OPEN SOCIETY, CLOSED MARKET?

JAPAN'S INTEGRATION INTO THE GLOBAL ECONOMY AND THE CRISIS OF 2008–2009

Stefan Lippert and Thomas Ammann

Abstract: It appears that Japan pursues a lopsided internationalization strategy – keeping foreign companies out while at the same time investing massively in foreign markets. This paper examines whether this is an appropriate position. First, we look into the foreign direct investment issue and try to understand the current situation in Japan. In particular, we analyze the underlying two-fold assumption: (a) that there are international companies willing and able to make large investments in Japan, and (b) that they cannot do it because the Japanese market is closed. The ratio of inbound FDI (foreign direct investment) to GDP is considerably lower in Japan than in other major industrialized nations, and Japanese companies directly invest four times as much abroad as foreign companies invest in Japan. This does not mean, however, that the Japanese market is closed. In fact, companies are deciding to invest in other countries where conditions are (or are perceived to be) more conducive to penetration. Second, we compare FDI with cross-border portfolio investments. Compared to FDI, portfolio investments in listed companies in Japan are relatively high. Foreign investors hold around one-fourth of the shares at listed companies. This figure has been rising continuously for 20 years, interrupted only in 2001–02 and in 2008–09. Third, we take a closer look at Japan's international trade and the overseas business of Japanese companies. Japan's industrial sector has integrated itself very actively in global trade (45 % of its sales are posted overseas), but the Japanese economy is not "export-driven". Its degree of integration into world trade is rather low. We assume that this can be explained by qualitative, HR-related factors. Finally, we ask what the chances are that ongoing internationalization will succeed amid and after the global recession of 2008–09.

*Keywords:*Japanese economy, globalization, foreign direct investment, portfolio investment, cross-border M&A, international trade

1 INTRODUCTION

Japan's politicians, businesspeople, economists and media broadly agree that rapid internationalization is crucial in order to tackle the issue of the country's aging, shrinking domestic market. On the other hand, a continuous stream of articles, speeches by Western (sometimes also Japanese) politicians, journalists, bureaucrats and businesspeople blame Japan for closing its markets to foreign companies. This sentiment is often condensed in the phrase "open society, but closed market". The term "open society" is intrinsically tied to Karl Popper's ([1945] 2002) seminal study *The Open Society and Its Enemies*. According to Popper, an open society ensures that political leaders can be overthrown without the need for bloodshed. Further, individuals are confronted with personal decisions as opposed to a closed (i. e., magical, tribal or collectivist) society. Typical examples for a closed society are dictatorships, theocracies, and autocratic monarchies. Hence there is no doubt that Japan has an open society.[1] The term "closed market" is harder to define. In this paper we refer to it as a market which is kept virtually shut to foreign investment and trade. To understand what "shut" means, we have to distinguish between legal and administrative barriers (for instance, import bans, high tariffs, complex and/or discriminatory taxes and regulations, anti-import campaigns by the government) on the one hand, and the social, cultural and mental context of doing business on the other. These dimensions are often mixed in the heat of the political and economic debate. Most recently, the Trade Commissioner of the European Union complained about a new "Dejima mindset", referring to the massive legal and administrative barriers to foreign investment and trade erected by the Tokugawa rulers (EU Commission 2008). Sparked particularly by a – partly perceived, partly real – wagon circling strategy of Japanese businesses against unsolicited takeovers and activist shareholders, there is a growing sentiment that Japan is heading toward an inward-looking, defensive mindset instead of actively embracing and welcoming international capital.

By contrast, Japanese firms have massively stepped up their investments in foreign markets. In 2008, Japanese acquisitions of foreign compa-

[1] Even the most critical accounts of the modern Japanese society do not insinuate that Japan has a "closed society" in Popper's sense. Nakane (1984: 152) examines the roots of the "homogeneous configuration" of the Japanese society and the implications for democracy and liberalism: "Japanese 'democracy' is a kind of community sentiment, with, as a major premise, a high degree of cohesion and consensus within the group. Liberalism with respect to opinion is not part of the concept, for 'democracy' may well be interpreted in terms of freedom of speech, by which is meant the freedom of the lower or the underprivileged to speak out". Eisenstadt (1996: 141) characterizes the Japanese society as "dynamic, controlled, but not totalitarian". Reischauer and Jansen (1995: 172) conclude that "Japan has become modernized, not Westernized". Nathan (2004: 21) points out that "it is by no means true that Japanese society today is paralyzed or static or even bereft of its fabled vitality. In fact, contemporary Japan is undergoing convulsive changes in values and behavior […], which are in the process of transforming the society into a landscape radically different from its traditional, or even recent, past." See also van Wolferen's (1990) bleak portrait of political and bureaucratic decision-making in Japan.

nies have totaled 78 billion U. S. dollars, more than triple the amount spent in 2007 and exceeding the previous annual record of 52 billion dollars set in 2006 (*Wall Street Journal* 7 January 2009; based on data from Dealogic). These acquisitions of mostly American, German, Australian and Indian companies are particularly driven by huge cash reserves, the growing demand of shareholders to internationalize and the fear of losing clients because of a lack of a global network. Hence it seems that Japan pursues a lopsided internationalization strategy – keeping foreign companies out while at the same time investing massively in foreign markets – as the following snapshots from leading Western and Japanese media show:

- "One-way street? As its companies expand abroad, Japan erects new barriers at home" (*Financial Times* 3 March 2008),
- "Japan builds new barriers to foreign takeovers, as cheap shares draw investors" (*Wall Street Journal* 1 May 2008),
- "Japan Inc. must lose xenophobia: Locking out foreign investors means saying no to capital that is needed to make economy grow" (*Nikkei Weekly* 5 May 2008).

This study examines whether this is an appropriate position. First, we will look into the foreign direct investment issue and try to understand the current situation in Japan. We will, in particular, analyze the underlying two-fold assumption: (a) that there are international companies willing and able to make large investments in Japan, and (b) that they cannot do it because the Japanese market is "closed". Second, we will compare foreign direct investments with cross-border portfolio investments. Third, we will take a closer look at Japan's international trade and the overseas business of Japanese companies. Finally, we ask what the chances are that ongoing internationalization will succeed.[2]

2 Foreign Direct Investment and M&A

2.1 Inbound Foreign Direct Investment (out-in)

Until the 1990s, the volume of inbound FDI stock in Japan was very small; the annual volume was just over three trillion yen. This figure has been rising rapidly since the end of the Asian financial and economic crisis of 1998–99. Increasing at an annual growth rate of around 16 percent, the inbound FDI volume stock amounted to 15 trillion yen in 2007 (Fig. 1).[3]

[2] The Japanese labor market is excluded from this study.

[3] These figures must not be mistaken for the value of inbound M&A deals, which is lower by far.

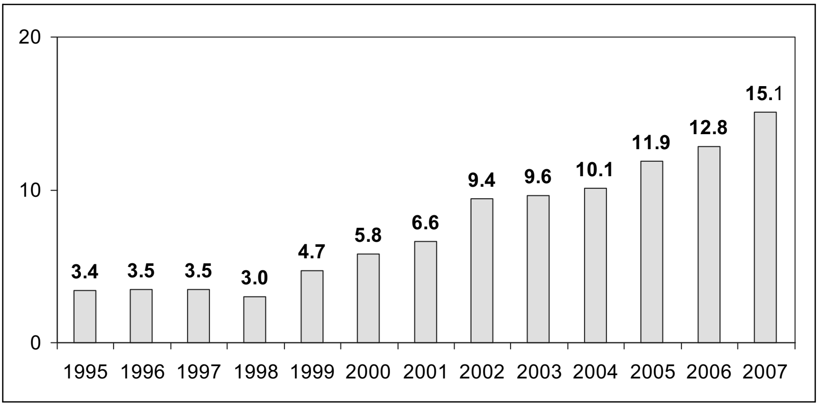

Fig. 1: **Development of inbound FDI stock**

Note: Trillion yen, net figures, based on the international investment position.

Source: METI *Japanese Trade and Investment Statistics* (JETRO 2009).

Given the size of the Japanese economy, this is just a drop in the ocean. A comparison with other leading industrialized nations produces eye-opening results. The ratio of inbound FDI stock to GDP in Japan is between two and three percent, while in the U. S. it is 13 percent, in Germany 18 percent, in France 34 percent, and in the U. K. as much as 48 percent (Fig. 2).

Since 1999, Japan's inbound FDI stock has risen from 0.7 percent of GDP to approximately 2.5 percent today (Fig. 3). This is still a long way from

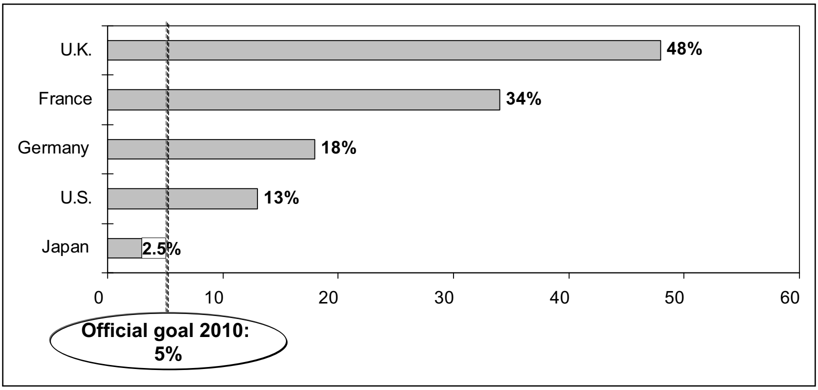

Fig. 2: **Inbound FDI stock / GDP (2006) in percent**

Source: Economist Intelligence Unit (2008: 12); *Financial Times* (3 March 2008).

the 5 percent goal (for 2010) announced by the Japanese government. Considering the global recession of 2008–09 it is highly unlikely that Japan will reach the goal.

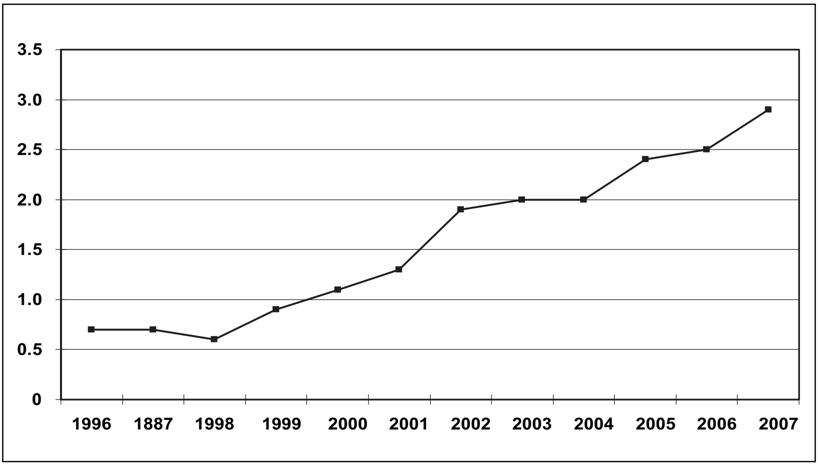

Fig. 3: **"Inbound FDI stock to GDP" ratio in percent: development**

Note: Japan's ratio of FDI to GDP has been growing since 1998. CAGR 1998–2007 is 19 percent.

Source: JETRO (2008: 91).

The small ratio of inbound FDI stock to GDP in Japan is frequently cited by Western politicians and the media to back up the theory that the country has a closed market. Comparing Japan with a country like the U. K., whose economy is wide open to direct investors from abroad, reveals the chasm that indeed exists between the industrialized nations in this respect. But this is only one side of the coin.

The actual situation is more nuanced. From a business perspective, a foreign company that wishes to make a direct investment in Japan faces three central questions (Alexander and Korine 2008):

- Could the investment generate substantial benefits on the market/revenue side? Specifically, does our strategic positioning, our value proposition and our marketing mix correspond with the conditions of the Japanese market? Are our products or services competitive in terms of price and (perceived) performance?
- Do the organizational capabilities and financial resources needed to achieve those benefits exist?
- Will the benefits outweigh the costs? In particular, is the NPV of the investment positive? How does the NPV (or IRR) compare with alterna-

tive investment options? Are there factors that may outweigh a relatively low investment return (for instance, gaining corporate fitness by accepting the challenge of tough domestic competition)?

Finally, a company has to take potential legal and administrative obstacles into account. This factor – as important as it is in Japan and elsewhere – has to be put into the perspective of the overall economic valuation of the investment. However, most debates in the media and the political sphere focus solely on the (perceived or real) legal and administrative obstacles. This is remarkable because, with the exception of a few industries and cases, these obstacles in Japan tend to be no higher than in comparable countries. However, they are often mixed up with entrepreneurial hurdles – such as strong domestic competition, inaccessible distribution channels, a value proposition that does not respond to the specific needs of Japanese customers, tight personal networks, shareholders' unconditional support of management, cross-shareholdings, and traditional *keiretsu* [conglomerate] structures. These entrepreneurial hurdles indeed tend to be high in Japan, but they are a part of the business and can be overcome using business approaches. This may be difficult, and it requires time, money, patience, and skill; but legal or administrative barriers can generally not be blamed for difficult market access in Japan.[4]

Other countries such as China, India and Russia may indeed, at least at first glance, be easier to enter.[5] In addition, it may be the case that the offering simply does not fit into the Japanese market. For instance, customer demands in terms of products, quality and service are generally very high in Japan. Management needs to combine the global headquarters' perspective with the peculiarities of the Japanese market. This has been the learning experience for top-notch Western companies whose Japanese

[4] This view is widely shared by Japan experts in business, academia, and international organizations. A recent OECD study of 39 countries assessed the FDI regulatory restrictiveness in nine sectors. The study ranked Japan as the tenth least restrictive economy (OECD 2007: 140). And Waldenberger (2008: 17) observes: "Regulatory barriers to FDI seem to be lower in Japan than in most other countries." Even 20 years ago, a decade before the deregulation and liberalization programs of the Hashimoto/Koizumi era, insiders with first-hand market experience pointed out that legal and administrative barriers to market entry were "generally overestimated" (Vaubel 1986: 84). See also Legewie (1998: 302).

[5] The Hidden Champions – i. e., relatively unknown world market leaders with less than US$ 4 billion in revenues, the vanguard of globalization – view China (73 %), the U. S. (53 %), Russia (48 %) and India (35 %) as the most attractive future markets. Japan ranks seventh (19 %), behind Eastern Europe and the rest of Asia (Simon 2007: 134).

ventures have failed: Vodafone, Carrefour, Pret a Manger, eBay and, in the 1980s, IKEA, to name just a few. These factors have nothing to do with a "Dejima mindset". By contrast, some companies such as the Hidden Champions are actually seeking the difficulties in Japan in order to improve their performance and to gain a strong reference for other Asian markets and beyond. Regardless of historical and political tensions, Japan is the lead market in Asia, and it is often stated that companies that make it in Japan will make it anywhere (Lippert and Simon 2007a, 2007b).

In summary, the ratio of inbound FDI to GDP is considerably lower in Japan than in other major industrialized nations. This does not mean, however, that the Japanese market is closed to foreign investors. In fact, companies are deciding to invest in other countries where conditions are (or are perceived to be) more conducive to penetration.

2.2 Outbound Foreign Direct Investment (in-out)

Let us now turn to outbound FDI. Here too, the figures have risen significantly since 1999, with an annual growth rate of eight percent. The annual volume of outbound FDI stock climbed from around 30 trillion yen in the 1990s to more than 60 trillion yen in 2007 (Fig. 4).

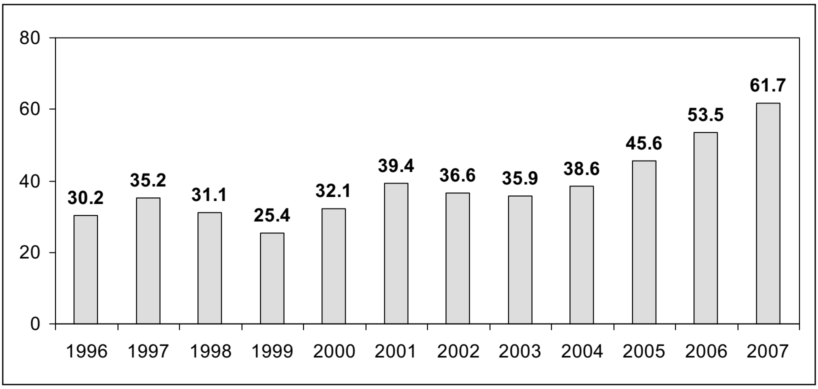

Fig. 4: **Development of outbound FDI stock**

Note: Trillion Yen, net figures, based on the international investment position.

Source: METI *Japanese Trade and Investment Statistics* (JETRO 2009).

This volume is over four times greater than the volume of inbound FDI. In other words, Japanese companies directly invest four times as much abroad as foreign companies invest in Japan. This imbalance is strictly the result of entrepreneurial decisions. Japanese companies see greater benefits through establishing transplants in the U. S., building factories in China, or acquiring companies in Europe, than international companies by investing directly in Japan. There is no master plan in Japan that encourages outbound FDI and hinders inbound FDI. International direct investors take their money elsewhere – while Japanese companies invest abroad and maintain their foreign investments (*Financial Times* 3 March 2008).

2.3 Cross-Border M&A

Cross-border M&A transactions are a part of FDI. In recent years, these transactions have become another key issue of the internationalization debate. However, there is often a great deal of confusion: FDI, M&A and buy-outs by financial investors are often mixed or confused. Individual cases, for example the spectacular case of Steel Partners vs. Bull Dog Sauce, or TCI vs. J-Power, are sometimes used as proof of an investment climate hostile to foreigners.

Let us first take a closer look at outbound M&A activities. In spite of the increasingly difficult global economic conditions, in 2008 Japanese companies concluded many purchases of foreign firms. These acquired firms include a broad variety of companies: pharmaceutical companies (Millenium, MGI Pharma, Ranbaxy, Sciele), banks (Lehman Brothers in Asia and Europe, significant stakes in UnionBanCal, Morgan Stanley and Merrill Lynch), insurance companies (Philadelphia Consolidated), industrial companies (Epcos, Lucite International), and luxury brands (Jil Sander). Even amid the global economic downturn, Japanese companies kept investing in foreign companies – however, on a much smaller scale than in the previous quarters (for instance, Kirin's US$ 1.2 billion acquisition of a 43 % stake in San Miguel Brewery of the Philippines).

In contrast to the first wave of foreign acquisitions in the 1980s, all of these transactions were strategic purchases related to core business sectors. The Japanese remained true to their traditional preference for private companies. As far as is known, the prices paid tended to lie in the upper end of the spectrum. This shows, for one, that Japanese management, having once decided for an acquisition, carry it out at almost any price – which is good news for potential sellers. It also shows that – until autumn 2008 – Japanese companies had sufficient funds to finance and quickly carry out larger transactions without a great deal of trouble. Decisive in this was not the low interest rates in Japan as much as the fact that, after many years of hard restructuring programs, many Japanese companies had accumulated extensive cash reserves that were either kept or used for investing in building foreign business. The shareholders are apparently in agreement with this approach, since the acquiring company gains prestige, size and market share, and since for the sellers and other stakeholders in the target it is usually a good deal, as the Japanese pay well and (because of the *kaisha* [company] philosophy) refrain from radical restructuring and firing programs. Further important drivers are the purchase of innovative technology, as well as the striving to offer customers a global network and establish new distribution channels and contacts.

In financial terms, Japanese firms spent 78 billion dollars on outbound M&A in 2008, more than triple the amount spent in 2007 and exceeding the previous record of 52 billion dollars set in 2006. However, an international comparison reveals that the Japanese "M&A blitz" (*Nikkei Weekly* 17 November 2008) is rather modest.

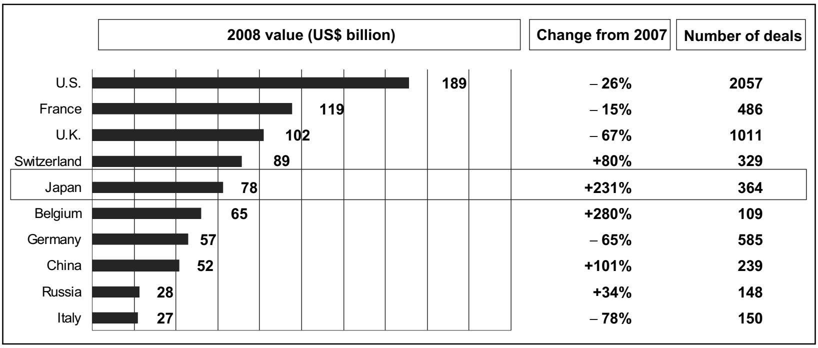

Fig. 5: **Outbound M&A: A rather modest "M&A blitz"**

Source: *Wall Street Journal* (7 January 2009), based on market data from Dealogic.

In 2008, Japan ranked globally just No. 5 in terms of deal volume. The U. S. ranked No. 1 (US$ 189 billion, about one fourth down from 2007). France was No. 2 (US$ 119 billion, down 15 % from 2007), and the U. K. was No. 3 (US$ 102 billion, down 67 % from 2007), Switzerland was No. 4 (US$ 89 billion, up 80 % from 2007). Belgium was No. 6, not far behind Japan (US$ 65 billion, up 280 % from 2007); and Germany was No. 7, in the same range (US$ 57 billion, down 65 %). China, Russia and Italy came in eighth, ninth and tenth (Fig. 5).

Let us now turn to inbound M&A. A very different picture emerges: apart from the takeover of two Japanese companies by U. S. giants in 2007 (Nikko Cordial/Citigroup and Seiyu/Walmart), only smaller "out-in" deals have occurred in recent years. In 2008, the value of Japan cross-border M&A deal activity was 10.4 billion U.S. dollars (Thomson Reuters 2008: 36).[6]

The reasons for the low level of inbound M&A are basically the same as those mentioned above with regard to FDI. Foreign companies take their money elsewhere, because they expect a higher return on investment in other markets than Japan. However, concerning inbound M&A, some specific reasons apply. It is extremely hard to find attractive takeover targets in Japan as companies try to stay independent as long as possible. Japanese capitalism – *not* Japanese law or administrative rules – sets the company (as the core of society), in the center, not the profit-maximizing owner. We are dealing here with the social, cultural and mental context of doing business in Japan, not with policy or bureaucracy. M&A are only resorted to when the pressure to consolidate is so great that there is no other possible way left and this has been accepted by all participants, including the employees of the company being taken over. The consensus is usually reached by including guarantees of job security and company continuation, which naturally reduces the effects of cost synergy, a central economic motivating force of M&A. In general, foreign M&A investors – both strategic and financial – are perceived as aggressively profit-oriented and hence not in line with Japanese corporate values. Under these conditions, it is not surprising that M&A in Japan are for the most part approved when the target is a foreign company.[7]

Rather than the legal admission of "triangular mergers" in 2007, which did not have much impact on the societal, cultural and mental barriers to inbound M&A, an unexpected change agent has emerged from within the business system: shareholder activism. This movement emerged a few

[6] Exceptions such as IMC's acquisition of Tungaloy, Bain Capital's acquisition of D&M Holdings Inc (formerly Denon Ltd.) and, most recently, Goldman Sachs' announced US$ 1.1 billion acquisition of Universal Studios Japan (March 2009) confirm the rule. Depending on the source, the total inbound M&A deal volume was in the range of US$ 5–10 billion in 2008, depending on the criteria applied and, in some cases, the estimated transaction value. We follow the figure provided by Thomson Reuters: Fourth Quarter 2008. Mergers & Acquisitions Review.

[7] Even back in the 1980s there were almost no legal hurdles barring foreign investors from acquiring a Japanese company. With regard to takeovers, Japanese commercial law is extremely liberal. The real problems of inbound M&A in Japan arise on the practical side. In most cases, a long-standing business relationship with the Japanese target company, mutual trust, and a good reputation are the conditions of a successful inbound M&A transaction (Vaubel 1986: 80). The legal admission of "triangular mergers" in 2007 has further eased inbound M&A investment. However, a takeover boom did not happen at all, as the structural obstacles have remained unchanged. For an analysis of the "triangular mergers" from an investor's perspective, see Lippert (2007a, 2007b).

years ago, when foreign investors (mainly hedge funds and private equity firms) started asking critical questions to the managers of their Japanese portfolio companies – something that was virtually unheard of in Japan until then. Japanese investment institutions have slowly followed suit.[8] However, the results to date have remained largely symbolic: almost all proposals from shareholder activists have been rejected by the majority of Japanese shareholders – individuals, corporations, banks and institutional investors. At first glance, the behavior of these shareholders might not be in line with the rational choice paradigm. However, they tend to see themselves as long-term stakeholders rather than profit-driven investors. This is their understanding of a "rational choice" as owners of the company. In particular, they trust the management. If management points out in a general shareholder's meeting that, for example, high cash reserves are needed to secure smooth financing of potential strategic investments (without providing any detail about the nature of the investments or even the strategy behind them), Japanese investors have a strong propensity to

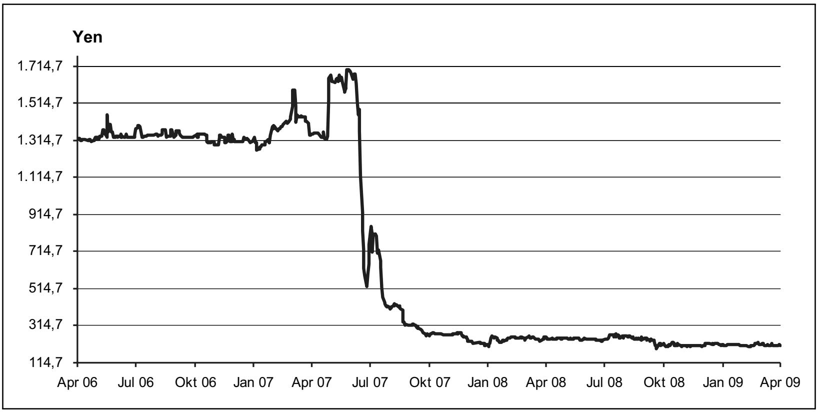

Fig. 6: **Cost of loyalty: share price of Bull Dog, 2006–09**

Note: Due to the split-up of stock on July, 2007, the adjusted closing stock price is used.

Source: Capital IQ.

[8] For an analysis of shareholder movement in the context of the market-oriented transformation of Japan's political economy between 1998–2006, see Schaede (2008: 17) where she points out that "shareholders are no longer satisfied by good relations, but demand high profitability". This describes the attitude of the activists. However, these activists have so far not been able to dominate general shareholders' meetings. It remains to be seen whether the crisis of 2008–09 will be advantageous for the activists – or not.

support this view based on trust and a desire for harmony. These are legitimate – albeit not necessarily profit-optimal – decisions of company owners[9].

The culture of close, trust-based cooperation between shareholders and management also includes avoiding hostile takeover bids (TOBs). One of the most spectacular cases was the hostile TOB from the U. S. hedge fund Steel Partners, whose offer to the shareholders of the sauce manufacturer Bull Dog was around twice as high as the previous share price (Fig. 6). The CEO lamented the terrible consequences of her company being taken over by a foreign investor. She was successful: The shareholders remained loyal to the management. But they paid a bitter price for their loyalty: the share price fell considerably below the previous average, and it does not look set to achieve the price offered by Steel Partners anytime soon.

2.4 *Corporate Defenses*

The fear of hostile TOBs has initiated a set of countermeasures on the corporate side. First of all, cross-shareholdings with business partners – customers, suppliers, banks, sometimes even competitors – seem to be on the rise again. This has created a great deal of media attention (see e. g.: *Japan Times* 2 September 2007). A closer look at the numbers reveals that this is a very slow, hardly significant process (Fig. 7).

Some 20 years ago, cross-shareholdings amounted to about 50 percent of the Japanese stock market value. Over the last two decades, cross-shareholdings decreased to as much as 11 percent in 2004. Since then a marginal increase has occurred, currently its value is about 12 percent (Economist Intelligence Unit 2008). Cross-shareholdings have particularly increased in quickly consolidating industries such as steel production and automotive supply (*Nikkei Weekly* 15 October 2007, 29 October 2007). However, warding off takeover attempts is just one driver. Others are ensuring stable business relations and investing cash piles in companies which management and other stakeholders know well instead of taking greater risks. In other words, we cannot say that the increase in cross-shareholdings,

[9] Abegglen (2006: 93) arrives at a radical conclusion: “The main stakeholder in the Japanese company is the employee. The share in the company held by whoever now has it represents a capital investment. That investment is entitled to a return, and that return is provided when at all possible. But there is no further obligation to, nor right held by, the shareholder. (The United States and the United Kingdom have somehow developed the curious view that the shareholder has total entitlement to the company.)”

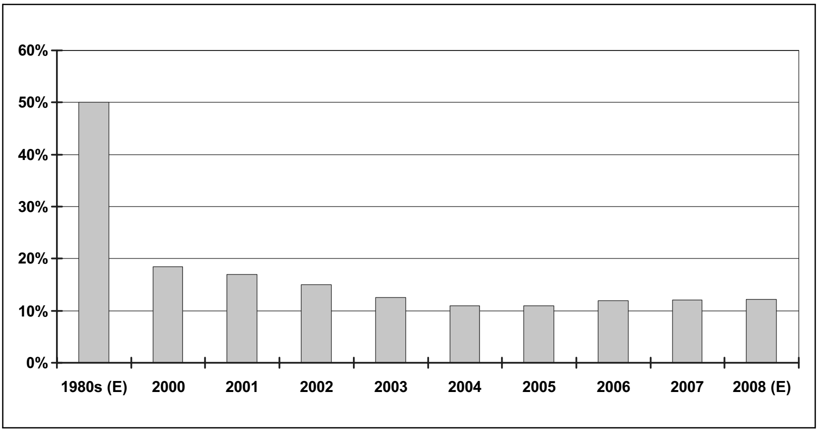

Fig. 7: **Cross-shareholdings as a percentage of Japan's stock market**
Source: *Japan Times* (2 September 2007).

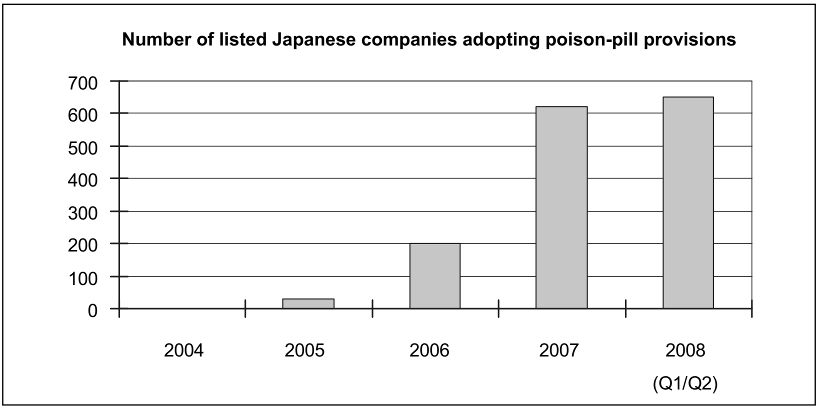

Fig. 8: **Number of listed Japanese companies adopting poison-pill provisions**
Source: *Nikkei Weekly* (19 May 2008).

given its pace and absolute volume, supports the "Dejima mindset" thesis.[10]

Second, many listed Japanese companies have adopted poison-pill provisions. These provisions are designed to ward off unsolicited TOBs. The numbers are indeed stunning: Practically nonexistent until 2005, the

[10] It is out of the question that cross-shareholdings have been on the decline since the 1980s. For a detailed discussion, including the most recent developments, see Schaede (2008: 95–99).

number of companies adopting poison-pill provisions has exploded since 2006. In 2007, the number of companies using poison-pills amounted to more than 600. In 2008, this number has just slightly increased; currently about 650 companies have adopted poison-pill provisions (Fig. 8).

This development shows how nervous the Japanese management was and is; supported by the owners, the management buys protection from takeovers and thereby secures its own position. That has a price, however: the company becomes less attractive in the eyes of investors – not only potential acquirers, but also portfolio investors. The takeover fantasy becomes lost. It is difficult to ascertain whether and in how far the introduction of such protective measures has a direct negative effect on the stock price, because these factors cannot be isolated and comparisons with companies from the same sector and are that are similar but have not adopted such measures, can hardly be made due to the great variety of other influencing factors. Therefore studies showing that the share prices of companies that have introduced protective measures have performed worse than a chosen benchmark are only very weak indicators. A recent Nikkei study has arrived at the result that companies that have introduce anti-takeover measures use their capital less efficiently than the average. In numbers that is: the return on equity (ROE) of 55 percent of the 110 largest companies that have introduced anti-takeover measures is under the average of 10 percent; that is, the ROE of the other 45 percent lie at or over 10 percent (*Nikkei Net* 22 April 2008). This minor difference indicates that it is particularly companies with lower profitability and high cash reserves that tend to make use of artificial protective measures, which makes sense but is hardly a surprise.

The best natural protection against unwanted takeovers is and remains a growing, profitable business, alongside well-structured finances and a high company value. As a consequence, a few companies have actually removed their poison pills in order to regain attractiveness for investors. Shiseido is certainly the best-known example; others are Nissen Holdings, Nihon Optical, and Toyama Chemical (Economist Intelligence Unit 2008: 24).

2.5 *Key Points*

Regarding direct investments, of which M&A are a part, there is a massive imbalance between Out-In and In-Out investments. Japanese companies invest a number of times over what foreign companies invest in Japan. The figures differ depending on category and definition; they lie between factor 4 (FDI) and significantly higher values (Cross-Border M&A). However, it should not be concluded from this that Japan is "closed". On the part of both we are dealing with entrepreneurial decisions. That other markets are more attractive in the eyes of investors has nothing to do with a "Dejima mindset", with legal or administrative barriers in Japan, but with evaluations of the economic situation. It could be that the particular entrepreneurial philosophy in Japan and the challenges of integration play a role; however, these are purely economic factors, as is the reluctance of Japanese shareholders to sell their shares to a well-paying investor.

3 Portfolio Investments

3.1 Market Perspective

In contrast to foreign direct investments (FDI), with portfolio investments entrepreneurial control is neither exercised nor striven for. An example of a typical portfolio investment would be a U. S. public fund that buys shares in a Japanese company. The fund is interested in increase of market value and receipt of dividends, not in gaining control of the company. Small minority shareholdings of strategic investors belong in this category, as well. In these cases, the aim is usually to strengthen mutual business interests, whether in development, purchasing, production, distribution or service.

More than a quarter of the share capital of Japanese listed companies is in international hands. The proportion of foreign investors in the Japanese stock market has been nearly continuously increasing since the end of the Bubble Economy: from 5 percent in 1990 to 28.6 percent in September 2007, the current peak of this development. This translates into a yearly growth rate of 11 percent. Banks and non-financial firms are reducing their shares in companies with which they have a business relationship. Between 1990 and 2006, the share of large banks decreased from 16 percent to five percent. The share of non-financial companies fell from 30 percent to 21 percent. As the share of individuals and institutional shareholders (i. e., trust banks, investment banks, and insurance companies) has stayed fairly constant, a regrouping of large banks and non-financial companies towards foreign investors has taken place (*Nikkei Weekly* 23 June 2008).[11]

The contrast to direct investments is striking: foreign portfolio investors have nearly continuously extended their position since the end of the Bubble Economy. This trend was interrupted only in 2001/2002. In the present

[11] The numbers must be taken with a grain of salt, as not all investors labeled "foreign" by the Tokyo Stock Exchange represent foreign money; for instance, an international fund buying Japanese shares with money from Japanese institutional or private investors is regarded "foreign" by the Tokyo Stock Exchange. For further details, see Schaede (2008: 110–112).

financial crisis, as well, foreign investors have reduced their Japanese holdings. The foreign ownership ratio of Japanese equities declined from 28.6 percent in September 2007 to 27.6 percent in March 2008 and 26.0 percent in September 2008.[12] Amid a deepening financial crisis, foreign investors became net sellers of 3.7 trillion yen worth of shares in the calendar year 2008 and 2.5 trillion yen in the first quarter of the calendar year 2009. In terms of number of shares, foreign investors bought (net) 24 billion shares from 2003 through 2007 and sold (net) 9.5 billion shares between January 1, 2008, and March 31, 2009. A rough calculation, which does not include stock splits, leads to the result that foreign investors have sold almost 40 percent of the shares they had bought on a net basis from 2003 to 2007 (*Nikkei Weekly* 13 April 2009).

Foreign investors have a massive impact on the direction of the Japanese stock markets, as their share of transaction value is around the 60 percent mark[13]. Hence there is a keen awareness that the Japanese equity market cannot recover without the stabilization of overseas financial markets and money flow from overseas.[14] A closer look at the market data suggests that, in the first half of the fiscal year 2008, sectors whose foreign ownership ratios decreased recorded large share price declines, whereas sectors whose foreign ownership rations increased recorded a smaller rate of decline of even a minor increase. However, there is no significant correlation between foreign ownership ratio and sector performance: The performance of sectors with high ratios of foreign ownership at the end of September 2008 have deteriorated the most since October 2008. Supply and demand factors (in the context of the global recession) need to be taken into account as well as valuations and fundamentals according to Mizuho Securities Equity Research[15].

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[12] Mizuho Securities Equity Research, Strategy/Equity Report 19 December 2008, based on a share ownership survey by Tokyo, Osaka, Nagoya, Fukuoka and Sapporo stock exchanges and Tōyō Keizai shareholder data.

[13] See Tokyo Stock Exchange, http://www.tse.or.jp/english/market/data/sector/index.html (found 6 May 2009).

[14] METI has set up an expert panel to address the issue of Japan's weak overall corporate governance rating. According to GovernanceMetrics International, Japan ranks 22th in an international comparison, between Belgium (No. 21) and Greece (No. 23). The U. K. ranks No. 1, the U. S. No. 3, and Germany No. 10. The panel's report (due by mid-2009) will contain recommendations that the Tokyo Stock Exchange and justice ministry have agreed to carry out. See *Wall Street Journal* (4 April 2009).

[15] Mizuho Research Web (http://research.mizuho-sc.com/mizuhoapp/AUSE00 1001.do?LANG=en#).

3.2 Sector and Company Perspective

The international portfolio investments are, by and large, evenly distributed among industry sectors. Let us take a look at the ten sectors with the largest market capitalization. The proportion of foreign investors lies between 15 and 36 percent (as of February 2009, Table 1). The average is 29 percent. In the three largest sectors – electrical appliances, information & communication, and transportation equipment (including automotive) – the proportions are 36, 34 and 29 percent, respectively. The foreign shareholder ratio is smallest in the electric power and gas sector.[16] These figures also indicate that the degree of internationalization of the business of a particular sector and the degree of internationalization of its owners are to some extent correlated. The sectors with the highest degree of international shareholders tend to operate globally (at least on the OEM level), whereas utilities, land transportation and banks focus on the domestic market.

Top 10 sectors (market value)	Market value* (billion yen)	Foreign stockholder ratio (percent)
1 Electrical Appliances	25,462	36.3
2 Information & Communication	22,967	33.9
3 Transportation Equipment	22,955	29.2
4 Banks	21,195	25.7
5 Electric Power & Gas	14,919	15.5
6 Pharmaceuticals	12,223	34.1
7 Chemicals	10,933	32.3
8 Land Transportation	9,078	19.7
9 Wholesale Trade	8,341	33.9
10 Machinery	7,898	30.9
		Average: 29.2

Table 1: **Foreign shareholder ratio: sector breakdown**

Note: *As of February 2009.

Source: Bloomberg, Mizuho Securities Equity Research.

Examining this in further detail by looking at the situation at the level of individual companies, confirms this view. Here, a number of different analyses are available.

[16] Data provided by Mizuho Securities Equity Research.

First, let us take a look at the 10 companies with the highest sales. Eight out of these ten companies are from two sectors: automotive (Toyota, Honda, Nissan), and wholesale trading (Mitsubishi, Mitsui, Itochu, Sumitomo, Marubeni). On average, 37.3 percent of all shareholders are not from Japan – clearly more than 10 percent above the foreign shareholder ratio of Japanese equities in general (Fig. 9).[17]

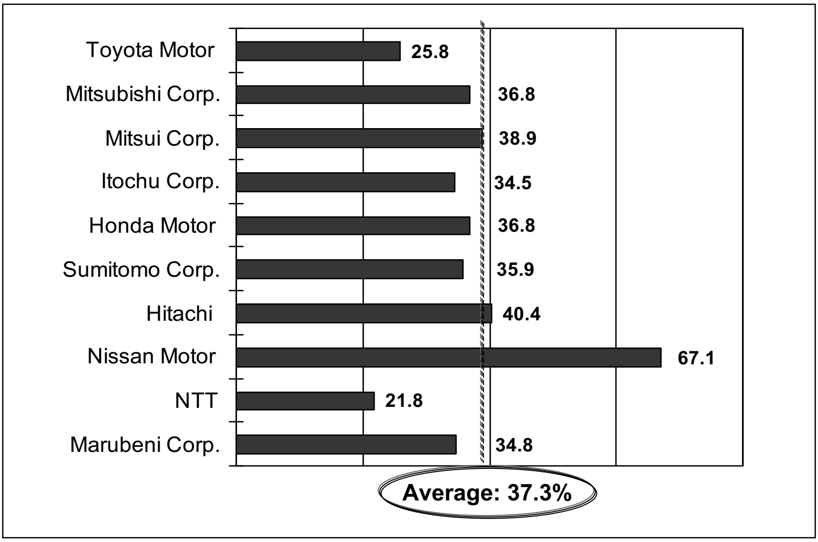

Fig. 9: **Foreign shareholder ratio: top 10 industrial companies (sales)** (Sep. 30, 2008; in percent)

Source: Mizuho Securities Equity Research.

Second, let us examine the 10 *industrial* companies with the highest sales (Fig. 10). These companies are the globally known representatives of "Japan, Inc." and often (mis)taken as bellwethers of the Japanese economy as a whole. Here, 36.7 percent of all shareholders on average are not from Japan, and 80 percent of these companies are divided between two sectors: automotive (Toyota, Honda, Nissan) and electrical appliances (Hitachi, Panasonic, Sony, Toshiba, Fujitsu). It should be noted that a conglomerate like Hitachi with its 1,000 or so subsidiaries, which has grown over decades and is very oriented towards Japanese tradition, is among the favorites of foreign investors. Hitachi lies far above the average, and – with the exception of Sony – clearly above national peers such as Toshiba (24 %) and Panasonic (28 %).[18]

[17] Data provided by Mizuho Securities Equity Research.
[18] Data provided by Mizuho Securities Equity Research.

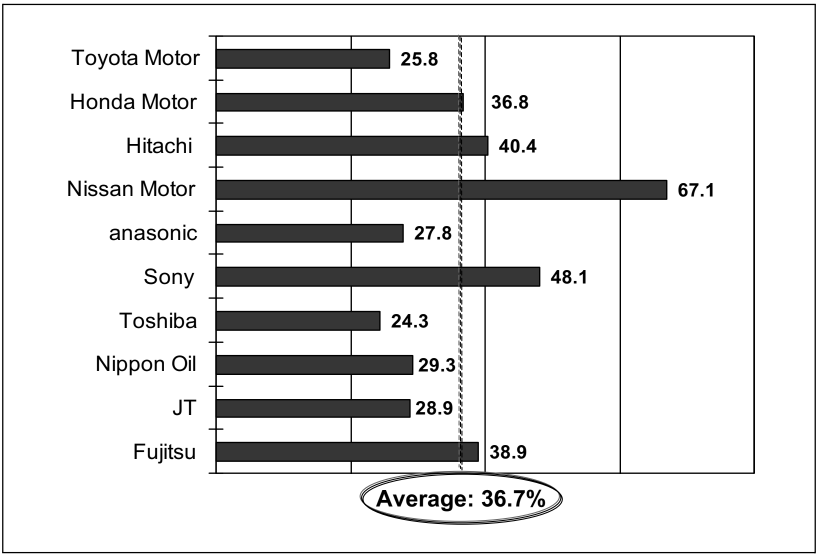

Fig. 10: **Foreign shareholder ratio: top 10 manufacturers (sales)** (Sep. 30, 2008; in percent)

Source: Mizuho Securities Equity Research.

3.3 Key Points

Compared to FDI, foreign indirect investments in listed companies in Japan are relatively high. Foreign investors hold around one-fourth of the shares at listed companies. The foreign ownership ratio of Japanese equities reached 28.6 percent in September 2007, then declined to 27.6 percent in March 2008 and 26.0 percent in September 2008. This figure has been rising continuously for 20 years, interrupted only in 2001–02 and in 2008 (each time following a global asset crisis). Foreign investors are key movers of the Japanese stock markets; their share of transaction value is around the 60 percent mark.

The foreign shareholder ratio of the ten largest sectors by market capitalization is 29 percent, clearly above the equity market average. Foreign investors have a strong preference for large companies. They account for around 37 percent of the shares of the top 10 companies and the top 10 manufacturers (in terms of sales), more than 10 percentage points above the market average.

4 Overseas Sales and International Trade

4.1 Overseas Sales

"Overseas Sales" includes not only exports from Japan, but also sales of products manufactured outside of Japan for foreign markets. An exact delineation is not always possible, since aspects such as taxation and, for some of the large companies such as Toyota, political considerations also play an important role.

The overseas sales ratio of Japan's manufacturing sector amounted to 45 percent in 2007, up from 42 percent the previous year. These figures were derived from a study of 994 listed manufacturers that publish their overseas sales ratio figures. The ratio falls sharply if we also include third-sector companies: 27 percent in 2006 and 29 percent in 2007 (*Nikkei Weekly* 9 June 2008).

These figures reflect how widely the degree of internationalization differs between companies in the industrial and service sectors. The service sector accounts for 72 percent of Japan's economic output and employment.[19] However, large parts of it are internationally not competitive and hence not present[20]. Regarding size, Japanese financial service companies, travel firms, etc., are certainly in the global league; however, regarding the ratio of foreign sales they are far behind their peers in other G7 countries. Japanese banks and insurance companies have increasingly used M&A in order to extend their business abroad. The current crisis has strengthened this trend. However, it remains to be seen, for example, how successful the bank Nomura will be in integrating the Lehman Brothers Organization in Asia and Europe, keeping key employees on board and building business with non-Japanese clients abroad.

By contrast, international service firms have successfully established a significant presence in Japan. The life insurance sector, one of the most regulated sectors, is an example – insurers from Europe and the U. S. compete head-to-head with their Japanese peers. Further examples are the markets in Japan for software and professional services which are dominated by foreign firms. Other areas of the service sector are still practically owned by Japanese companies, such as retail and corporate banking, retail, travel, tel-

[19] For comparison: U. S. 79 %, Germany 69 %. See CIA World Fact Book 2009 (https://www.cia.gov/library/publications/the-world-factbook/index.html [accessed 17 July 2009]).

[20] The large trading companies such as Mitsubishi, Mitsui, Sumitomo, Itochu, Marubeni and Sojitz are indeed internationally very active, but – considering their specific business model catering primarily to Japanese companies – cannot be referred to as "service companies" in the usual sense. They form a category of its own, a unique element of the Japanese economy.

ecommunications, domestic public transportation, health care, and education. In any event, it should not be concluded from the fact that international service firms play a limited role in major parts of the Japanese service sector that the market is "closed".[21] For example, there would be no legal or administrative obstacle for an international bank to build up a retail network of hundreds or even thousands of branches across the country. However, international banks focus on other markets. This decision is driven by business cases, not by the constraints mentioned in the OECD report. Other markets promise higher returns on investment[22].

In the industrial sector, the top 10 companies by sales generate 53 percent of their sales and 37 percent of their operating profits overseas (non-weighted average).[23] Comparing this small sample to the considerably larger sam-

21 See OECD (2008). Chapter 5 of the survey points out that "labour productivity growth in the service sector […] has slowed markedly in recent years in contrast to manufacturing. The disappointing performance is associated with weak competition in the service sector resulting from strict product market regulation and the low level of import penetration and inflows of foreign direct investment (FDI). Reversing the deceleration in productivity growth in the service sector is essential to raise Japan's growth potential. The key is to eliminate entry barriers, accelerate regulatory reform, upgrade competition policy and reduce barriers to trade and inflows of FDI."

22 See Lippert (2006). The situation in health care or education, two sectors highlighted in the OECD survey, is certainly different. But the key question is again: Are there really international hospitals or universities willing to invest in Japan but kept from doing so by legal or administrative barriers?

23 The fact that international business contributes so much less to profits than to sales triggers deep questions about the globalization of Japanese firms. Tax aspects are irrelevant considering the high corporate tax rate in Japan (that many companies, especially SMBs, do not pay corporate taxes at all is a separate issue). Political aspects (i. e., shifting profits to other, politically less sensitive markets) may play a role in only a few cases (such as Toyota in the U. S.). The yen-dollar/euro exchange rate has been extremely volatile in recent years. The profitability of international operations was low even when the yen was extremely weak (as in 2006–07). This means that the cause must be found in other, purely business-related, factors as for instance: meager knowledge about the international market and its conditions, especially by rotating Japanese expatriate managers; share-driven marketing strategies based on low price rather than value; the handling of cultural, mental and linguistic differences; and the problematic integration of international business units and foreign employees into the Japanese organization. See Beechler (2005: 92) emphasized the human factor, especially the role of non-Japanese employees in Japanese MNCs: "If the rules of global competition continue to change and only those firms that have access to key talent and that put the best people in the job regardless of nationality are able to survive, the definition of who is 'we' (*seishain*) and who is 'them' (non-*seishain*) may become more nationality-blind."

ple mentioned above shows how strongly the size of a company affects its degree of internationalization. The difference in overseas sales ratio with respect to the sample of the 994 companies is 8 percentage points.

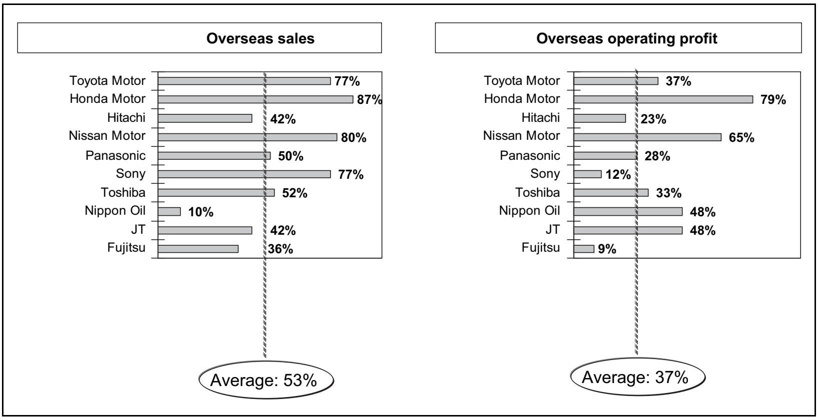

Fig. 11: **Overseas sales & profits: top 10 industrial companies (sales)** (Sep. 30, 2008)

Source: Mizuho Securities Equity Research.

Size, in the sense of total sales, is supportive when gaining access to foreign markets. At first glance this seems intuitive – building up foreign business requires time, money, management capacity, etc. The Hidden Champions, however, demonstrate that there are other possibilities – their relatively limited size and decentralized organization are often an advantage when attempting to capture a foreign market. The proportion of foreign sales in relation to total sales of Hidden Champions is about 60 percent. Although their average sales volume amounts to some hundred millions of euros, they achieve a degree of internationalization higher than that of the ten largest Japanese industrial companies in terms of sales (Simon 2007: 129).

4.2 International Trade

We will now turn to exports and imports, the cornerstones of international business. Exports are more precisely documented than the less clearly defined – though more reflective of business practice – term "Overseas Sales".

Japan's trade volume has been mushrooming at a "Chinese" pace in recent years (2002–2008): exports by 7.6 percent annually and imports by as much as 11.1 percent (Fig. 12). China's growth is, in fact, a key factor here. However, the situation changed dramatically in the second half of the calendar year 2008, when exports and imports imploded. Exports plunged 16.4 percent to 71.14 trillion yen, while imports declined 4.1 percent to 71.86 trillion yen. As a result, Japan posted its first annual trade deficit since 1980 in the fiscal year 2008 (on a calendar-year basis, Japan reported a small trade surplus). The trade deficit in the fiscal year 2008 is moderate; it amounts to 725 billion yen (US$ 7.4 billion), equal to about one percent of the annual export volume (*Nikkei Weekly* 27 April 2009).

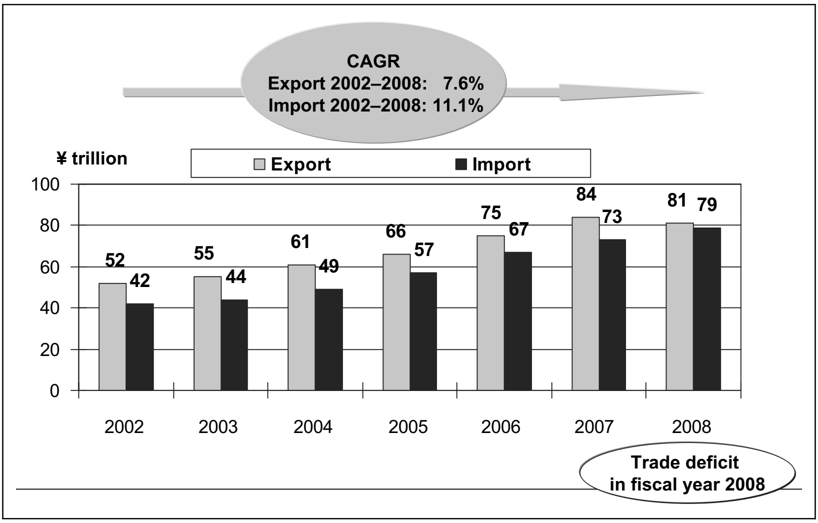

Fig. 12: **Exports and imports: development 2002–2008**

Note: Calendar-year based.

Source: Ministry of Finance Japan, *Trade Statistics of Japan* (MOF 2009).

In March 2009 alone, the value of exports tumbled 45.6 percent from a year earlier. However, compared with February 2009, March exports were up 2.2 percent, marking the first month-to-month increase. Exports to the U. S. shrank 51 percent in March 2009 from a year earlier, exports to China 31.5 percent (*Wall Street Journal* 23 April 2009).

Japan's export volume was around 777 billion dollars in 2008, half of the export volume of Germany. China and the U. S. were ranked second and third. In terms of absolute export volume, Japan is roughly level with France or Italy (Fig. 13).

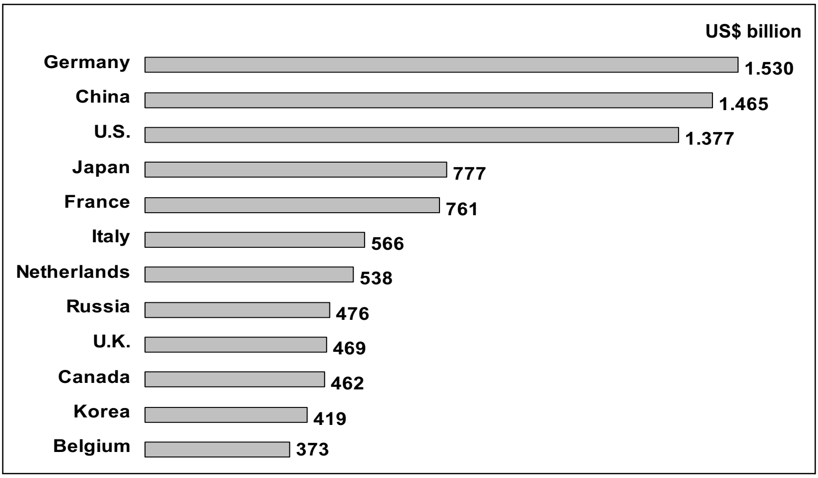

Fig. 13: **Export champions 2008**

Note: Partly estimated.

Source: CIA World Factbook.[24]

This seems counter-intuitive in view of the omnipresence of Japanese cars, electronics and machinery around the world, and many people find it hard to believe. The widespread argument that export statistics do not include transplant production is true, but it does not explain the large discrepancy between Japan and the world leaders in this regard. Even with a completely unrealistic estimated figure of 500 billion dollars for the value of transplant output, Japan still lags far behind Germany (and the German figure would have to be revised upwards as well, because German manufacturers also produce abroad for foreign markets). The situation has not changed much since the 1980s, despite the comprehensive liberalization and deregulation programs undertaken by the Japanese government, highly volatile foreign exchange rates and fluctuating raw materials prices (Waldenberger 2008: 4).

If we contrast the export volume with GDP, the following picture emerges (Fig. 14): Germany and China are the globalization champions, with export volumes of 40 percent and 35 percent of GDP respectively. Mid-table we find Russia (27 %), France (26 %), and Italy (24 %). At the bottom of the list come the U. K. (17 %), Japan (16 %), and the U. S. (8 %).[25]

[24] See CIA World Fact Book 2009 (https://www.cia.gov/library/publications/the-world-factbook/geos/JA.html [accessed 17 July 2009])

[25] See OECD (2008). For an analysis of the (similar) situation in the 1980s and 1990s, see Legewie (1998).

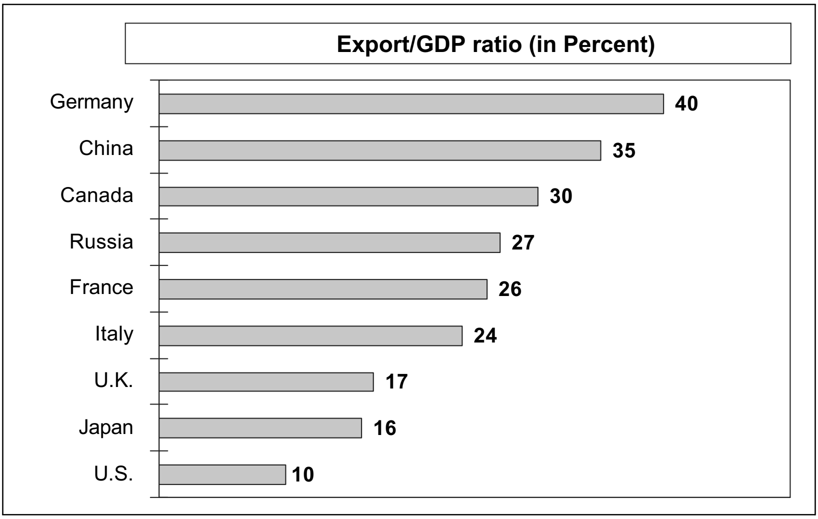

Fig. 14: **Export share of GDP: international comparison**

Note: Nominal GDP, 2008 estimates (as of April 2, 2009); own calculations.

Source: CIA World Fact Book 2009, updated as of 23 April 2009.[26]

Obviously there is no direct correlation between the export ratio and the level of GDP per capita. By simply comparing Japan's export ratio with those of other countries or an average we cannot answer the question whether Japan's actual export ratio is "too low" in terms of national economic welfare. Many other factors need to taken into account, as for instance: the commodity structure of trade; the availability of cultivatable land, primary energy and other natural resources; the geographic distance to and the number of trade partners. In a recent paper, Waldenberger concludes that border barriers to trade, domestic regulations, specific national standards, or business practices (such as long-term relationships, cross-shareholdings and multi-layered distribution systems) can not explain Japan's low trade dependency. Further, Japan's commodity and regional structure of trade had quickly adjusted to changes in the international trading environment over the last few decades. Waldenberger emphasizes that the high quality, product and service requirements of Japanese customers – on average about 20 percent above the level in Germany (Lippert and Schürmann 2008) – calls for inbound FDI to effectively support exports to Japan. However, the difficulty in securing Japanese personnel

[26] See CIA World Fact Book (https://www.cia.gov/library/publications/the-world-factbook/ [accessed 27 April 2009]).

makes FDI presents a structural barrier which, in combination with the high customer requirements, "might at least partly explain why Japan trades so little." (Waldenberger 2008: 19) This explanation is convincing, yet it refers only to imports. The low export ratio must be explained in other ways. Previous research on the Japanese Hidden Champions (Lippert and Simon 2008) suggests that the explanation cannot be found in trade barriers or structural impediments of other countries.[27] To understand the low export ratio, we need to look at the mindset and organizational resources of Japanese companies.

First of all, large parts of the Japanese economy have traditionally focused on the domestic market – the service sector (except for the large trading companies and, recently, some retailers) and, more important for the present study, the small and medium sized businesses (SMBs) of the industrial sector. The typical Japanese SMB manufacturer takes it for granted, that its "natural" role is selling parts or components to a Japanese original equipment manufacturer (OEM) or Tier 1 supplier. From the typical SMB's point of view, serving global markets independently is the role of the OEM or Tier 1 supplier.

Second, this mindset is exacerbated by a lack of managers with the will and the skill to build up business abroad. Not only foreign affiliates in Japan, but also Japanese SMBs have great difficulties recruiting top talent that combines product know-how, salesmanship, entrepreneurial goal-orientation with international experience and language proficiency. Japanese top talent still has a strong propensity to work with large, well-established companies or public institutions. Entrusting a foreign manager with the leadership of the international affiliate is for most Japanese companies – regardless of size – not an option. And even if a capable Japanese manager is found, it can be safely assumed that this person does not want to stay longer than the typical rotation period – two to three years – away from Japan and the company headquarters. Staying too long abroad may have a negative impact on his or her career path (the *gaijin kusai* [smelling like a foreigner] problem, which may even affect the manager's family). A frontier spirit is often less rewarded than devotion to day-to-day duties at headquarters, which includes tight networking with local business partners and colleagues.

Third, Japanese managers abroad rarely have incentives to achieve breakthrough sales successes. Most of them are inclined to take on no more risk than what is needed to make the required sales numbers. Rather

[27] There seem to be not more than 100 Japanese Hidden Champions, a very small number in comparison with the 1,200 Hidden Champions in the German-speaking countries.

than aggressively pushing into new businesses they tend to focus on existing customer relationships. The same holds generally true for Japanese companies selling through international distribution partners; even in big markets such as the U. S., Japanese executives tend to accept stable, but low returns. These experience-based assumptions are far from complete. They are derived from many years of contact with Japanese firms, but not supported (yet) by an in-depth empirical study. All in all it seems to be the case that primarily "soft", human resource-related factors explain Japan's low degree of integration into international trade – both imports and exports.[28]

4.3 Key Points

Japan's industrial sector has integrated itself very actively in global trade in recent years: 45 percent of its sales are posted overseas. The largest industrial firms (by sales) far exceed this figure, with overseas sales ratios of 53 percent. These firms are the vanguard of globalization in Japan. Some mid-sized manufacturers follow suit. Among these there are only a few Hidden Champions that have independently captured a significant proportion of the global market. The degree of internationalization of the service sector lies far behind that of the industrial sector; Japan is the furthest behind of the G7 nations.

Japanese foreign trade (import and export) has grown by 7.6 respectively 11.1 percent annually in recent years (2002–2008). Exports outweigh imports, but the import volume is rising more quickly than the export volume. The picture changed dramatically in the second half of the calendar year 2008. As a result, Japan suffered its first annual trade deficit (fiscal year 2008) since 1980.

It is often stated that Japan has an "export-driven economy". However, the figures tell us differently. Japan ranks fourth in the list of the world's top exporters, considerably behind Germany, China and the U. S. Germany and China stand out even more if we contrast export volume with GDP. Mainly due to a large number of economic, geographic and other factors, economic research has not yet found a generally accepted answer to the question whether this is "optimal" in terms of national economic welfare. Qualitative, experience-based reasoning suggests that HR-related factors explain Japan's relatively low degree of integration into international trade.

[28] These factors overlap with the above discussed reasons for the low profitability of the overseas operations of Japanese manufacturers (see also Beechler 2005).

5 Conclusion and Outlook

Japan is strongly affected by the current global recession. Its economy contracted at its fastest pace in nearly 35 years during the fourth quarter of calendar year 2008. Japan's GDP shrank by 3.3 percent, or an annualized pace of 12.7 percent during the quarter, a much steeper decline than in the U. S. or the euro zone for the same period (*Wall Street Journal* 17 February 2009, based on Japanese government data). Tokyo's stock market traded near lows not seen since 1982. Japan's GDP is projected to shrink 6.5 percent in calendar year 2009. A recovery in domestic demand from mid-2010 is expected to lift output growth into slightly positive territory (OECD 2009). However, the outlook for both 2009 and 2010 "remains the worst since WWII"[29].

At the present time it is entirely unclear which countries, sectors or companies will be among the winners or losers of the crisis. It is equally unclear when, where and how new global growth will occur. There are indications that China, India, South East Asia and the U. S. will generate new growth. This will mean for Japan and Europe, regions with a rapidly aging population, that they will have to make an enormous effort if they are to not lag behind. What is clear is that the traditional export-oriented growth model – producing for the American market and, at the same time, financing American consumption – will no longer function. This applies to Japan, but also to Korea and China. The current recession and the strong yen are forcing companies into a profound restructuring. A boost in domestic demand – for example, in the health care sector, but also in the fields of housing, non-carbon energy, "green" technology and workplace modernization – is crucial for future growth of Japan and its neighbors. A "muddling through" strategy will not work, as the necessary condition – growth in the surrounding countries – is missing. In contrast to the 1990s, this time not only the costs but the market perspectives will be considered on both sector and company level. The strategic move toward "choose and focus" (*sentaku to shūchū*) is – at least in the industrial sector – irreversible (Schaede 2008: 254–260). The fusion of Panasonic and Sanyo, the ongoing consolidation of the semiconductor industry or the positioning of Sharp as a "total solar power solutions provider", are examples of this direction.

But this is just one side of the coin. Assuming that (a) the fundamental trend of globalization will continue – that is, the worldwide capital and trade streams will appreciably increase in the coming decades – and that (b) the current sociodemographic development in Japan will continue,

[29] Data provided by Morgan Stanley: *Japan Economics* (1 May 2009: 31).

then it is clear that it will not be possible for Japanese companies to avoid a forced internationalization across all three sectors.

The most important "problem child" is the service sector, which generates 72 percent of economic output and employment, but suffers from low productivity, weak profitability, and a lack of competitiveness. Pretax profits of large companies in the service sector declined 23.2 percent in the fiscal year 2008; a further decline by 6.4 percent is projected for the fiscal year 2009 (Bank of Japan 2009). Japanese service firms should actively seek a smart strategic mix of cooperation and competition among themselves and with their international peers on overseas and domestic markets. An insulation strategy would have extremely negative consequences for living standards in the long run. The Japanese government should actively pursue structural reforms in the service sector to boost productivity (OECD 2009; Kondo *et al.* 2000). The other "problem child" is the huge SMB segment within the industrial sector. Many Japanese mid-sized manufacturers – probably several hundred – are potential Hidden Champions. However, instead of independently conquering the world market, they keep focusing on their domestic OEM or Tier 1 customers. Foreign capital and market expertise might help to transform Japanese SMBs into Hidden Champions.

We have seen that the characterization of Japan as "open society, closed market" is not an appropriate position. Apart from a few exceptions, the Japanese market is open, or at least not less closed than those of comparable industrial nations. From the perspective of foreign companies, the problem does not lie in legal or administrative barriers that hinder access to Japan. The exceptions prove the rule. Even in sectors that are strictly regulated, such as health care, education, or domestic public transportation, there is the question whether, independent of the present crisis, there are in fact foreign companies that would want to invest in these sectors. The real difficulties foreign companies in Japan are facing are of a solely entrepreneurial nature: finding and satisfying Japanese customers, tough domestic competition, limited access to distribution networks, recruiting and retaining local talent, impatient overseas headquarters, et cetera (Lippert and Schürmann 2008). The Japanese market is not closed, but difficult to conquer. Its peculiarities are unlikely to change in the short term. This has different implications for investors and vendors of goods and services.

For an investor who wants to sell a company to a Japanese buyer, there are great opportunities especially in the high tech, environmental and energy sectors. Not only cash-rich strategic investors, but also the large trading firms and banks are looking for attractive takeover candidates for clientele interested in investment. For a strategic or financial investor who wants to buy a Japanese company, the outlook remains modest; a radical change in the attitude toward selling a Japanese company to a foreign investor is unlikely to happen – at least in the next one or two decades.

For a vendor of goods and services, the Japanese market provides very attractive opportunities particularly in the fields of green technology and life sciences; it is not by chance that German solar power specialists such as Q-Cells and Schott Solar as well as China-based Suntech Power are in the process of entering the Japanese market, competing directly against Sharp and other domestic incumbents. However, Japan's industrial companies, with their crisis experience gained in the 1990s, technological prowess, and outstandingly trained, highly productive and willing employees will come out of the present crisis strengthened. The competition with Japanese manufacturers will continue to increase in other countries, especially India and China. There may also be individual cases where a temporary association or cooperation is economically sensible (such as the collaboration of Mori Seiki and Gildemeister, two world leaders in precision machines and machine tools). This will mean: increased sales potential for foreign top-vendors in Japan and good chances for owners of foreign firms that are willing to sell to Japanese investors; however, it will also mean increased competition in key markets of the future.

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