	295,170	412,836
	% change	8.2	21.2	39.9
	% contribution	-8.0	21.7	11.2
Japan	Value of exports	403,247	415,862	469,862
	% change	-15.8	3.1	13.0
	% contribution	32.7	4.3	5.2
	Value of imports	349,235	336,832	381,528
	% change	-8.0	-3.6	13.3
	% contribution	13.1	-5.2	4.3
US	Value of exports	729,100	693,103	724,771
	% change	-6.8	-4.9	4.6
	% contribution	22.8	-12.4	3.1
	Value of imports	1,140,999	1,161,366	1,257,121
	% change	-6.3	1.8	8.2
	% contribution	33.3	8.6	9.1

Note: JETRO estimates for the value of world exports (nominal) in 2003, percentage changes and percentage contributions by country and region. IMF data for the value of world exports (nominal) in 2001-2002. Percentage contributions of countries and regions are percentage contributions to the growth of the total value of world imports and exports.

Sources: Prepared from WTO, IMF and national statistics.

**Table I-3 Trends in global trade by major categories of goods (value of exports)**

(Units: US\$ million, %)

	2000	2001	2002	2003
IT-related products	1,216,854	1,072,753	1,088,424	1,218,143
% change	22.0	-11.8	1.5	11.9
% contribution	30.9	62.2	5.4	12.5
Semiconductors and other electronic components	314,591	249,289	262,363	291,660
% change	28.9	-20.8	5.2	11.2
% contribution	9.9	28.2	4.5	2.8
Chemicals	722,730	732,690	811,823	962,291
% change	8.4	1.4	10.8	18.5
% contribution	7.8	-4.3	27.3	14.5
Automobiles	364,644	367,248	405,892	468,492
% change	3.0	0.7	10.5	15.4
% contribution	1.5	-1.1	13.3	6.0
Iron and steel	209,807	196,271	217,096	267,157
% change	11.5	-6.5	10.6	23.1
% contribution	3.0	5.8	7.2	4.8
Mineral fuels	607,159	542,240	540,091	677,329
% change	62.9	-10.7	-0.4	25.4
% contribution	33.0	28.0	-0.7	13.2

Note: Estimates for percentage contributions in 2003.

Sources: Prepared from IMF and national statistics.

**Table I-4 Global trade in primary commodities**

(Units: US\$ million, %)

	2000	2001	2002	2003
Value of imports of primary commodities (world)	653,660	597,428	591,146	744,853
% change	55.5	-8.6	-1.1	26.0
Value of imports of primary commodities (China)	23,666	21,210	22,200	36,300
% change	129.5	-10.4	4.7	63.5
Export price of agricultural products (% change)	-3.5	-2.2	2.4	12.0
Export price of mining products (% change)	39.5	-8.4	-0.9	20.0
Export price of manufactured products (% change)	-2.5	-2.5	1.3	10.0

Note: Imports of primary commodities indicate the combined imports of 17 goods included in the CRB index.

Sources: Prepared from IMF, WTO and national statistics.

**Table I-5 Inward FDI of major economies**

(Units: US\$ million, %)

	2002	2003	% growth rate	% contribution	% share
US	72,411	39,890	-44.9	-4.8	7.4
EU15	372,521	284,098	-23.7	-12.9	52.7
Luxembourg	117,088	73,191	-37.5	-6.4	13.6
France	48,950	47,026	-3.9	-0.3	8.7
Germany	36,048	12,878	-64.3	-3.4	2.4
UK	27,802	14,574	-47.6	-1.9	2.7
Japan	9,245	6,325	-31.6	-0.4	1.2
East Asia	74,651	79,701	6.8	0.7	14.8
China	49,308	47,077	-4.5	-0.3	8.7
Asian NIEs	19,249	28,623	48.7	1.4	5.3
ASEAN4	6,094	4,001	-34.3	-0.3	0.7
Latin America (19 countries)	44,212	35,998	-18.6	-1.2	6.7
10 new EU members	23,026	12,719	-44.8	-1.5	2.4
Developed countries	497,570	360,018	-27.6	-20.1	66.8
Developing countries	185,786	178,897	-3.7	-1.0	33.2
World	683,356	538,915	-21.1	-21.1	100.0

- Notes:
1. Net flows are based on balance of payments.
  2. JETRO estimates for developed countries, developing countries and world.
  3. "Latin America" consists of the following 19 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

Sources: Prepared from IMF, OECD, Economic Commission for Latin America and the Caribbean data and balance of payments statistics for each country and region.

**Table I-6 Global cross-border M&As (by country and region)**

(Units: US\$ million, no. of deals, %)

	Target country/region					Acquirer country/region				
	2002		2003			2002		2003		
	Value	No. of deals	Value	% change	No. of deals	Value	No. of deals	Value	% change	No. of deals
World	406,279	5,199	320,400	-21.1	5,176	406,279	5,199	320,400	-21.1	5,176
US	79,493	827	70,168	-11.7	769	86,386	1,053	87,155	0.9	1,190
EU15	216,384	2,053	136,235	-37.0	1,955	243,023	2,485	139,057	-42.8	2,174
UK	61,113	486	35,350	-42.2	536	61,828	647	72,704	17.6	627
France	31,490	250	18,830	-40.2	239	37,201	325	9,497	-74.5	257
Germany	48,928	390	26,921	-45.0	358	58,617	378	19,455	-66.8	333
Netherlands	11,576	122	9,371	-19.0	119	28,869	245	9,830	-66.0	179
Japan	7,279	105	12,605	73.2	107	8,114	137	7,457	-8.1	148
East Asia	17,532	514	19,245	9.8	638	13,213	376	16,214	22.7	502
Asian NIEs	9,882	245	12,526	26.8	255	7,875	250	7,738	-1.7	352
ASEAN4	4,728	129	2,599	-45.0	147	2,814	78	3,846	36.7	93
China	2,922	140	4,119	41.0	236	2,524	48	4,631	83.5	57

Note: As of July 8, 2004.

Source: Prepared from Thomson Financial data.



## B. Japanese trade with China expands while stagnating with the US

### 1. Exports grow for a second straight year, while imports grow for the first time in three years

Japanese trade, measured on a customs-clearance basis, saw exports grow for a second straight year (up 13.0% in 2003 to US\$469.9 billion), while imports grew for the first time in three years (up 13.3% to US\$381.5 billion). In volume terms, exports rose 4.9% and imports 7.1% (Table I-7). The trade surplus grew for a second year running, rising US\$9.3 billion (11.8%) to US\$88.3 billion. In the first six months of 2004, the growth rate increased further, with exports up 23.3% and imports up 17.0%, from a year earlier.

### 2. Exports to China grow 43.5% on the back of a surge in automobile output and robust growth in capital investment, while exports to the US decline for a third consecutive year

Exports to China grew 43.5% in 2003 to US\$57.2 billion. A breakdown by category reveals a 53.8% surge (to US\$35.5 billion) in exports of machinery and equipment, such as automobile components (up 104.6%), precision instruments (up 69.7%) and general machinery (up 53.0%), due to a sharp rise in automobile production and capital investment in China.

Meanwhile, exports to the US fell for a third straight year (down 2.7% in 2003 to US\$115.4 billion), as a result of declines (also the third straight) in exports of machinery and equipment (down 3.6% to US\$92.4 billion). Automobile exports to the US slumped 7.9% to US\$32.8 billion. Exports of IT-related products were also sluggish, slipping 5.2% to US\$24.6 billion. Overall, there was a narrowing in the gap in exports of machinery and equipment (excluding transport equipment) to China (US\$31.7 billion) and the US (US\$48.1 billion).

### 3. China accounts for 19.7% of Japanese imports; the US accounts for 15.4%, as the gap between the two increases, compared with 2002

The story was the same regarding imports in 2003: Chinese imports grew a robust 21.9% to US\$75.2 billion, while imports from the US edged up a mere 1.8% to US\$58.7 billion. China first overtook the US as Japan's primary source of imports (in value terms) in 2002. The gap widened further in 2003, as China's share of the value of Japanese imports grew to 19.7% in 2003 from 18.3% in the previous year; conversely, the US share shrank from 17.1% in 2002 to 15.4% in 2003. In the first six months of 2004, growth in imports from China was again higher, increasing 26.0% on a year earlier, compared with just 6.5% for the US.

One of the reasons for the widening gap in imports from the US and China is the trend in imports of machinery and equipment: such imports from China grew 35.4% to US\$28.0 billion, while those from the US shrank 1.4% to US\$27.2 billion. Roughly two-thirds (or 66%) of machinery and equipment imports from China are IT-related products.

### 4. Surge in exports of LCD TVs to the US and EU markets, as Japanese manufacturers reap the benefits of developing digital consumer electronics products in Japan

At the core of Japan's IT-related trade are imports and exports of IT components, semiconductors in particular. In 2003, there was a rise in exports of finished IT products, such as telecommunications devices and video equipment. For many years, the majority of exported finished IT products were computers and peripherals. Since 2002, however, the largest category of exports has been video equipment, which grew 19.0% in 2003 to US\$16.0 billion. This is due to the growth in exports of products such as digital and other cameras (up 23.8% to US\$9.6 billion) and LCD TVs (up 82.5% to US\$1.0 billion), reflecting the impact of the development of new digital consumer electronics products in Japan for the home market. Exports of TVs from Japan began to decline after peaking at US\$1.8 billion in 1994 (by 2001, the figure had fallen to just US\$400 million). In 2002, however, exports began to pick up, recovering to US\$1.2 billion in 2003 (Fig. I-1), led by a surge in exports of LCD color TVs to the US (up 74.3%) and a twofold rise in such exports to the EU. LCD panels, a core component of LCD color televisions, are also being supplied (i.e., exported) to overseas assembly plants.

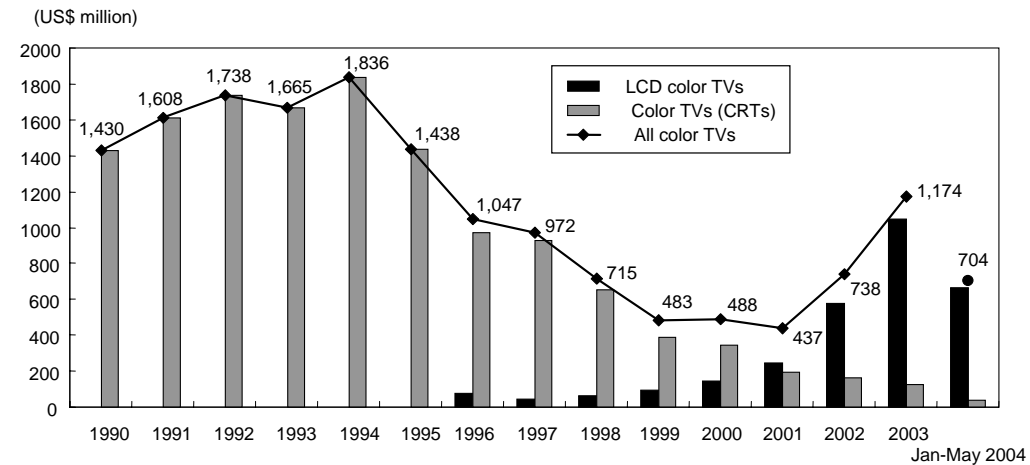
**Table I-7 Japan's trade**

(Units: US\$ million, %)

	2003	2003				2004	
		I	II	III	IV	I	II
Total exports	469,862	109,092	112,495	116,980	131,295	134,874	138,346
(YOY change)	13.0	16.7	11.3	7.9	16.4	23.6	23.0
US	115,412	27,866	28,415	28,164	30,967	30,574	30,943
EU15	71,893	17,737	17,435	17,096	19,625	21,749	20,144
China	57,219	12,204	13,546	14,754	16,716	16,585	18,423
Asian NIEs	110,415	25,079	25,649	27,175	32,512	32,921	34,617
ASEAN4	43,293	9,733	10,445	11,226	11,889	12,091	12,637
% change in export volume index (2000=100)	4.9	7.5	2.6	2.3	7.3	13.1	13.9
Total imports	381,528	92,353	92,575	94,382	102,218	106,679	109,607
(YOY change)	13.3	20.2	15.4	7.3	11.3	15.5	18.4
US	58,658	14,057	15,253	14,129	15,219	14,995	16,209
EU15	48,789	11,696	11,599	12,158	13,337	14,508	13,462
China	75,193	16,810	17,889	19,041	21,454	21,246	22,467
Asian NIEs	38,847	9,061	9,401	9,390	10,994	11,225	11,648
ASEAN4	47,751	11,565	11,602	12,033	12,552	12,952	13,238
YOY % change in import volume index (2000=100)	7.1	8.2	8.4	5.0	7.1	9.0	6.6
Proportion of oil imports	12.0	14.1	11.7	11.1	11.1	11.8	11.2
Proportion of imports of manufactured products	61.5	59.0	61.0	62.4	63.3	62.5	61.6
GDP							
Real GDP growth rate	2.5	0.1	0.9	0.7	1.8	1.5	-
% contribution to exports	1.1	0.1	0.2	0.4	0.6	0.5	-

Sources: Prepared from *Trade Statistics* (Ministry of Finance, Japan), *National Accounts* (Cabinet Office).

**Fig. I-1 Japan's exports of color TVs**



Notes: 1. LCD color TVs are TVs under HS code 8528-12-190. Data are for 1996 only.  
2. "All color TVs" is the combined total for LCD and CRT TVs.

Source: Prepared from *Trade Statistics* (Ministry of Finance, Japan).

## C. Outward FDI from Japan

### 1. Outward FDI in fiscal 2003 declines 2.1%

Japanese outward FDI (based on reports and notifications) remained almost unchanged in fiscal year 2003 (April-March) in value terms, edging down just 2.1% to US\$36.1 billion, compared to the previous year. In terms of the number of investments, however, investment activity grew for a third straight year, rising 247 to 2,411 (Table I-8). Broken down by industry, investment in manufacturing grew for a third consecutive year, rising 10.6% to US\$16.2 billion. Investment in non-manufacturing, on the other hand, declined 10.3% to US\$19.6 billion.

### 2. Growth in investment by Japanese automakers and auto components makers in China and Central and Eastern Europe

Japanese FDI in the US grew 28.8% in 2003 to US\$10.6 billion, fueled by increased investment in the chemical industry. FDI entering China rose 78.0% to US\$3.1 billion (the fourth increase in as many years), with particularly marked growth in investment by automakers, resulting in a 4.4 times increase (to US\$800 million) in FDI in transportation equipment, over the previous fiscal year. Growth in investment in Central and Eastern Europe (based on data for five countries) was also fueled by investment in the automobile sector, which grew 2.3 times in 2003 to US\$500 million. Growth in FDI in the ASEAN4 nations of Indonesia, Malaysia, Philippines and Thailand, which rose 27.1% to US\$1.9 billion, was likewise fueled by investment in the automobile sector.

**Table I-8 Japan's outward FDI (based on reports and notifications)**

(Units: US\$ million, %)

	FY2002	FY2003		
		Value	% change	% share
North America	8,449	10,680	26.4	29.6
US	8,215	10,577	28.8	29.3
Latin America	5,746	5,262	-8.4	14.6
Cayman Islands	4,036	2,123	-47.4	5.9
Brazil	406	1,551	281.8	4.3
EU15	15,067	12,034	-20.1	33.3
UK	4,412	1,785	-59.5	4.9
Netherlands	3,295	6,869	108.5	19.0
France	3,574	1,561	-56.3	4.3
Germany	381	694	81.9	1.9
Luxembourg	271	190	-29.7	0.5
Central and Eastern Europe (5 countries)	201	472	134.4	1.3
East Asia	5,250	6,233	18.7	17.3
China	1,766	3,143	78.0	8.7
Asian NIEs	1,961	1,154	-41.2	3.2
ASEAN4	1,523	1,936	27.1	5.4
Oceania	1,335	1,006	-24.7	2.8
Other	810	406	-49.9	1.1
Total	36,858	36,092	-2.1	100.0

- Notes: 1. Figures announced in yen converted to US dollars using the Bank of Japan interbank average exchange rate for the period. Conversions were made at US\$1=¥121.90 for FY2002 and US\$1=¥113.03 for FY2003.
2. The total for "East Asia" is the combined total for China, the Asian NIEs and ASEAN4. The five countries of Central and Eastern Europe are Romania, Hungary, Poland, the Czech Republic and Slovak Republic.

Sources: Prepared from *Outward and Inward Foreign Direct Investment* (Ministry of Finance, Japan) and *Foreign Exchange Rates* (Bank of Japan).

## D. Inward FDI in Japan

### 1. FDI entering Japan grows 4.4% in fiscal 2003

FDI entering Japan in fiscal 2003 (based on reports and notifications) was somewhat flat, rising 4.4% to US\$18.7 billion (Table I-9), while the number of investments fell by 34 to 1,431. Broken down by industry, there was a 36.1% fall in investment in manufacturing (to US\$4.3 billion), but a leap of 28.8% to US\$14.4 billion in non-manufacturing. Within manufacturing, investment in the food sector grew 6.6 times to US\$400 million, while in non-manufacturing, finance and insurance investment increased 69.7% to US\$9.0 billion; investment in trade and commerce grew 54.2% to US\$3.3 billion.

### 2. Total stock of inward FDI at year-end 2003 up 1.4 times from year-end 2001

The total inward FDI stock into Japan as of the end of 2003 was up US\$11.3 billion (14.5%) from the previous year, to US\$89.8 billion (a 2.6% increase in yen terms to ¥9.7 trillion), while the total outward FDI stock rose US\$30.3 billion (9.9%) to US\$335.9 billion (a 1.5% decrease in yen terms to ¥35.9 trillion). Japan's total inward FDI stock is now 1.4 times what it was in 2001 (¥6.6 trillion), which is well on the way to achieving the Japanese government's stated goal of doubling its inward FDI stock in the five year period between the end of 2001 and end of 2006.

**Table I-9 Japan's Inward FDI (based on reports and notifications)**

(Units: US\$ million, %)

	FY2002	FY2003		
		Value	% change	% share
North America	5,380	3,893	-27.6	20.8
US	4,876	3,090	-36.6	16.5
Latin America	1,837	4,075	121.9	21.8
Cayman Islands (UK)	1,671	2,586	54.7	13.8
Bermuda (UK)	70	1,431	1,934.8	7.6
EU15	5,256	6,018	14.5	32.1
Netherlands	3,221	2,800	-13.1	15.0
France	90	193	114.3	1.0
Germany	980	1,173	19.7	6.3
UK	257	230	-10.7	1.2
East Asia	373	1,427	282.9	7.6
China	3	3	2.8	0.0
Asian NIEs	370	1,425	284.8	7.6
Oceania	48	14	-70.0	0.1
Japan	4,462	3,181	-28.7	17.0
Other	580	113	-80.5	0.6
Total	17,935	18,722	4.4	100.0

- Notes:
1. Inward FDI from Japan is by foreign affiliates in Japan.
  2. Figures announced in yen converted to US dollars using the Bank of Japan interbank exchange average rate for the period. Conversions were made at US\$1=¥121.90 for FY2002 and US\$1=¥113.03 for FY2003.
  3. The figure for East Asia is the combined total for China, the Asian NIEs and ASEAN4.

Sources: Prepared from *Outward and Inward Foreign Direct Investment* (Ministry of Finance, Japan) and *Foreign Exchange Rates* (Bank of Japan).

## E. The WTO and other international trade issues

### 1. Progress in WTO negotiations and issues to be addressed

From the beginning of 2004, negotiations regarding the Doha Development Agenda appeared as if they would be back on track, as countries moved toward compromise. And, as the EU indicated its willingness to meet demands for the phased abolition of agricultural export subsidies, and prospects for negotiations on trade facilitation seemed likely to get underway, the WTO seemed to be taking a step further toward reaching a framework agreement at its General Council meeting in July. The three key issues in agricultural negotiations are the improvement of market access, cuts in domestic subsidies, and the abolition of export regulation (subsidies). The biggest point of contention regards how the tariffs should be cut, with interest currently focused on a tiered formula applied to each category of goods, according to the size of tariffs. At the center of agricultural negotiations are the US, EU, Australia, Brazil and India (Japan has been unable to make its presence felt in this arena). In negotiations on market access for non-agricultural goods (mining and industrial goods, and forestry and fishery products), discussion has focused on either: (1) allowing flexibility in application of tariff reduction in certain categories of goods – those subject to high tariffs – based on a proposal to apply a formula for reductions to each individual category without exception; or (2) selecting certain sectors for application of zero tariffs in advance of others. Unless major progress is made in these negotiations, however, it is unlikely that a detailed agreement will be reached by July. There has also been little progress in opening up trade in services, with only 44 countries having submitted initial offers regarding sectors for liberalization as of the end of June. Actions are being taken by developing countries, who are pushing for improvements in the liberalization offers from developed countries concerning the “movement of service providers”. In membership negotiations, it is expected that Saudi Arabia’s accession will be accepted within the year, and negotiations regarding Russia’s accession are also making progress. In addition to progress in negotiations on services, Russia has indicated its willingness to accede to demands for a reduction in automobile tariffs (until now a stumbling block) in bilateral negotiations with Japan, with some analysts believing that Russia’s accession will be achieved as early as the end of 2005.

### 2. The opening of China’s markets and state of liberalization since accession to the WTO

The Chinese government is actively implementing commitments in fields such as tariff reductions and legal reforms, in accordance with its WTO accession protocol. Regarding controls on foreign investment, the fine print regarding liberalization of the trade and distribution sectors (until now a bone of contention) has been clarified through an amendment in April 2004 to the Foreign Trade Law, which sits at the apex of legislation regulating foreign trade in this sector. Also, the recently adopted “New Management of Commercial Enterprises with Foreign Investment” provides for the entry of foreign affiliates to China’s domestic retail and wholesale markets. How this legislation will actually be applied, however, is another matter. And concerns remain among Japanese companies regarding whether liberalization will be achieved according to schedule. The WTO has a Transitional Review Mechanism (TRM) for reviewing China’s fulfillment of its obligations under the accession protocol, which is being used by Japan and other countries to demand that their concerns are properly addressed. Using this mechanism, Japan submitted comments and questions to China in 2003 regarding, among other things, the schedule for government procurement agreement membership applications, the schedule for the amendment of the tariff rate on photographic products, unreasonableness and poor objectiveness of data in anti-dumping investigations, and opacity of standards on application of criminal penalties against parties infringing Intellectual Property Rights (IPR).

## II. Free trade agreements (FTAs) in East Asia and Japanese companies

### A. Growing worldwide trend toward FTAs and impact on Japanese companies

#### 1. Growing worldwide trend toward FTAs

- a. Working on the basis of the number of agreements reported to the WTO, there are currently 107 FTAs in effect around the world. In Europe, the EU has expanded to include 25 countries, with a combined GDP of approximately US\$11 trillion and exports worth US\$2.5 trillion (Table II-1). In the Americas, the 34-nation Free Trade Area of the Americas (FTAA)— which would make a combined GDP of US\$13.6 trillion and exports totaling US\$1.3 trillion—is under negotiation. Across the world, moves are also underway to create intercontinental FTAs. The EU, for example, is in negotiations with Mercosur, while the US has reached an agreement with Morocco and entered negotiations with Thailand, after concluding FTAs with Singapore and Australia.
- b. East Asia (the Asian NIEs countries of the Republic of Korea [ROK], Taiwan, Hong Kong and Singapore; the ASEAN4 countries; China and Japan), devoid until recently of FTAs, has seen activity in this area pick up since 2000. Moves to create a free trade area have begun, first of all, in ASEAN, with six original member countries bringing tariffs down to 0-5% on almost all categories of goods in 2003, under the Common Effective Preferential Tariffs for the ASEAN Free Trade Area (CEPT-AFTA). The six will be joined in 2006 by Vietnam, which will bring intra-regional tariffs down to the same level (0-5%). The signing of FTAs between Japan and Singapore in 2002, and between China and Hong Kong and China and Macau in 2004 are further examples of the removal of trade barriers in the region. FTA negotiations have also started between China and ASEAN, Japan and ASEAN, and Japan and, individually, Thailand, the Philippines, Malaysia and ROK. Under these agreements, tariffs will be progressively phased out between 2005 and around 2012. Thus, in just another ten years, East Asia will be a completely free trade area, with the exception of trade between Japan and China, China and ROK, and various combinations of trade with Taiwan.
- c. While world trade grew fourfold between 1985 and 2003, trade in East Asia surged ahead 7.8 times, during when intra-regional trade in the North American Free Trade Agreement (NAFTA) and EU grew 4.4 times and 4.2 times, respectively. Thus, despite the absence of economic integration at the institutional level, the East Asia region has had the world's highest rate of growth in intra-regional trade. And by making the transition to institutional integration, economies in the region will have the opportunity to enjoy a fresh round of economic development.

**Table II-1 Total number of FTAs currently in effect by region and period**

	Europe, Middle East, Africa	Americas	Asia-Pacific	Inter-regional	Total
1955-59	1				1
1960-64	1	1			2
1965-69				1	1
1970-74	1	1		2	4
1975-79	3		2		5
1980-84	1	1	2		4
1985-89		1		2	3
1990-94	16	2	3		21
1995-99	22	2	1	1	26
2000-	22	4	6	8	40
Total	67	12	14	14	107

- Notes:
1. The above figures are based on the 208 regional trade agreements (RTAs) listed on the WTO website (defined as RTAs reported to GATT or the WTO and currently in effect) minus 101 agreements that were excluded due, for example, to (1) becoming void with the expansion of the EU on May 1, 2004; (2) double counting of agreements arising from new accessions to existing FTAs; and (3) double counting due to reporting to both GATT and GATS.
  2. FTAs are allocated to a period according to their effective date, or the year of reporting to GATT or WTO where the date of entry into effect is unknown (GCC: 1984, ECO: 1992).
  3. The figures indicate the number of agreements.

Source: Prepared from the list given on the WTO website ([http://www.wto.org/english/tratop\\_e/region\\_e/eif\\_e.xls](http://www.wto.org/english/tratop_e/region_e/eif_e.xls)), as of May 1, 2004.

## 2. East Asian FTAs and their impact on Japanese companies

### a. The formation of AFTA and the response of Japanese companies

Beginning in January 2003, intra-regional tariffs among the six original member countries of ASEAN were lowered to 0-5% (with the exception of certain goods), sparking a rise in production concentration in the ASEAN region and reorganization among Japanese automobile and consumer electronics manufacturers operating in the region. Due to the establishment of AFTA, production activity in the ASEAN region has entered a new era, as region-wide production and sales networks develop throughout the region.

### **[Opinions of Japanese automakers (in response to AFTA)]**

To date, the strategy of Japanese automakers has been to treat the ASEAN market as a number of segmented markets, and work to meet demand in each country individually. But due to the lowering of intra-regional tariffs on finished vehicles (apart from in Malaysia), intra-regional export of finished vehicles is spreading. Sourcing of auto parts from within the region is increasing as well—even ahead of finished vehicles—using schemes such as ASEAN Industrial Cooperation (AICO), which, like others, has its drawbacks, such as the need to obtain approval for each individual project. This trend is gathering pace as AFTA develops and the need for complex procedures is eliminated.

### b. ASEAN-China FTA and the impact on Japanese affiliates: the situation in Thailand

The ASEAN-China FTA brought the maximum tariff rate on agricultural products down to 10% as of January 1, 2004, while tariff reductions on manufactured products and other goods are expected to enter into force on schedule (July 1, 2005). With the exception of certain “sensitive” categories of goods, the FTA is to be completed by 2010. In the automobile and consumer electronics sectors, Japanese affiliates are expected to prepare for the realization of the ASEAN-China FTA in the following ways:

- 1) Japanese automakers are ramping up capacity in both China and ASEAN, which it regards

as separate markets. Within ASEAN, these automakers, under CEPT, have begun exporting finished cars between their operations in countries throughout the region, and may in the future include operations in China. However, as the lowering of tariffs on finished cars is expected to be still some ways off, the country's inclusion has yet to be considered in detail.

- 2) Automobile parts manufacturers operating in East Asia are moving to boost local procurement (including from within ASEAN). In some countries, such as Thailand, parts manufacturers are investing in new or expanded facilities to try to raise capacity to meet the needs of these automakers. Thai tariffs on imports of auto parts from China are relatively high (5-30%), so the elimination of tariffs through conclusion of an FTA between the two countries may well lead to an increase in sourcing of mass-produced parts, in particular, from China.
- 3) The main effects on Japanese consumer electronics manufacturers are likely to be as follows: (i) a new trend in some companies toward an internal division of labor between their ASEAN and Chinese operations; and (ii) an increase in competition as a result of the FTA in the consumer electronics sector, as Chinese brands enter the Thai market.

**[Opinion of Japanese consumer electronics manufacturers (in response to the FTA between ASEAN and China)]**

Some manufacturers are starting to increase their internal division of labor between their ASEAN and Chinese operations. Many Japanese consumer electronics manufacturers are splitting up tasks, along the lines described by one company based in Thailand, which says, "Despite some differences depending on the product, we generally use China as a center for production for the domestic market, and use operations in Thailand as an export base for the rest of the world." However, some companies are also starting to divide up production in the manner described by another manufacturer in Thailand, which says, "Depending on the model, some export production is being swapped between China and Thailand, with some microwave oven production being shifted from China to Thailand, and some fax machine production being moved from Thailand to China."

In the consumer electronics sector, an FTA is expected to accelerate the rise in competition from Chinese brands in the Thai market. At 15-20%, Thai tariffs on finished consumer electronics products are high and, as one Japanese affiliate in Thailand explains, "The Thai domestic market is protected by high tariffs, and the influx of Chinese products is currently low." Thus, there is a strong likelihood that, if tariffs were abolished, Chinese-made products would flood the Thai market. As another Japanese affiliate based in Thailand points out, "Over the past couple of years, there has been a rapid surge in Chinese products entering the market. At discount stores such as Carrefour and Lotus, half-price washing machines and similar products have begun to appear. Volume retailers account for around 60% of the Thai retail market, and so their impact is considerable."

3. Economic partnership agreements (EPAs) involving Japan, and their impact on Japanese affiliates overseas
  - a. Effects of the Japan-Singapore Economic Partnership Agreement (JSEPA)

At a review meeting on December 11, 2003, it was confirmed that trade in goods on which tariffs have been abolished under JSEPA was steadily growing, and that bilateral economic relations between Japan and Singapore were growing stronger. Under JSEPA, a total of 69 Singaporean companies have obtained Certificates of Origin for customs-free exports to Japan, resulting in a savings (for the companies) of \$US4.8 million in customs duties. In the service sector, haircut specialist QB Net (QB House) launched a "10-minute express haircut for S\$10" in Singapore in July 2002 under a licensing agreement with a local partner, and established a wholly owned subsidiary, QB Shell, in December 2002.
  - b. Japan-Mexico EPA (scheduled to enter into force in April 2005) and the likely effects it will have



on Japanese companies investing in Mexico

Mexican tariffs on automobile imports from Japan are a high 23%. And although companies that manufacture in Mexico qualify for a tariff-free import quota, the number of vehicles that can be imported from Japan (just 30,000 units in 2003) is much smaller than that from the EU (150,000 units in 2003) and Brazil (140,000 units in 2003), as these countries have larger quotas under FTAs and automobile agreements with Mexico. The Japan-Mexico EPA, however, will allocate to Japan a fresh quota equivalent to 5% of domestic unit sales in Mexico (approximately one million units), which will be usable by companies that do not have production operations in Mexico as well. An increase in exports equivalent to this quota is therefore expected. After six years, tariffs on units in excess of this quota will be abolished, greatly improving future access to the Mexican market.

Tariffs on auto parts and materials will also be scrapped, so they will no longer be subject to the high level of general duty (currently between 13-23%), making them easier to source from Japan.

Japanese-affiliated maquiladora companies producing products such as TVs and audio equipment for the US market make extensive use of non-Japanese supplies that will not be covered by the Japan-Mexico EPA, such as Chinese-made parts. Thus, many companies are expecting to benefit more from improvements in the business environment than the removal of tariffs. Mexico's business environment has been faced with several difficult issues in recent years, such as rising production costs due to increasing labor costs, deteriorating public safety, and frequent changes to the legal system. Thus, the Japan-Mexico EPA, unlike traditional FTAs, includes a provision for bilateral consultation mechanisms, the use of which should give Japanese investors in Mexico a voice in improving the business environment there, while also increasing the country's attractiveness as a production base for export to North America.

c. Overseas Japanese affiliates' expectations of Japan-East Asia EPAs currently under negotiation

While not yet at the stage of initiating any form of action in response, Japanese affiliates (especially in the countries concerned) have high expectations of the FTAs currently being negotiated between Japan and a number of countries in East Asia, including Thailand, Malaysia, the Philippines and ROK. Some of the concrete benefits they expect to reap are:

- 1) Tariff reductions, for example, would allow for a large-scale switch to imports of parts from Japan instead of locally produced parts, and also lead to growth in exports from Japan of finished products
- 2) Growth in investment from Japan, in particular in the service sector (where FDI is regulated under foreign business control laws)
- 3) Facilitation, streamlining and improvement of transparency of procedures (such as customs, approvals and mutual recognition procedures) and reduction of non-tariff measures
- 4) Improvement of the business environment as a result of EPAs, such as infrastructure improvements (new highways, port facilities and the like), and a reduction of electricity costs

## B. New business strategies of Japanese, US, European and Asian companies in East Asia

### 1. Investment in East Asia by Japanese, US and European companies

- a. As the formation of FTAs in East Asia gathers pace, investment in the area is increasing, led by Japanese, Korean and Taiwanese firms. US and European firms are also attracted to East Asia, owing to the area's improved investment conditions and favorable tariff arrangements covering movement of products/goods between economies with FTAs in place. According to statistics on FDI made in ASEAN countries by Japanese, European and US companies, the cumulative amount of FDI made in ASEAN between 1985 and 2003 was US\$100.5 billion from Japan, US\$49.4 billion from the US, and US\$72.2 billion from four European countries (UK, Germany, France and Italy), putting Japan in first place (Table II-2). This is a reflection of the formation of deep-rooted production networks in ASEAN by Japanese companies, especially manufacturers, as they transplanted their mass-production operations from Japan to ASEAN in the wake of the appreciation of the yen in the 1980s. If we look at the distribution of overseas production bases established by Japanese electronics manufacturers over time, we find that investment was concentrated in ASEAN in the 1980s, where 126 subsidiaries were formed compared with just 19 in China. In the 1990s, investment in ASEAN and China proceeded in parallel, with 189 subsidiaries being established in ASEAN and 249 in China during this period. From 2000, however, investment in China gained the ascendancy, with 61 new subsidiaries compared with just nine in ASEAN.
- b. According to Chinese statistics on inward FDI, the cumulative value of investment received between 1979 and 2003 was US\$40.7 billion from Japan, US\$43.6 billion from the US and US\$28.6 billion from four European countries (UK, Germany, France and Italy). Japan and the US were thus level pegging, with the European four somewhat behind. The value of inward FDI into China by Japan, the US and Europe between 2000 and 2003 was US\$4.6 billion from the US, US\$4.1 billion from Japan, and US\$2.8 billion from the European four (Table II-3).

**Table II-2 Receipts of FDI by the ASEAN4 from Japan, US and Europe (based on approvals)**

(Unit: US\$ million)

	Cumulative value of FDI	Value of FDI (annual average value)		
		1990-95	1996-99	2000-03
Japan	100,522	6,399	8,516	3,959
US	49,408	3,427	4,185	2,111
Europe	72,165	3,956	7,414	3,403

- Notes:
1. The value of FDI is based on approvals for each country.
  2. "Cumulative value" indicates the cumulative value from 1985 to 2003.
  3. The industries covered are mainly manufacturing, of Thailand and Malaysia, and also including some non-manufacturing for Indonesia and the Philippines.
  4. "Europe" consists of the UK, Germany, France and Italy combined total.

Source: Prepared from national statistics.

**Table II-3 Receipts of FDI by China from Japan, US and Europe**

(Unit: US\$ million)

	Cumulative value of FDI		Value of FDI (annual average value)					
			1990-95		1996-99		2000-03	
	Contract value	Implemented value	Contract value	Implemented value	Contract value	Implemented value	Contract value	Implemented value
Japan	57,230	40,748	3,071	1,376	3,468	3,595	5,588	4,127
US	86,190	43,619	4,053	1,488	6,088	3,699	8,458	4,610
Europe	48,136	28,583	2,542	707	3,994	3,085	3,836	2,845

Notes: 1. "Cumulative value" of FDI is the cumulative value of contracts from 1979 to 2003 (including compensation trade from 1979 to 1985) and the cumulative value of investments implemented from 1985 to 2003.  
2. "Europe" consists of the UK, Germany, France and Italy combined total.

Source: Prepared from *Almanac of China's Foreign Economic Relations and Trade* for each year.

## 2. Establishments of operations in East Asia by leading Japanese, US and European companies

How then do the Japanese, East Asian, US and European companies—those hoping to take advantage of the future expansion of business opportunities in East Asia—intend to expand their operations there? Attracting the most interest among leading companies in electronics, automobile, chemicals and iron and steel sectors are the following two points:

- a. Firstly, big players in these sectors are very eager to expand their presence in the Chinese market, even while recognizing the risks involved, such as possible infringements of IPR and a revaluation of the yuan (Table II-4). Inward FDI into China, aimed at the domestic market, will continue to follow an upward trend, despite being affected, to a greater or lesser extent, by cyclical factors. US high-tech companies are striving to acquire first-mover advantage in China's giant market of 1.3 billion people, with each company adopting their own defenses to protect themselves against IPR infringements. The strategy adopted by US companies is to compete against Chinese companies while avoiding head-on encounters and seeking out a cooperative way forward—a trend that is expected to grow more pronounced as the Chinese economy continues to develop. Among European companies, leading players in fields such as electronics (Phillips), heavy electrical machinery (Siemens), automobiles (Volkswagen) and chemicals are expanding their operations in China as domestic consumption there increases and massive investment is plowed into the country's infrastructure. Meanwhile, Taiwanese IT manufacturers, to meet orders taken at home, are pursuing growth by further bolstering their production operations in China. Of Taiwan's US\$50.52 billion output of IT products in 2003, 63.3% was produced in China. In response, leading US vendors are establishing R&D operations in Taiwan. And due to the increase in outsourcing of production in the form of original design manufacturing (ODM), Taiwanese firms have begun to pour resources into developing their own R&D capabilities. The Korean firm Samsung Electronics is targeting sales of US\$40 billion by 2010 for its China unit—a fourfold increase from their 2004 level. Japanese electronics manufacturers and firms in the iron/steel and chemical industries are stepping up their local production and forming mergers with Chinese companies in order to meet increased local demand in China, and as a response to anti-dumping actions. In the area of semiconductors, which make up China's largest category of imports, Taiwanese foundries (contract manufacturers specializing in front-end processing) and companies engaging strategically in front-end processing (diffusion processing such as printing of design circuits), such as Motorola and NEC, are entering China.
- b. Secondly, leading Japanese, US and European automakers and consumer electronics manufacturers (predominantly Japanese) are increasing their emphasis on the ASEAN region as a production base (Table II-5). Automakers from these economies are focusing their sights on the rapidly growing Chinese market, while at the same time viewing Thailand—which is continuing to attract concentrations of automakers—as an emerging center for automobile production for the region. In fact, Japanese, US and European automakers have come to view Thailand in particular

as a global center of production for one-ton pickup trucks, and they are consequently stepping up their production capacity there. At the same time, automakers are currently supplying passenger cars to the host markets in which their production operations are based, in line with a strategy to produce vehicles where demand exists, while some companies, after the reduction of tariffs brought by the CEPT agreement, are beginning to export finished cars between their operations in different countries. Others still are embarking on developing broad production, development and sales networks, centered around production operations in Thailand, to cover a wider area of Asia, which includes India as well as East Asia (Fig. II-1). Toyota, meanwhile, announced in September 2002 its "IMV Project" to produce "innovative international multipurpose vehicles"—a catchall term for pickup trucks and multipurpose vehicles—developed for emerging markets in regions such as Asia, South America and Africa. The project, which began in August 2004, puts Thailand at the center of pickup truck production for the world market, and calls for an increase in annual production (of pickup trucks) from 88,000 units in 2002 to 200,000 units. Of these, half are to be exported to over 90 countries in and outside the East Asia region. Thailand is the first location outside Japan to be chosen by Toyota for the production of strategic vehicles for the world market. Furthermore, leading consumer electronics manufacturers—in particular those from Japan—see ASEAN as being at the core of export operations. Leading producers of home appliances (e.g., air conditioners, refrigerators and washing machines) in particular continue to expand their export operations in Thailand. One of Thailand's advantages, as a Japanese consumer electronics manufacturer operating in the country points out, is that "the supporting industries for production of home appliances are, in some respects, the same as those required by the automobile industry, and these are already clustered in Thailand." Regarding production of audio-visual equipment, on the other hand, Malaysia has become a key base for exports, due to its concentration of electronic parts manufacturers. According to one Japanese audio-visual equipment manufacturer in Malaysia, "the transplantation of production from Japan has resulted in a large increase in production of video cameras over the past few years."

**Table II-4 Desire to expand operations in China**

<b>Chemical industry</b>	
Due to, among other things, accelerating investment in China by leading user industries, such as automakers and consumer electronics manufacturers, the stream of large new plants being built by leading European and US companies, and the increase in implementation of anti-dumping actions against exports, Japanese companies are stepping up production in China in order to reap economies of scale due to demand growth. At the same time, however, they are also taking into account the risks of investment in relation to supplies of raw materials and potential stability of operations.	
<b>Iron and steel industry</b>	
As a result of the rise in demand generated by China's rapid economic growth, the country is now leading the East Asian iron and steel market both in terms of production and imports. Asian steelmakers (including Japanese) are reorganizing their production and development networks to cater to Chinese demand. Leading Japanese steelmakers Nippon Steel Corporation and JFE Steel have launched joint ventures with local Chinese partners, while, Korea's POSCO and Taiwan's China Steel are pursuing a strategy of active expansion in China. Leading Chinese steelmakers are also pursuing a more active investment strategy.	
<b>Development of operations in China by Samsung Electronics</b>	
Samsung Electronics regards China as more than just a production base and emerging market. Following its establishment of three distributors in Beijing and elsewhere in 2003, the company plans to follow up with the creation in 2004 of new distributors in Shenyang and Chengdu to strengthen its sales in the northeast and northwest of the country. It has set a target of achieving sales of US\$40 billion by 2010, or four times the level in 2004.	
<b>Volkswagen (automobiles)</b>	
Recognizing its importance in fueling auto demand, Volkswagen has positioned China as its top priority market. It has invested 10 billion yuan (US\$1.2 billion) in the domestic market in developing a new plant (currently under construction) with an annual capacity of 330,000 units, and also plans to expand production capacity in Shanghai. While recognizing that the Chinese market has sufficient demand to absorb output, Volkswagen's Chinese operations will be assigned even greater strategic importance in the future as a base for exports.	

Source: Based on interviews with companies.

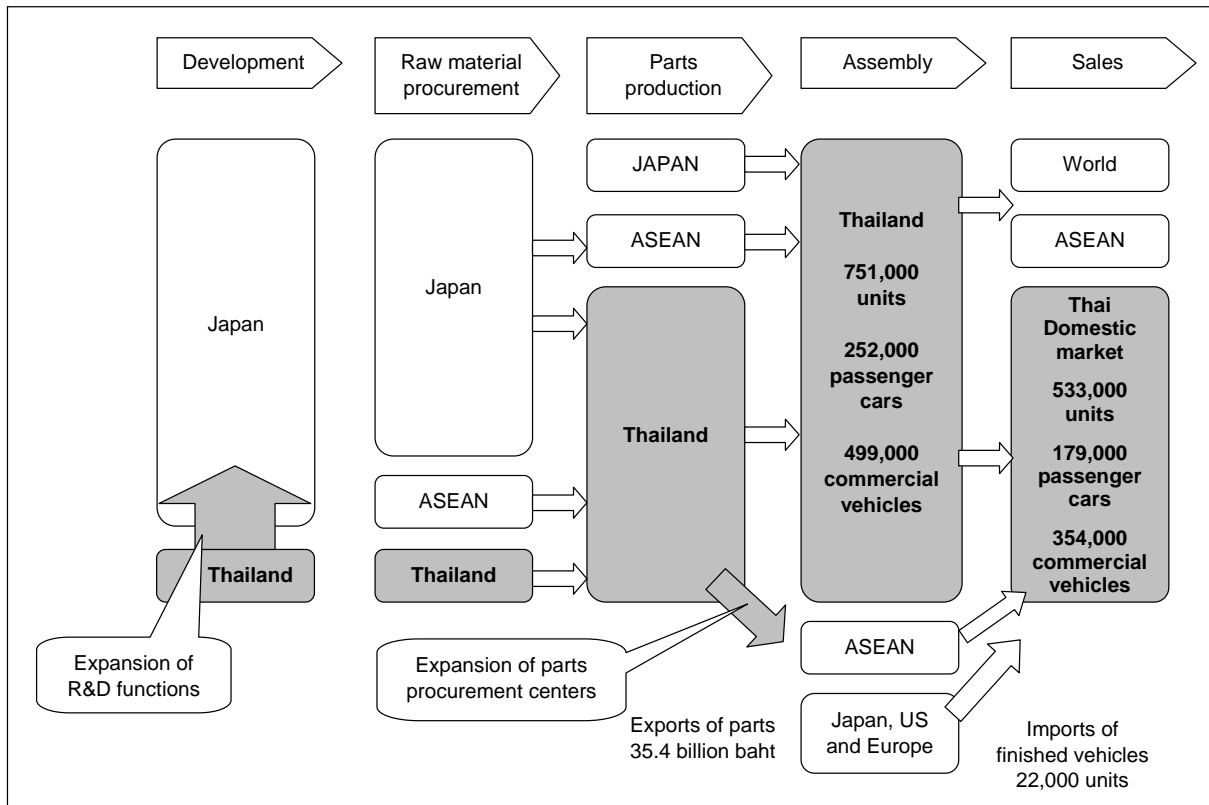
**Table II-5 State of development of operations in China and ASEAN by automakers**

		Thailand	Malaysia	Indonesia	Philippines	China
Toyota group	Toyota	⊙	●	⊙	○	△○○○
	Hino	●	△	⊙	○	○
	Daihatsu		⊙ (country)	⊙△	△△	△△
Honda		⊙	⊙	○	⊙	○○⊙
GM General Motors group	GM	●		●△		○○○
	Isuzu	⊙△	○△△	○△	⊙	○○○
	Suzuki	△	△△	⊙	△△	○○△
	Fuji Heavy Industries	△ (GM)	△			△
	Fiat	△ (GM)			△	○
Ford/Mazda group	Ford	⊙	○	△	●	○○
	Mazda		△△	△	△	△△
	Volvo	⊙	N.A.		△	
Renault/Nissan group	Renault		○			
	Nissan	⊙⊙	○	⊙	○△	○○○△
	Nissan Diesel	△		○	⊙○	○
DaimlerChrysler/Mitsubishi group	DaimlerChrysler	△△	△△	⊙	△△	○○
	Mitsubishi	● (99.9%)	△	⊙△	●	△△
	Mitsubishi Fuso					△
Volkswagen-Audi		△	△		△	○○
PSA (Peugeot Citroen)		△	△△△	△		○
BMW		●△	△	△	△	○
Total		21	23	19	21	39

Note: Automakers and trading companies, etc. Total for companies from the same country  
 ●100% ownership ⊙Over 50% ownership ○Up to 50% ownership  
 △Technical partnership and contracting out of production

Source: Japan Research Institute data updated by JETRO using data from Fourin and company websites.

**Fig. II-1 Position of Thailand in automobile development, parts procurement and production**



Source: Prepared from *The Situation of Japanese Companies in the Automobile and Motorcycle Industries in Thailand* (JETRO, Hiroshi Yoneya) and *The State of Establishment of Operations in Thailand by American and European Light Automobile Parts Manufacturers and the Response of Japanese Automobile Parts Manufacturers* (JBIC Institute, Japan Bank for International Cooperation).

## C. Rebuilding Japan's manufacturing base and the challenges of an East Asian free business area

### 1. Rebuilding Japan's domestic development and production infrastructure

#### a. Development of global products in the Japanese market

Japanese manufacturing witnessed a hollowing out as the electronics industry—which represents Japan's manufacturing core—continued shifting its production operations overseas, and Japanese companies saw their global market shares shrink. In response, Japanese companies have begun rebuilding their development and production systems within Japan, through management reforms (such as adopting a policy of "select and focus"), development of new products, improvement of high-mix low-volume production methods (through the introduction of cellular manufacturing systems), reduction of product development and delivery times and costs through the introduction of supply chain management (SCM), and increased domestic production of semiconductors, a core high value-added component. Owing to this, manufacturers of digital consumer electronic products (e.g., flat screen TVs and digital cameras) have succeeded in capturing large global market shares by bringing to market new products that were first experimentally manufactured and then mass produced in Japan (Table II-6). To acquire a high share of world markets, production in China and other parts of East Asia is essential (Fig. II-2).

#### b. The advantages of Japan as a production base

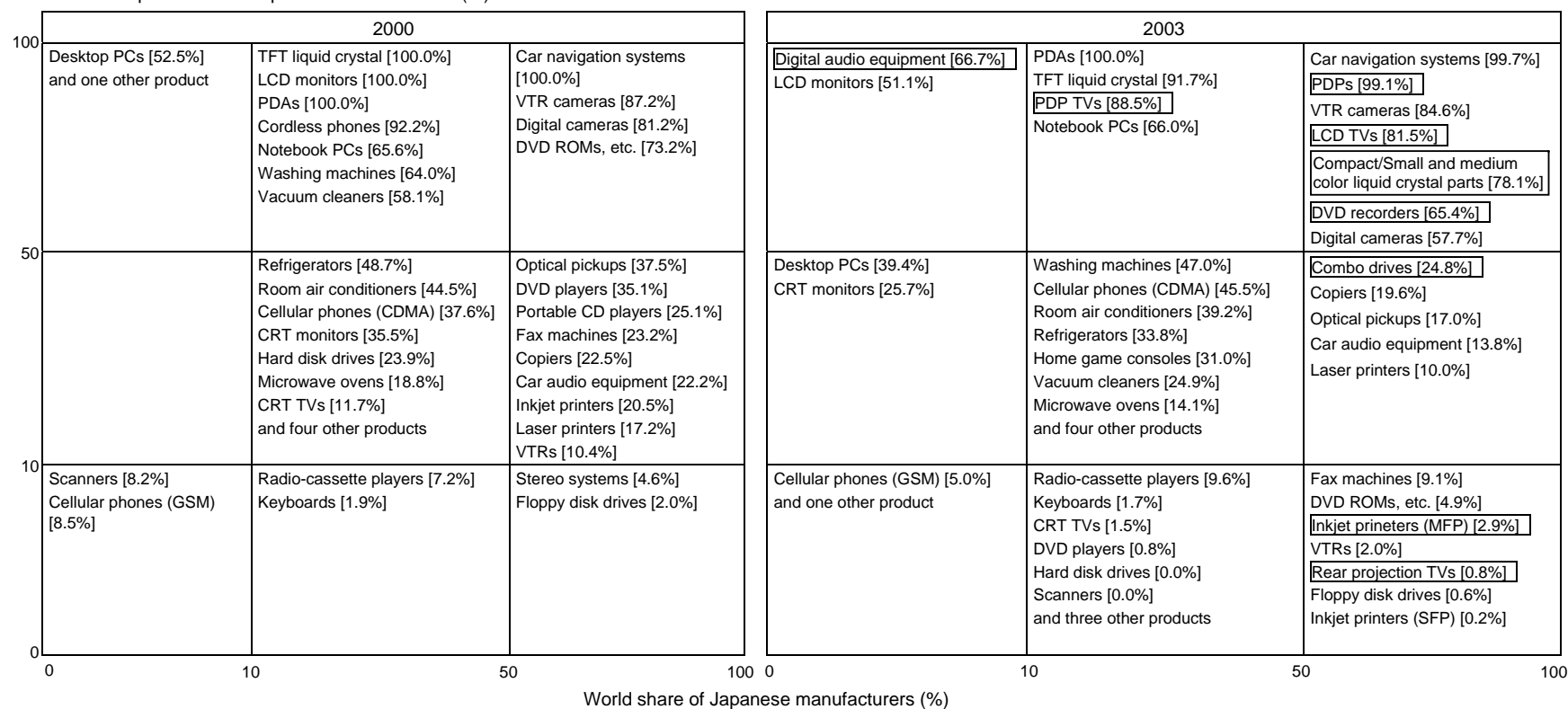
Japan is an advantageous location for mass production as well as the development and test production of digital consumer electronics products. When comparing the relative advantages (as a production base) of China and Japan, China does not necessarily come out as being more competitive, if costs and lead times are taken into account (Fig. II-3-4).

Japan's strengths include: (1) a well-established market for end products; (2) resources that enable core design functions to be conducted entirely within Japan; (3) a strong infrastructure for production of advanced components; and (4) companies' efforts to improve their production technologies by such means as the introduction of cellular manufacturing system.

These strengths apply equally to that prime example of a core industry: the automobile industry. An examination of Toyota's automobile production and development structure reveals that its R&D, technology development and product development operations are all located in Japan, from which the company launches its products onto world markets. Development operations in Asia consist primarily of technologies adapted to local procurement.

**Table II-6 Japanese consumer electronics manufacturers' share of world production and ratio of domestic production**

Ratio of domestic production of Japanese manufacturers (%)

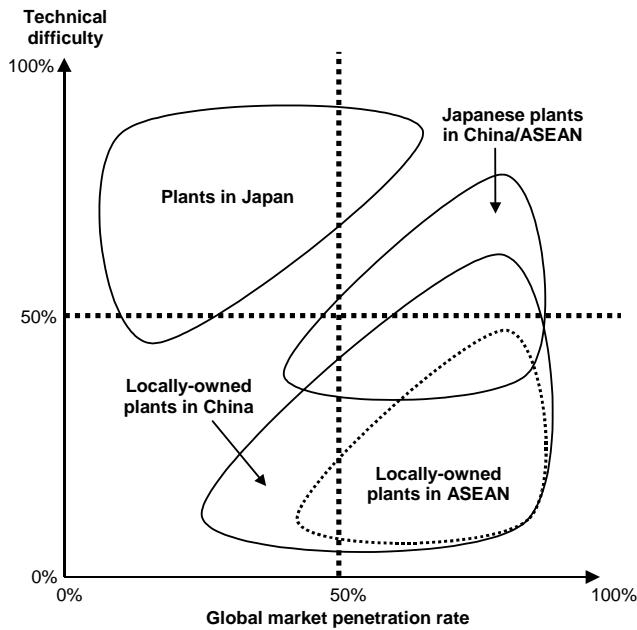


Note: Figures in [ ] indicate the ratio of domestic production by Japanese manufacturers (%).

Source: Editions for each year of *Worldwide Electronics Market Research* (Fuji Chimera Research Institute).

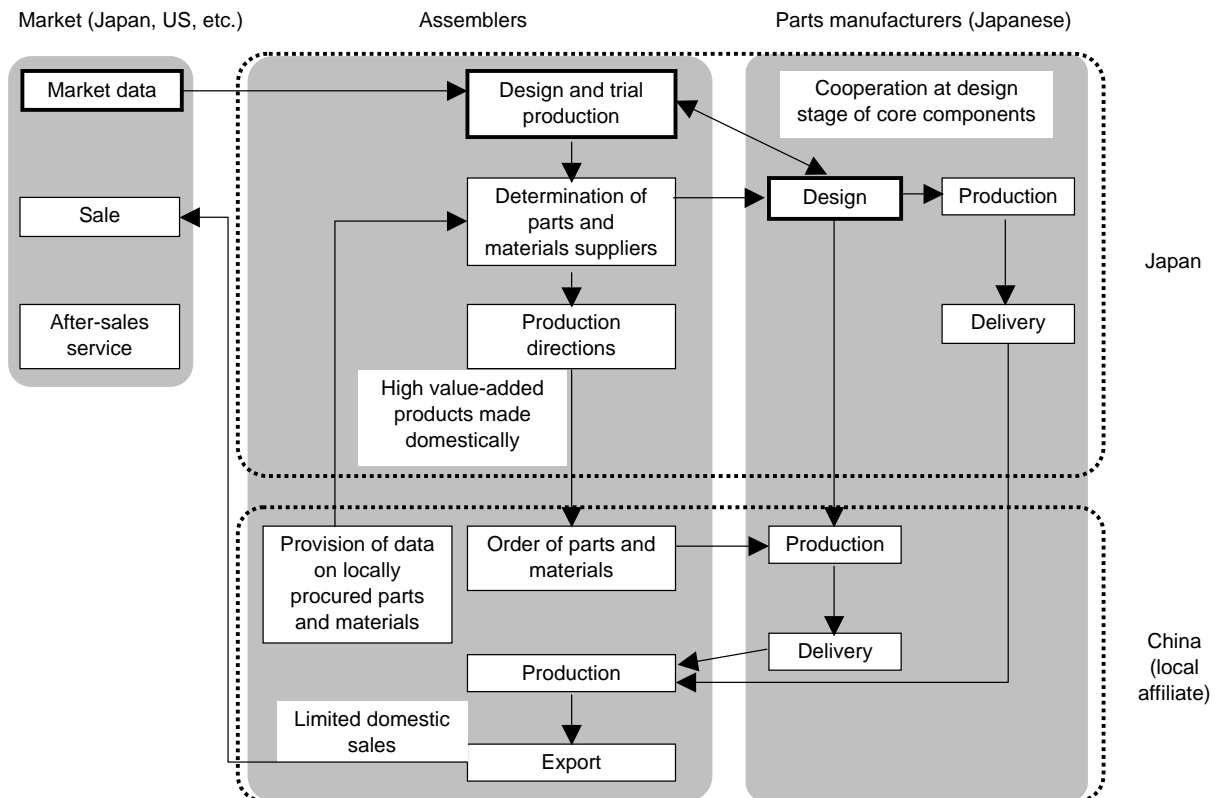


**Fig. II-2 Division of labor between Japan and East Asia (conceptual scheme)**



Source: Prepared by JETRO.

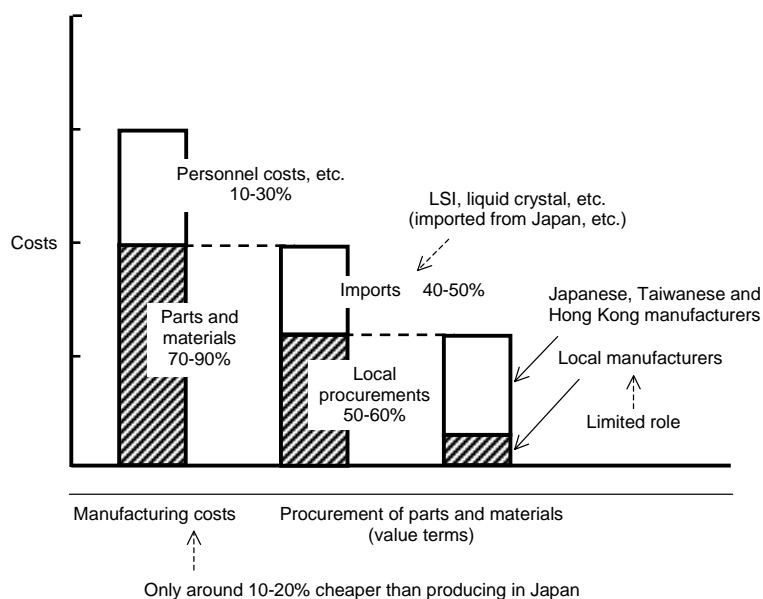
**Fig. II-3 Division of roles between Japanese and Chinese operations of digital equipment manufacturers**



◆ For items produced in China, design and test production—as well as determination of parts and material suppliers—usually occurs in Japan, as there is a strong tendency among Japanese firms to designate their China operations as "offshore".

Source: Prepared by JETRO.

**Fig. II-4 Manufacturing costs of Chinese production operations (outline)**



Source: Prepared by JETRO based on interviews with Japanese affiliates in China.

## 2. Challenges for Japan in an East Asian free business area

In order for Japanese companies to make fresh new strides in an East Asian free business area, which will have intra-regional freedom of movement of people, goods, capital, services and other resources, the following challenges must be faced:

- a. Firstly, Japan must lead East Asia in the development of technologies in cutting-edge fields and the development of new high value-added products.

Japan has a well-established market for end products that has, over the years, met the needs of world's most demanding and discerning consumers. The country also boasts a domestic manufacturing infrastructure underpinned by outstanding production technology and cutting-edge component development capabilities. In the digital consumer electronics sector in particular—where markets and the competitive environment are subject to rapid change and speed is of the essence—Japan is at an advantage in that it can offer the flexibility needed for manufacturers to respond quickly to consumer needs and a swiftly changing market, by working closely with parts and materials suppliers to design even complex product easily. The rise, however, of companies from ROK, Taiwan, China, and even Europe and North America, will result in a further intensification of competition. Amid this, Japan must develop products—from among those that succeed in the domestic market—capable of competing in world markets. The ability of Japanese companies to produce cutting-edge components must be strong. The Japanese market (i.e., consumer needs in Japan) must first of all be taken into account at the design stage for semiconductors, which are core components in digital consumer products. And in order for Japan to further strengthen its industrial base and maintain its position as a hub of development and production of high value-added products, it needs to reinforce incentives (such as through investment in cutting-edge technologies, training of high-level engineers and increased R&D) of locating in Japan, so as to win the international competition of attracting companies—both from Japan and abroad.

- b. Secondly, Japan needs to engage in cross-border global approaches to combat IPR infringements, which hinder the free distribution of goods and technologies in East Asia.

In the past, Japanese companies have had to pay expensive patent licensing fees to US and European companies, while only a few have been fully exploiting the acquired IPR. Only in Asia do Japanese companies' receipts from technology licenses exceed expenditures. And based on their experience with companies in US and Europe, Japanese companies need to develop a strategic approach regarding how best to exercise their IPR against Asian companies.

In fact, the biggest challenge regarding intellectual property in East Asia is the difficulty of exercising rights. It is often the case that the lack of judicial and administrative remedies against infringements in a host country gets in the way of Japanese companies protecting their IPR, causing them to lose considerable amounts of time and money. To combat this problem, there has been a recent shift toward pursuing the enforcement of IPR via a third country, as seen, for example, in cases of patent litigation being brought against ROK and Taiwanese companies in US courts. Meanwhile, Japan's recent pro-patent policy has had its effect on the country's courts and legal systems: Japanese firms can now expect speedier and more effective remedies against IPR infringement. And in some cases, which were taken to Japanese courts, settlements were reached after the court issued provisional injunctions preventing the violator from selling pirated goods – or after Japanese customs officials issued injunctions at the border.

- c. And thirdly, it is essential that Japan attract and welcome human resources from East Asia, in order to revitalize its economy and assist Japanese companies in their efforts to globalize.

Important agenda items in EPA negotiations with East Asian countries are the freer movement of business human resources (strongly called for by Japanese firms) and liberalization of movement of nursing and care workers (sought by East Asian governments). At current, Japan's basic policy is to "actively promote acceptance of foreign workers in specialized and technical fields." To enable high-caliber human resources from East Asia to play an active role in revitalizing the Japanese economy and assist Japanese firms in their globalization efforts, the following Status of Residences, among others, will be important: "investor/business manager," "intra-company transferee" and "skilled labor". The easing of residence status requirements and extensions of periods of stay, as well as the streamlining and expedition of residence status acquisition procedures will be equally important.

### III. Revitalization of the Japanese economy through globalization

#### A. Increasing soft power and regional economic revitalization

##### 1. Increasing soft power

- a. East Asia is home to a diverse range of people and languages, cultures and societies. Thus, the formation of an East Asian free business area, and the resultant economic benefits, will depend upon the fusion of non-economic elements, including the adoption of shared values. In order for Japan to play a leading role in the formation of such an area through FTAs, the country must work to enhance its “soft power”, i.e., its co-optive, non-coercive appeal to others. There are two sides to measuring Japan’s soft power. The first is the extent of the spread and popularity of elements of Japanese culture and information overseas, such as the popularity of Japanese films, music and fashion, as well as Japanese brands and international aid. The other measure is the level to which Japan invites overseas human resources, students, capital (FDI into Japan) and tourists. In order for Japan to increase its soft power stock, the country also needs to promote a positive and welcoming image abroad, by advertising its appeal in other countries.
- b. Viewed as a whole, Japan’s content industry (including the film and video software industries) is still relatively small by international standards, accounting for just 2% of GDP, compared with 5% in the US and a world average of 3%. The industry’s share of exports is also extremely low, at just 3%, compared with 17% in the US. Because the content industry can make such a major contribution to improving a country’s image overseas, countries in Europe as well as the US and ROK, have included the strengthening of the content industry in their national strategies to increase soft power.
- c. Valued at ¥196.8 billion in 2002 (based on box-office receipts), the Japanese film market is one sixth the size of the US’s. Nevertheless, Japan is still the world’s second largest film consumer, ahead of France (¥146.5 billion) and ROK (¥32.0 billion). However, the ratio of domestic to foreign films in Japan is small at 1:3, compared with 3:7 in France and 5:5 in ROK. And with film imports in 2001 standing at ¥90.98 billion, compared with exports of ¥10.75 billion, Japan is a major net importer.
- d. In many countries, such as France and ROK, large injections of public funding are provided, as a matter of national policy, to assist the development of domestic/home-grown film industries. In France, the National Center of Cinematography (CNC), backed by the Ministry of Culture and Communication, provides a variety of tax credits and loans, while Unifrance promotes French films around the world. ROK, meanwhile, has adopted a raft of measures to boost support for the industry, including enactment of the Basic Law on the Promotion of Cultural Industries in 1999, establishment of the “Content Korea Vision” program in 2001, and the introduction of the Law for the Promotion of the Online Digital Content Industry in 2002. The Korean Film Council (KOFIC), established in 1999, also supports the country’s film industry, by assisting the development of human resources and funding domestically, arranging subtitled translations and providing support for exhibition at international film festivals overseas.
- e. Japan is now moving in a similar direction, as reflected in JETRO’s participation in the American Film Market (AFM) in February 2004 and the Cannes Film Festival in May, in order to help develop a market for Japanese films overseas. At Cannes, many countries have their own national pavilions, giving them a major presence. Japan was able to follow suit this year, through a collaborative effort by JETRO, Japan’s Ministry of Economy, Trade and Industry, the Cultural Affairs Agency, and the Association for the Diffusion of Japanese Films Abroad (UniJapan Film). The result was the industry’s first all-Japan promotion of Japanese films, including a Japan Booth for film exhibitors and a Japan Pavilion where appearances were made by leading figures in the Japanese and international film industries, including Hirokazu Kore-eda, director of *Dare mo Shiranai* (Nobody Knows), and Mamoru Oshii, director of *Innocence*.
- f. The Content Task Force, set up by the Intellectual Property Policy Headquarters within Japan’s

Cabinet office, has identified the following issues that Japan's content industry must address: (1) the lack of transparency and rationality in fund administration, contracts and working conditions, etc.; (2) the poor social and economic recognition of the content industry and the people who work in it; and (3) inadequate marketing to develop overseas and new domestic markets. Even in the world-beating Japanese animation industry, the majority of companies are small businesses, and there are problems arising from the slow uptake of digital technology, the exodus and shortage of human resources, and a hollowing out of the domestic animation industry due to the transplant of production to other countries in Asia.

## 2. Regional revitalization through globalization

### a. Export of regional agricultural, forestry and fishery products under the "Nippon Brand" label

In May 2003, 33 Japanese prefectures came together to establish a convention to promote the export of agricultural products under "Nippon Brand". The purpose of the convention is to organize independent action to promote exports of signature local products through, for example, participation in food trade fairs and the organization of exhibitions and food sampling events. Responding to these developments at the regional level, the central government has also dramatically expanded its budget for promoting agricultural exports. And, in April 2004, an Export Promotion Office was established in Japan's Ministry of Agriculture, Forestry and Fisheries.

Regarding products that are already being exported, JETRO is working to further expand exports, and has instituted a special program to develop the overseas market for Japanese foods, primarily in East Asia, and to identify products, especially primary commodities, that have promising export potential. In fiscal 2004, support was provided to create concrete opportunities for business negotiations by, for example, organizing Japanese food seminars and food tasting events, inviting foreign buyers to production areas in Japan, conducting surveys regarding the implementation of import procedures, arranging trial export of products to identify potential problem areas, and producing pamphlets in foreign languages about products with export potential. Some of the areas that have been identified as needing to be addressed in order to successfully market Japanese agricultural, forestry and fishery products in East Asia include: researching marketing methods suited to consumer tastes (which differ from those of Japanese consumers); reducing selling prices in overseas markets; establishing Japanese brand awareness; expanding distribution channels to include local supermarkets; and differentiating products from those of other countries through the development of attractive designs and packaging.

### b. Measures to attract foreign tourists to Japan's regions

The number of foreign travelers to Japan in 2003 was 5.21 million, an increase of 1.5 times compared with 1993. Of this number, 67.4% were tourists from areas of Asia such as ROK, Taiwan, Hong Kong and China. In view of the growing number of Asian tourists visiting Japan, one effective means of generating further growth is by attracting wealthy tourists from Asia. In Kyushu, for example, where tourists from Asia accounted for 90% of foreign tourists in 2002, the Kyushu Association of Corporate Executives unveiled a strategy in February 2004 entitled "Proposals Regarding New Tourism in Kyushu", in a bid to turn tourism into one of Kyushu's leading industries. The plan laid out concrete strategies for promoting international tourism through: (1) boosting marketing of tourism in Kyushu through inviting foreign journalists to visit the area and polling the views of foreign tourists and students; and (2) lowering the cost of tourism by, for example, reducing the cost of travel within Japan (Table III-1).

### c. Exchanges between industrial clusters and globalization of regional economies

As business activities become more globalized, industrial networks that had until now formed exclusively within regions are also growing increasingly global in nature. In order to make up for resources lacked locally, and to overcome the current problem of industrial hollowing out faced by regional economies, it is necessary to actively attract foreign firms and research

institutes, and to promote collaboration and exchanges of human resources and technologies with local enterprises and organizations. In other words, the development of collaborations with regional clusters overseas is required.

The keys to promoting international exchange between regional clusters are: (1) rediscovering and reinforcing local strengths, so as to boost regional innovativeness and originality; (2) exploiting the attractions of local clusters, through attracting foreign investment and leveraging international exchanges between clusters; and (3) developing structures that enable local governments and other regional bodies to exercise greater initiative, such as through the recruitment and training of high-caliber human resources and integration of budgets and power, as in Germany and the US, where regional clusters have been vitalized through independent initiatives developed as a result of giving local governments more discretionary powers.

**Table III-1 Concrete measures to promote international tourism in Kyushu**

Achievable in the short term	Require adjustment period before implementation	Require considerable preparation before implementation
Proposal 1: Measures to increase the number of tourists drawn from overseas		
<ul style="list-style-type: none"> <li>- Develop packaged tours that tie in Kyushu with large scale tourist attraction events or facilities in neighboring countries</li> <li>- Organize invitational tours for foreign media</li> <li>- Identify the needs of foreign tourists and students through monitoring survey</li> <li>- Conduct market research and develop tourism products that cater to market needs</li> <li>- Attract golf visitors from ROK</li> <li>- Develop Japan tours that include Kyushu on itineraries (to attract foreign visitors entering Japan via Tokyo and Osaka)</li> <li>- Develop excursions for foreign business visitors, including spouse tours</li> <li>- Establish a model "Visit Japan" zone</li> </ul>	<ul style="list-style-type: none"> <li>- Attract school trips from overseas</li> <li>- Draft a Kyushu-wide action plan to attract foreign tourists</li> <li>- Introduce East Asia-wide unlimited ride rail/bus passes</li> <li>- Expand services covered by "welcome card" (discount pass for foreign tourists)</li> <li>- Offer incentives to tourists who take part in "monitor tours", i.e., tourists evaluate aspects of tourism in Japan in exchange for various incentives.</li> <li>- Increase the number of stores accepting credit cards and payment in foreign currencies</li> <li>- Develop infrastructure to enable use of overseas cell phones</li> <li>- Bring together foreigners who had lived in Kyushu as students/expats</li> </ul>	<ul style="list-style-type: none"> <li>- Set up duty-free shops</li> <li>- Reduce fees on air/sea port facility usage to bring down transportation costs</li> </ul>
Proposal 2: Measures to raise tourism infrastructure to international levels (tangible and non-tangible)		
	<ul style="list-style-type: none"> <li>- Increase and standardize multilingual (four languages) signposts</li> <li>- Set up tourist information offices (marked with an "I") staffed by multilingual attendants</li> <li>- Introduce ticket machines and fare tables with multilingual support</li> </ul>	<ul style="list-style-type: none"> <li>- Promote foreign language education for younger age groups</li> </ul>
Proposal 3: Measures to promote deregulation		
	<ul style="list-style-type: none"> <li>- Obtain approval to make Kyushu a special "visa free" zone</li> </ul>	

Source: Prepared from *Proposals Regarding New Tourism in Kyushu* (Kyushu Association of Corporate Executives, February 2004).

## B. Action to attract FDI to Japan begins in earnest

### 1. Full-fledged action to attract FDI to Japan gets underway

In his January 2003 policy speech, Japanese Prime Minister Junichiro Koizumi, announced a target of doubling Japan's total stock of inward FDI in five years (from ¥6.6 trillion at the end of 2001). Following the adoption of the "Program for the Promotion of Foreign Direct Investment in Japan" by the Japan Investment Council (chaired by the prime minister) in March 2003, concrete action to attract FDI to Japan began in earnest (Table III-2), and these measures are now steadily yielding results. In fiscal 2003, JETRO's Tokyo Invest Japan Business Support Center (IBSC) handled 93 cases leading to FDI in Japan (compared with 39 in fiscal 2002), resulting in a total investment of ¥3.27 billion and the creation of an estimated 350 new jobs. There were also two cases of cash mergers (i.e., the merger and creation of wholly owned subsidiaries using cash as compensation) by foreign firms: the acquisition of Kito Corp. by the Carlyle Group, and the acquisition of Chinon by Kodak. Investment in Japan is steadily rising, with the total value of inward FDI stock, as of the end of 2003, totaling ¥9.6 trillion—a 40% rise from the ¥6.6 trillion figure at the end of 2001. The expansion of inward FDI into Japan over the past few years is due in large part to M&As involving foreign firms. The current number of M&As in Japan, however, is still small compared with other major developed countries (Table III-3).

### 2. Foreign-led M&As in the UK and Germany

Since the mid-1980s, the UK has experienced what has come to be called the "Wimbledon phenomenon," in that, just as most of the leading players at its famous tennis tournament are foreign, so too are many companies in core industries, such as finance, automobiles and computers. Despite domestic opposition, the Thatcher government of the time was firmly committed to a laissez-faire policy, and never voiced any negative criticism concerning the acquisition of British firms by foreign investors. Instead, it regarded all companies doing business in the UK as British companies. The Blair government has inherited this laissez-faire approach to M&As by foreign firms. Underlying this has been a recognition that foreign investment contributes to the UK economy through, among other things, the creation of employment and generation of export growth. The Confederation of British Industry (CBI) was initially critical of allowing unregulated acquisition of British firms by foreign investors, but changed its stance in the 1990s to advocate the institution of arrangements similar to those in the UK at the EU level (Table III-4).

Germany, meanwhile, witnessed a surge of M&A activity in the 1990s, recording the world's biggest ever M&A in 2000: the hostile takeover of Mannesmann by the UK's Vodafone. Traditionally, M&As involving foreign investors in Germany were unregulated. However, there was little activity due to cross-shareholdings and the domination of industry by the banks. In particular, it was believed that hostile takeovers would rarely occur. The Mannesmann takeover symbolized the radical changes that had occurred in the environment surrounding M&As involving foreign firms: firstly, a series of reforms had been made to the capital markets following the privatization of Deutsche Telekom in 1996, including the entry of individual investors to the stock market and establishment of the Neuer Markt for growth stocks; secondly, the executives of leading German companies had begun to adopt the American "shareholder value" approach to business; and thirdly, companies were having to fight harder to survive in the face of intensifying competition arising from German unification, globalization, and the deepening and expansion of the EU. Throughout the 1990s, there was a rise in the equity culture that Germany had lacked in the past.

### 3. Creating further M&A opportunities for foreign firms in Japan

Four key reasons behind the relatively low level of foreign-involved M&A activity in Japan, as compared to that in the UK and Germany, are: (1) short experience in liberalizing capital transactions and in attracting foreign investors; (2) the lack of tolerance and appreciation of foreign firms (who are in fact contributing to the Japanese economy); (3) the shortage of M&A service providers capable of handling cross-border M&As, and the concentration of the few that there are in Tokyo; and (4) the absence of external pressure, such as that exerted on the UK and Germany as a

result of European integration.

The environment for M&As in Japan, however, is changing rapidly, marked by: (1) the introduction of new M&A legislation (e.g., the lifting of the ban on pure holding companies in 1997, introduction of equity-swap and share transfer systems in 1999 and a corporate split-up system in 2001, and the recognition of triangular mergers and cash mergers in 2003 [as special measures under the Revised Industrial Revitalization Law], which is likely to be later incorporated into amendments to the Commercial Code); (2) irresistible pressure on Japanese companies to reorganize, due to growing competition as a result of deregulation and a prolonged economic recession; (3) the collapse of cross-shareholdings and decline of long-term shareholders; and (4) the rise of more vocal shareholders, such as foreign investors, institutional investors and investment funds (who are quick to voice their concerns and demands) and an increase in hostile take over bids. Against this background of change, out-in M&A activity in Japan is expected to rise further.

Inviting foreign capital is an effective option to help Japanese companies survive, strengthen their competitiveness and continue to grow, as competition intensifies around the world. And crucial to further expanding opportunities for out-in M&As in Japan and ensuring more M&A success stories will be: (1) more aggressive action to attract inward FDI into Japan; (2) increasing the number of successful M&As resulting from such investment and breaking down resistance to FDI; and (3) developing organizations and human resources capable of handling cross-border M&As.



**Table III-2 Main measures to promote inward FDI into Japan implemented from FY2003 onward**

(1) Dissemination of information within Japan and abroad	<ul style="list-style-type: none"> <li>- Total of 76 seminars and symposiums staged in 13 foreign countries to attract inward FDI into Japan</li> <li>- TV spot featuring Prime Minister Koizumi broadcast approximately 130 times in the US and Europe</li> </ul>
(2) Improvements in the business environment	<ul style="list-style-type: none"> <li>- Introduction of triangular mergers and cash mergers under the Revised Industrial Revitalization Law (April 2003), and incorporation and permanent adoption of these M&amp;A measures under amendments to the Commercial Code, scheduled to be submitted as a bill in 2005, under consideration</li> </ul>
(3) Reviewing administrative procedures (clarify, streamline and speed-up)	<ul style="list-style-type: none"> <li>- JETRO Invest Japan Business Support Center (IBSC) established in Tokyo and the "FDI general information and consultation office (Invest Japan)" established in each ministry and agency, creating one-stop shops for information and expedition of administrative procedures (May 2003)</li> <li>- Establishment of IBSCs in Yokohama, Nagoya, Osaka, Fukuoka (April 2004) and Kobe (July 2004)</li> </ul>
(4) Create favorable employment and living environments	<ul style="list-style-type: none"> <li>- Legal clarification of the doctrine of "abuse of right of dismissal" by amendment of the Labor Standards Law (effective from January 2004)</li> <li>- Maximum period of contracting of temporary workers extended from 1 year to 3 years and employment of temporary workers in manufacturing permitted through amendment of the Labor Dispatch Law (effective from March 2004)</li> <li>- Development of system regarding international schools (e.g., to allow graduates meeting certain conditions to qualify for university entrance)</li> <li>- Promotion of employment in Japan of overseas students (e.g., permitting "short stay" residence status for a maximum of 180 days)</li> <li>- Conclusion of social security agreements (signed with the US and ROK, under negotiation with France and Belgium)</li> </ul>
(5) Improve local and national structures and systems	<ul style="list-style-type: none"> <li>- Launch of "Project on Selected Area to Promote FDI" (adopted by 5 regions in FY2003 and 4 regions in FY2004)</li> <li>- Involvement of top officials of several local governments in attracting FDI and measures to create one-stop shop for information services</li> </ul>

Note: When 100% of the shares in a company are acquired through a merger, etc. to create a wholly owned subsidiary, a triangular merger occurs where shares in the parent company (including a foreign company) are used as compensation, and a cash merger occurs where cash is used.

Source: Prepared from Japan Investment Council (JIC) Expert Committee, *Follow-up "Program for the Promotion of Foreign Direct Investment in Japan"* (May 19, 2004) and other sources.

**Table III-3 Out-in M&As in major developed countries and value of inward FDI**  
(cumulative total, 1999-2003)

(Units: no. of M&As, US\$ billion)

	Japan	Germany	US	UK	France
Number of M&As by foreign companies (Out-in M&As)	583	2,276	5,722	3,454	1,800
Out-in M&A rate (%)	10.7	36.0	15.5	25.9	37.8
Value of M&As by foreign companies (Out-in M&As)	72.9	417.3	957.1	510.0	136.1
Out-in M&A rate (%)	15.2	69.4	18.2	43.4	33.3
Value of inward FDI	42.9	324.5	890.0	301.8	236.3

Notes: 1. The Out-in M&A rate indicates the proportion of the M&A market in each country accounted for by M&As where the ultimate parent company of the acquirer is foreign.  
2. Figures for inward FDI indicate the cumulative net flow on a balance of payments basis.

Sources: Prepared from Thomson Financial data (as of March 18, 2004) and OECD data.

**Table III-4 Changes in UK's attitude toward M&As by foreign companies**

1945-60s	Some intervention by the government	<ul style="list-style-type: none"> <li>- Inward FDI in the UK by foreign companies welcomed (strict controls on outward FDI against the background of the "sterling crisis" and decline of exchange reserves).</li> <li>- Foreign investment in the UK required prior approval under the 1947 Exchange Control Act. However, hardly any investment applications were refused.</li> <li>- Some cases of government intervention (e.g., US Ford's conversion of Ford UK into wholly owned subsidiary in 1961, and acquisition of Rootes by Chrysler, also of the US).</li> </ul>
1970s	<p>"English disease"</p> <p>Advent of the Thatcher government</p>	<ul style="list-style-type: none"> <li>- UK suffers from what is known in Japan as the "English disease": high inflation, high unemployment, frequent strikes, decline in international competitiveness of British firms, deterioration of trade balance, increase in budget deficit, etc.</li> <li>- Conservative Thatcher government (1979-90) introduces market principles, pursues deregulation, and promotes other economic reforms such as privatization of state-owned enterprises.</li> <li>- Active solicitation of investment in UK through Invest in Britain Bureau (IBB), established in 1977 specifically for job creation and regional regeneration.</li> </ul>
Mid-1980s onward	<p>"The Wimbledon phenomenon"</p> <p>Opposition from industry, unions and opposition parties</p> <p style="text-align: center;">↕</p> <p>Government committed to laissez-faire</p>	<ul style="list-style-type: none"> <li>- Wave of foreign acquisitions of British firms in traditionally important industries, such as the automobile and financial sectors.</li> <li><b>Automobiles:</b> Large number of automaker affiliates acquired by foreign firms from the mid-1980s with the privatization of British Leyland. With the exception of Rover (sold by BMW of Germany to a UK investment company in 2000), every British automaker is currently affiliated to a foreign parent.</li> <li><b>Finance:</b> Wave of acquisitions of British financial institutions by foreign firms as a result of the "Big Bang" financial reforms of 1986 (the "Wimbledon phenomenon"). In particular, most of the merchant banks, which symbolized the history and tradition of the City, were made subsidiaries of foreign companies.</li> <li><b>Other:</b> Leading British confectionery maker Rowntree acquired by Nestlé of Switzerland (1988), while ICL, the UK's only computer manufacturer, became an 80%-owned subsidiary of Fujitsu due to poor business results (1990).</li> <li>- Some opposition emerged from the opposition parties, industry and unions, etc. to these acquisitions of British firms in key industries by foreign investors.</li> <li>- However, the Thatcher government was unwavering in its commitment to laissez-faire, leaving acquisitions by foreign companies to the market.</li> <li>- Announcement of the "Tebbit Doctrine" by then Minister of Trade and Industry Norman Tebbit in July 1984, which eliminated "public interest" from the grounds for review of a takeover.</li> <li>- Regarding the Wimbledon phenomenon, the British government stated that the question was one of "who does what" rather than "who owns what", and asserted the importance of raising London's competitiveness as a financial center.</li> <li>- Formulation of City Code (1985). Self-regulation of corporate acquisitions by the City (London's financial district). This allowed highly untrammled acquisition activities, with companies able to take hardly any action against hostile acquisitions.</li> </ul>
From mid-1990s	Decline in resistance to M&As by foreign investors	<ul style="list-style-type: none"> <li>- Weakening of aversion/resistance to acquisitions by foreign companies (due to spread of acceptance of competition through the market throughout the 1980s among businesses and the public, and a recognition of the contribution to UK economic reconstruction of inward FDI).</li> <li>- The Blair government (from 1997) inherits this laissez-faire approach to acquisitions by foreign companies.</li> <li>- The CBI and other representatives of industry switch from a traditionally critical attitude to acquisition activities. Advocate development of hands-off acquisition system similar to the UK's at the EU level.</li> </ul>

Source: Prepared from various sources.

#### **IV. Conclusion: Formation of an East Asian free business area and new opportunities for Japanese companies**

Since reaching a trough in January 2002, the Japanese economy has been in recovery, fueled by dramatic across-the-board improvement in corporate profits and an upturn in formerly lackluster capital investment. Major manufacturers are leading the way, thanks in large part to strong automobile sales in the North American market, strong sales of hit digital consumer electronics products such as LCD TVs and DVD recorders, and growth in exports to the still rapidly growing Chinese economy. The recovery in the corporate sector is also now gradually spreading to the household sector. In addition to strong external demand coming from the US and China, growth in domestic demand, based on an upturn in personal consumption, is also now acting as an engine of recovery. One of the main factors underlying the recovery in domestic demand is the revival now being enjoyed by Japanese companies. The digital consumer electronics and automobile industries, among others, have witnessed a dramatic improvement in their international competitiveness. This is a product of improvements in manufacturing resulting from: (1) intense competition to develop new products for the well-established domestic market for end products; (2) the capacity for core design functions to be handled entirely within Japan; (3) the strong manufacturing base in cutting-edge parts; and (4) corporate efforts to improve production technologies, such as through the introduction of cellular manufacturing system. While at the macro-level, the so-called “three-excesses” that have beset Japanese companies for over a decade since the collapse of the bubble economy – namely, excessive facilities, employment and corporate debt – have been almost entirely eliminated through the efforts of the companies themselves. Nevertheless, the recovery among small and medium-size enterprises, middle-ranking enterprises and non-manufacturers has not appeared as robust as that enjoyed by large manufacturers; further restructuring is required if profitability improvements are to be achieved.

In order for the present recovery not to stall and the Japanese economy to continue to enjoy sustained growth, there must be no let-up in the series of economic recovery measures being taken, such as: (1) accelerating the disposal of non-performing loans, which allows financial institutions to once again play their proper role in creating credit; (2) introducing further management reforms, such as “select and focus”, to keep companies profitable in the face of global competition; and (3) continuing with monetary measures aimed at defeating deflation.

A longer-term challenge facing Japan is the rapid pace at which the country is moving toward an aged society. Swift action to head off a resulting decline in Japan’s economic vitality is required. Alongside this is having the East Asian market on Japan’s doorstep – a market that, with injections of Japanese technology, capital, management know-how and human resources, has the potential to grow by leaps and bounds. If Japan is to maintain its economic vitality without falling into a state of diminishing equilibrium, structural reforms must be made in the Japanese economy, so as to position the country to fully absorb the dynamism of East Asia, which is now on the brink of full-scale development, and where an economic network is forming to create what is in fact – if not in name – an East Asian free business area. If the transition can be made to a more advanced level of institutional integration, the region can enter a new era of fresh economic development. Japan and East Asia therefore need to pursue institutional integration in earnest.

#### **Japan in an East Asian free business area**

Formerly a region devoid of FTAs, East Asia has witnessed a growing trend toward their formation since 2000. Following first-round talks with ROK, Japan has also entered into negotiations to sign bilateral economic partnership agreements with Thailand, Malaysia and the Philippines, after the ASEAN-Japan Commemorative Summit Meeting in Tokyo in December 2003. At the same time, negotiations to sign a comprehensive economic partnership agreement – with ASEAN as a whole – were also slated to begin in 2005. China is paving the way in negotiations with ASEAN. Another focus of interest is on ties between Southwest and East Asia. Discussions are already underway between ASEAN and, individually,

Pakistan, India, Sri Lanka and Bangladesh; China and India too have entered discussions on an FTA.

As noted, East Asia has, until now, seen the development of de facto economic networks, rather than economic integration at the institutional level. Despite this, the region has experienced the world's highest rate of growth in intra-regional trade: while world trade grew fourfold between 1985 and 2003, as previously noted, East Asian trade (consisting of the ASEAN4, Asian NIEs, China and Japan) grew 7.8 times. By comparison, growth in intra-regional trade in NAFTA and the EU was just 4.4 times and 4.2 times, respectively. If tariffs can be eliminated, the movement of people and trade in services liberalized, and intellectual property protected in the region, then East Asia has the potential to exhibit the world's most dynamic economic growth. China in particular, which continues to enjoy high growth, has a market that is rapidly growing both in size and attractiveness, as income levels rise. For example, unit automobile sales reached 4.39 million in 2003, putting it in third place behind only the US and Japan. Companies from East Asian countries and regions such as Japan, ROK and Taiwan, as well as those from the US and Europe, are all aware of the risks inherent in China (e.g., IPR infringements and revaluation of the yuan), but are still eager to expand their presences there. Further expansion of FDI in China is expected as foreign investors seek to tap into the Chinese market. The perception of China has changed from "threat" to "opportunity". To make the most of this opportunity, investors must keep a close watch on China's efforts to open up its rapidly growing market and move quickly in response, while at the same time working to minimize risks through, for example, increased collaboration with Chinese companies.

In order for the Japanese economy to grow through integration into this East Asian free business area, two things in particular are necessary. First of all, Japanese companies need to develop an outlook that lifts the distinction between "domestic" and "foreign", and instead treat the East Asian market, as far as possible, as an extension of their own domestic market. It is necessary therefore to develop geographically broad-based research, production and sales networks in East Asia by making full use of the region's business resources. In more concrete terms, this means expanding production and sales operations throughout East Asia—from the Japanese archipelago to the Korean peninsula, Beijing, Shanghai, Hong Kong, Shenzhen, Taiwan and the ASEAN economies—so as to incorporate the companies and human resources of East Asia into their own growth strategies. Moves to develop production, development and sales networks within Asia, including India and East Asia, are now afoot, with automakers leading the way. Secondly, East Asian companies need to utilize the Japanese market. As East Asian companies seek to increase their competitiveness in the future, the Japanese market can play the role of a test market for entering the markets of other developed countries, and as a source of information on the development of new products. In the market for welfare-related and other services as well, East Asian human resources will likely have an important role to play. For these and other reasons, it is important that East Asian companies be drawn to Japan.

### **What Japan needs to do**

Firstly, EPA negotiations currently in progress with Thailand, the Philippines, Malaysia and ROK need to be concluded as swiftly as possible. Japan should also explore economic collaboration with China, whose presence is essential to the development of an East Asian free business area. Japan, as East Asia's largest economy, needs to take the lead and set an example in breaking down national borders by, for example, developing investment rules, harmonizing standards and mutual recognition arrangements, protecting IPR, and removing restrictions on international movements of people, as well as by removing tariffs and liberalizing trade in services.

Secondly, Japan's economic structure must be changed so as to improve productivity. This will require: (1) more R&D in cutting-edge fields such as biotechnology, nanotechnology, IT and environmental technology; (2) a greater focus on the development and production of high-value added products such as digital consumer electronics products; (3) the development of service industries suited to an aged society; and (4) improvements in productivity. Particularly necessary are injections of foreign capital, technologies and management know-how to provide the "push" to raise productivity, stimulate competition, and create new business opportunities in Japan. Also, as economic integration progresses,

these opportunities in Japan can then lead on to rapid growth in East Asia as a whole.

Attracting human resources, business know-how and technologies to Japan on a sustained basis requires expanded inward FDI into Japan. In light of this, Japan set the aggressive target, as previously noted, of doubling the country's total stock of inward FDI in five years time. By the end of 2003, the figure (¥6.6 trillion in 2001) had already grown 1.4 times, to ¥9.6 trillion, signaling that FDI is steadily growing. The expansion of inward FDI into Japan in the past few years is due in large part to M&As involving foreign firms. Techniques widely used in the US that make it easier for foreign investors to engage in M&As, such as triangular and cash mergers, are presently only permitted under the Industrial Revitalization Law. But in order for these measures to function more effectively and attract more foreign investors, it is crucial that: (1) inward FDI be actively courted; (2) the number of successful out-in M&As as a result be increased and resistance to foreign investment broken down; and (3) agencies and human resources capable of handling cross-border M&As be developed.

Thirdly, if Japan is to play a leading role in the formation of an East Asia free business area while also increasing the country's appeal and image globally, it must develop its soft power, the potential of which, many argue, is enormous. Japan's content industry, whose animation productions dominate world markets, is an example of one industry that can help toward this goal. Through its contribution to soft power, this industry is thus a key field from the point of view of national strategy: not only does it outweigh industries such as the iron and steel industry as an economic resource, but it is also an important cultural and tourism resource. Japan must therefore learn from countries in Europe and North America and adopt measures to develop the content industry as a part of national strategy. Obstacles to the development of Japan's content industry overseas, however, are the weak involvement of government (which currently lacks such a national strategy) the shortage of opportunities to garner publicity for the Japanese content industry at film festivals in Japan and overseas, insufficient support for means of transmitting information and generating publicity, and the impediments to distribution of genuine products, in the absence of effective measures to combat rampant content pirating. These and many other issues will have to be surmounted first.

Whether or not Japan can retain its leadership in East Asia – and continue to display leadership alongside the US and Europe in the global economy – will depend on how successful Japan's structural reforms are and how well Japanese companies incorporate themselves into East Asia over the next few years.

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