Economics

Japan's "go global" experience: implications for China

DBS Group Research

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- **Japan's "go global" experience offers lessons for China, which is encouraging its companies to invest abroad**
- **Two waves of Japanese outward investment occurred – first in the 1980's and then in the 2000's – driven by different factors and exhibiting different patterns**
- **The yen's internationalization process accelerated initially but lost momentum following the bubble burst in 1990s**
- **China's situation today is closer to Japan's in the 1980s**

Japan's overseas investment has played a significant role in the global economy for decades. Japanese companies have a strong global presence, making the country one of the world's largest exporters and FDI investors. The yen is commonly held by global central banks as part of their foreign reserves, and is one of the major currencies making up the IMF's Special Drawing Rights basket.

Today, China is pushing for its own "go global" strategy, encouraging companies to invest abroad and promoting the internationalization of the RMB. As part of this initiative, Beijing has initiated the "One Belt, One Road" project, pledging to improve the connectivity of countries in Asia and Europe through building infrastructure, increasing investment and broadening trade. It has also taken the lead to launch the Asian Infrastructure Investment Bank.

What will be the motivations and the key areas of interest for Chinese companies investing abroad? How will investment impact trade flows? And what conditions must be met for currency internationalization to succeed? Japan's experience may provide some insights and lessons.

Japan's two waves of outward investment expansion

There were two major waves of Japanese outward investment expansion in recent history: first in the 1980s and then in the 2000s.

First wave: Wage costs in Japan surged during the 1970s due to persistently strong economic expansion. Moreover, in the three years following the Plaza Accord in 1985, the yen appreciated by 50%. Rising wages and a strong yen eroded the competitiveness of Japanese manufacturers, prompting them to move the labor-intensive activities to neighboring countries. The appreciation of the yen also strengthened the purchasing power of Japanese firms, encouraging them to acquire financial and real estate assets in the developed markets overseas.

Annual flows of Japanese outward direct investment (ODI) increased from USD 7bn in 1985 to USD 31bn in 1990. Investment reached a peak in 1990 and declined through 1990s, owing mainly to the asset bubble burst, after which the real economy deteriorated and yen volatility increased (Chart 1).

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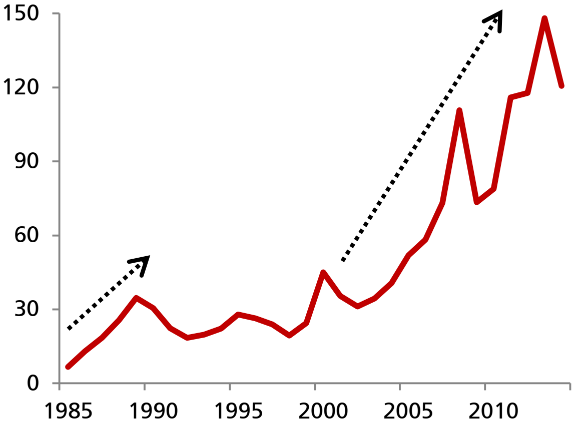
Chart 1: Japan's outward direct investment

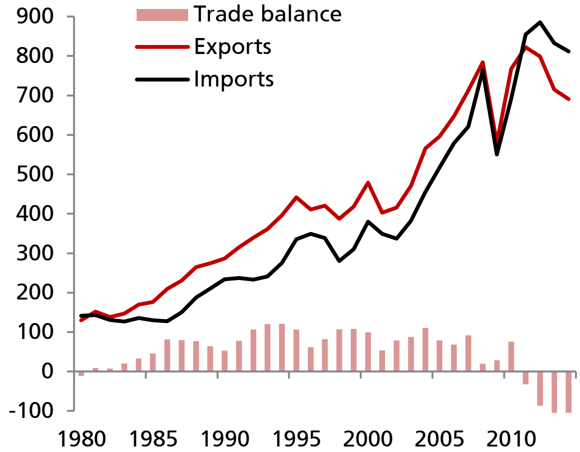
annual flows, USD bn



Note: 1985-95 data discontinued, transformation made by DBS

Chart 2: Japan's external trade

USD bn



Investment flows often drive trade. The investment destination countries (Asian countries in particular) increasingly relied on Japan for the supply of intermediate goods. As such, Japan's exports expanded strongly, from USD 130bn in 1980 to USD 286bn in 1990. Imports rose from USD 141bn to USD 234bn. Japan's trade balance moved into surplus and widened steadily. This trend continued until the mid-1990s, when the Asian financial crisis erupted and the regional economic environment deteriorated sharply (Chart 2).

The use of the yen became more popular as Japan's economic power strengthened. The share of Japan's exports invoiced in yen rose from 29% in 1980 to 40% in 1990; that of imports rose to 15% from 2%. Meanwhile, the share of yen in the world's allocated foreign reserves climbed steadily through the 1980s, reaching the peak of 9% in 1991. The internationalization of the yen was aided by not only the rise in Japan's economic power and appreciation of the yen but by policy deregulation as well. The government revised the Foreign Exchange Law in 1980 to liberalize cross-border transactions. For instance, Japanese residents started to be allowed to buy and sell foreign currency assets freely via authorized foreign exchange banks and designated securities firms (despite restrictions on direct transactions with non-resident entities).

Second wave: The second wave of Japan's overseas investment occurred in the 2000's. It occurred against the backdrop of falling growth and investment returns in Japan's domestic market and booming emerging markets. GDP growth in Japan has averaged just 1% since 1990s, firstly due to the burst of asset bubbles and then to falling population. By contrast, the emerging Asian economies recovered rapidly from the 1997-98 financial crisis and achieved robust growth in 2000s. Japanese firms expanded offshore businesses in an aggressive manner as a result, in order to pursue higher investment returns and maintain earnings performance. The ease of doing business in emerging markets since 2000 aided this growth, as did the expansion of free trade, deregulation of FDI rules and increased globalization.

Between 2000 and 2014, annual ODI flows soared to USD 121bn from USD 45bn (Chart 1). By the end of 2014, Japan's ODI stock in the world had reached USD 1.3trn, equivalent to 29% of its GDP. Investment was tilted towards services industry during this period (e.g., financial services and wholesale & retail trade), as Japanese firms penetrated into the domestic markets of emerging economies and focused more on the local demand.

Trade flows further expanded. Japan's exports increased from USD 479bn in 2000 to USD 690bn in 2014. Imports grew even more rapidly, from USD 380bn to USD 812bn. The trade surplus began to narrow and a deficit emerged since 2011 (Chart 2). This partly reflected the increase in Japan's energy imports after the 2011 earthquake disaster. Meanwhile, for investment destination countries like Korea and

Chart 3: Per capita GDP: Japan vs. China

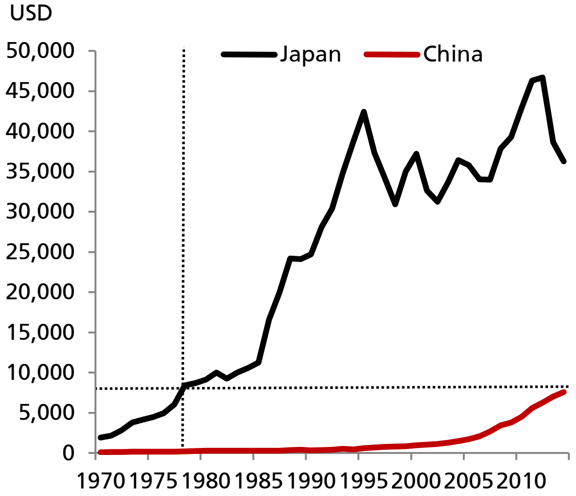
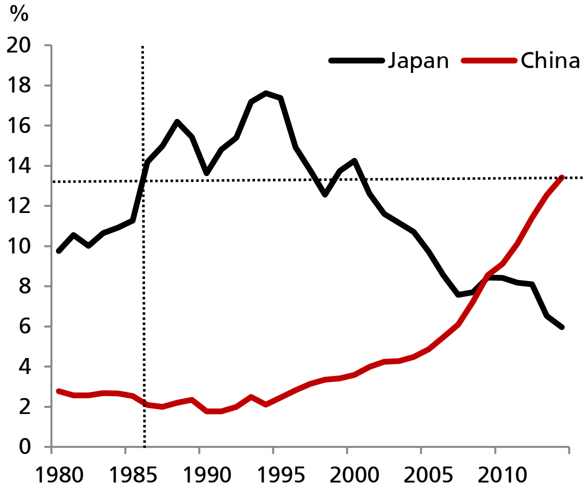


Chart 4: Share in global GDP: Japan vs. China



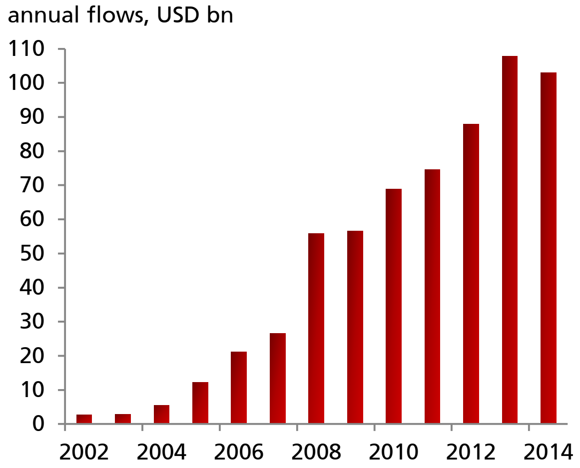
Taiwan, their reliance on Japan for imports of intermediate goods has decreased as the manufacturing supply chain matured.

The yen's international status weakened during this period, however. The share of the yen in global allocated foreign reserves dropped to 6% in 2000 and then to 3%-4% in recent years, sharply down from the peak of 9% in 1991. Its share in Japan's exports/imports settlements stopped rising and remained flat in the 2000s at about 40% and 25% respectively. In fact, the Japanese government attempted to internationalize the yen and promote Tokyo as a global financial center in a proactive manner during this period. The Foreign Exchange Law was revised further in 1998, eliminating virtually all the remaining restrictions on the capital account. For instance, residents started to be allowed to conduct direct transactions with non-resident financial institutions, a further step of liberalization compared to the 1980 law. But these efforts didn't pay off. Japan's economic malaise and banking crisis after the asset bubble burst seriously undermined investors' confidence on the yen and reduced the attraction of the yen-denominated assets.

China today vs. Japan in 1980s

China's situation today is closer to Japan's in 1980s. China's per capita GDP currently stands at USD 7,600, equivalent to Japan's level in 1977-1978 (Chart 3). The size of the Chinese economy accounts for 13% of global GDP, similar to Japan's 10-15% in the 1980s (Chart 4).

Chart 5: China's outward direct investment



Note: 2002-05, 2014 data exclude financial sector investment

Chart 6: China's external trade

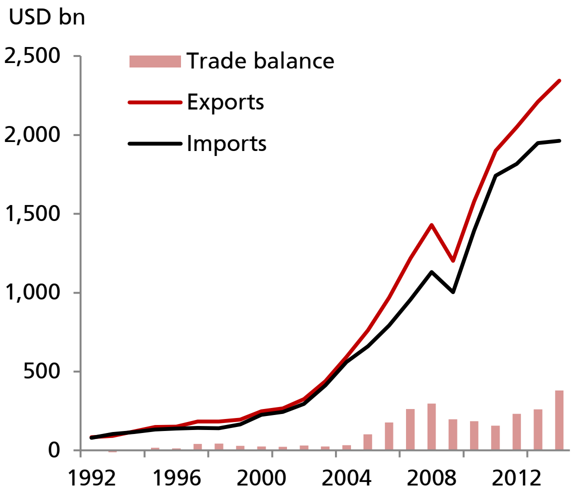


Chart 7: China's ODI, by market (2005-2012)

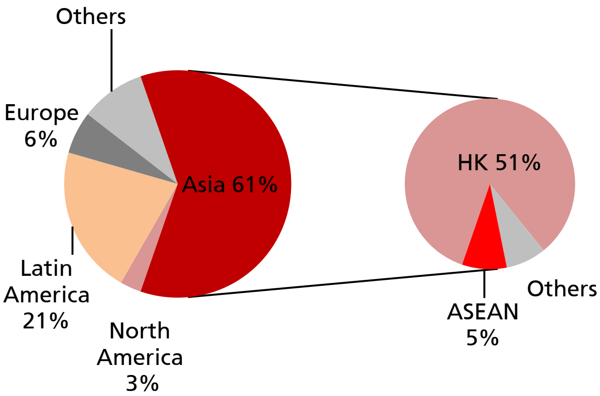
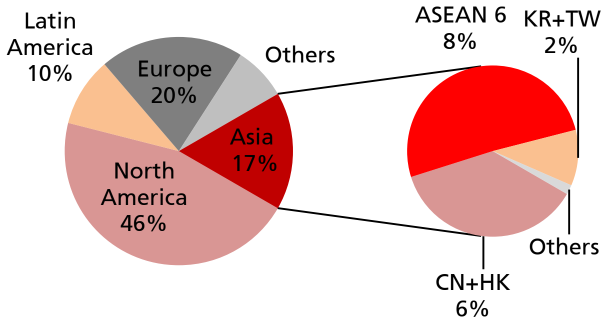


Chart 8: Japan's ODI, by market (1987-1995)



Like the yen in the 1980s, the RMB is also facing appreciation pressures, because of China's persistent current account surplus and the accumulation of foreign reserves. Versus the US dollar, the RMB has appreciated 25% since it was de-pegged in 2005. Wage costs in China have risen sharply on the back of strong growth and the labor shortages. If Japan's experiences in 1980s are any guide, a strong currency and rising wages will provide motivations for Chinese companies to invest abroad, especially in the labour intensive manufacturing sector and the financial/ real estate sectors. A rise in Chinese ODI should boost trade flows. And the use of RMB should also be broadened.

Developments so far have followed this outline. China's outward investment has jumped in the last several years after the 2008 global financial crisis. Annual ODI flows, which stood at USD 27bn in 2007, surged to USD 103bn in 2014 (Chart 5). The outstanding stock of ODI rose to 7% of China's GDP last year, a share that Japan reached only in early-2000s. Meanwhile, China's exports and imports have continued to expand in recent years and the trade surplus has continued to widen (Chart 6). Unlike the yen in the 1980s, the RMB is not a reserve currency as China's capital account is not sufficiently open. But the share of RMB in China's trade settlements has increased and its share in global payments has risen to 2%.

Much room still exists for China to diversify its overseas investment portfolio. More than 60% of China's ODI is allocated in Asia at present, primarily in Hong Kong. Asia ex-Hong Kong accounts for just about 10% of China's ODI (Chart 7). By contrast, Japan allocated nearly 20% of its investment in Asia in 1980s-1990s, equally across major markets (Chart 8).

Sector wise, China's investment is highly concentrated in services and mining. Manufacturing accounts for less than 10% of all ODI (Chart 9). In Japan in the

Chart 9: China's ODI, by sector (2006-2012)

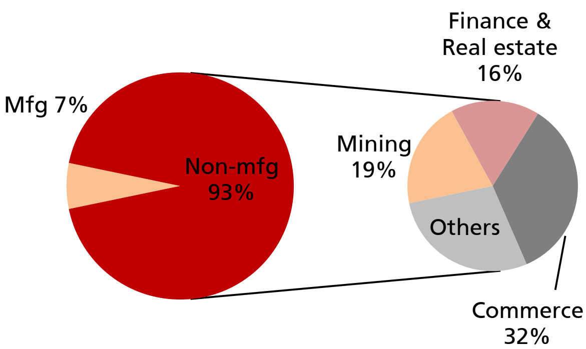
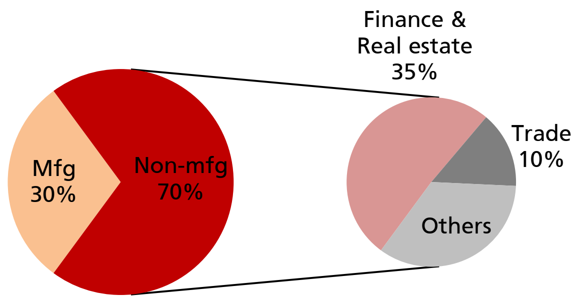


Chart 10: Japan's ODI, by sector (1987-1995)



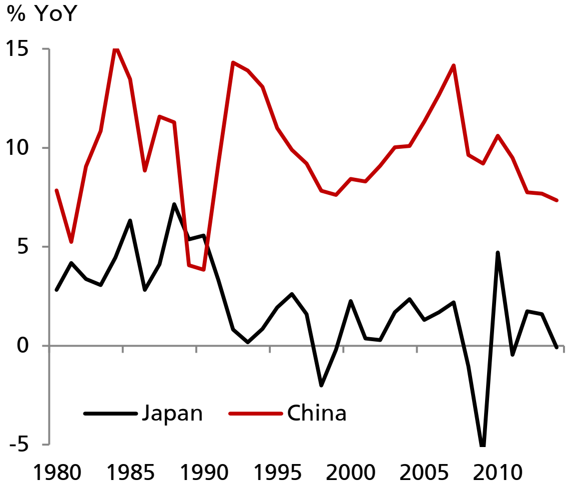
1980s, services accounted for 70% of ODI and manufacturing accounted for 30% – even when the yen surged after the Plaza Accord and the acquisition of foreign financial/real estate assets reached the peak (Chart 10). Much room remains for China to increase its overseas investment in the manufacturing field.

The differences from Japan's 2000s

China's situation today is vastly different from Japan's in 2000s. Although investment returns are slipping in China, they remain high – GDP growth is still running at 7%. In Japan, the economy entered a long period of stagnation in the past decade, with GDP growth hovering at just 1% (Chart 11). Given that China's domestic growth remains relatively strong, pursuing higher returns may not yet be the primary objective of Chinese companies' outward investment.

As long-term fundamentals remain solid and investor confidence in the RMB remains strong, China still faces a favorable macro environment in which to boost RMB internationalization. This is different from Japan in the 2000s, when the yen's internationalization lost momentum as a result of slow growth and falling investor confidence. In fact, Japan's experiences in the past 30 years suggest that both economic fundamentals and policy deregulations are important preconditions for currency internationalization to succeed. In China today, there is still a lot to be done on the latter front, such as capital account opening, financial liberalization and institutional reforms.

Chart 11: GDP growth: Japan vs. China



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2) "Expanding beyond borders: the yen and the yuan" (ADB Institute working paper), Paola Subacchi, 2013

All data are sourced from CEIC, Bloomberg, Bank of Japan, Ministry of Finance (Japan), Ministry of Commerce (China), State Administration of Foreign Exchange (China), IMF and SWIFT. Forecasts are DBS Group Research.

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