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CHINESE INVESTMENT IN THE UNITED STATES: AVOIDING THE MISTAKES OF THE JAPANESE

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China is the second largest economy in the world and by several projections is on track to eventually overtake the United States as the world's largest economy. Chinese outward investments globally and specifically into the United States are set to surge. Already, the Chinese acquisition of natural resources globally continues to makes frequent headlines. At the same time, the United States, Europe and Japan continue to suffer from the aftermath of the financial crisis, with slow recovery, unprecedented government deficits and stubbornly high unemployment, which commentators say will continue to cause political tension and instability. This delicate political and fiscal environment, which may worsen before improving, recalls a time three decades ago when a rising Japan began to increase its investments and influence abroad. Despite the state of Japanese economy now, there still are some insights Chinese investors can gain from reviewing the mistakes of the Japanese in their investment surge of the 1980s.

Indeed, in past Harvard Financial Symposia and in the news, numerous observations have been made about Japan's missteps in fiscal and financial policies which have led it to nearly two decades of economic stagnation, mainly as a warning to the United States and Europe on the importance of prudent economic policy, quantitative easing and fiscal stimulus. In the same fashion, Japan's mistakes in United States investment can provide similar warning signals, as the investments were made despite worsening trade disputes, high U.S. unemployment and with a United States which was less than confident as a nation after the 1970s.

The objective of these brief observations is to provide some basis for discussion to calmly put into perspective the mistakes and obstacles that major Japanese investment in the United States faced as a counterpoint to current Chinese investment trends. Many of these observations are based on exchanges with those who were directly involved in the early wave of Japanese investments, as well as the subsequent workouts and divestiture of failed investments. Of course, China and Japan are completely different, with distinct economic and political factors. However, both China and Japan are non-European countries investing in the United States, with large U.S. trade deficits and other sources of trade friction. Therefore, the mistakes noted here hopefully illustrate some of the issues and solutions taken. It is also important in perspective to note that in the end, despite such mistakes and missteps, major Japanese investment in the United States continues to thrive today, amounting to many hundreds of billions of dollars, with no negative public reaction to new Japanese investment or M&A.

First of all, as to the Japanese mistakes, there are many, but not all are necessarily unique to the Japanese. Japanese investment in the 1980s was part of a massive investment bubble, with all its characteristic lofty projections of, in hindsight, unrealistic growth and returns. Through rapid Japanese economic growth, currency appreciation under the Plaza Accord and other factors, Japanese corporations controlled massive amounts of capital to invest abroad. While it is simplistic to list just a few of the Japanese mistakes under these extraordinary economic circumstances, the obvious mistakes and issues noted below are: trophy purchases and herd mentality; difficulties in managing U.S. operations; failing to gauge the local and political climate; and general cultural issues.

TROPHY PURCHASES/HERD MENTALITY

To many observers, the acquisition of Rockefeller Center in the late 1980s was symbolic of the Japanese threat felt in the United States; the buying up of America. It was an example of a trophy purchase, a high visibility, U.S. brand name, high-end acquisition by one of Japan's pre-eminent corporations. It subsequently became a symbol of failure after a bankruptcy filing in 1995 and large losses from a real estate market downturn. Another trophy was the Tiffany building bought in 1986 and subsequently sold at great loss. The Universal Studios acquisition by Matsushita is often mentioned as well. These acquisitions, while carefully executed, occurred during a Japanese investment frenzy with domestic and foreign acquisition exacerbated by intense competition among Japanese corporations to invest. In the real estate area, numerous Japanese real estate and finance companies competed against each other to buy, and bid up the price of, trophy buildings especially in Los Angeles and New York.

The Universal Studios deal is said to have been triggered largely by rival Sony's acquisition of Columbia Pictures. With such focus on "brand" and trophy asset values, business analysis went to the wayside. Japanese acquirers feared "missing the boat" when competitor Japanese were buying---resulting in a herd mentality even among the most sophisticated Japanese corporations. In turn the U.S. sellers of assets and investment advisors were more than pleased to sell at the height of the market, feeding this frenzy.

While Chinese acquisitions are more carefully planned from a business perspective and generally conducted only upon approval by the Government, with a prudent focus on global natural resources and energy, the binge acquisition by the Japanese warrants caution.

DIFFICULTIES IN MANAGING U.S. OPERATIONS

Another obstacle that affected Japanese acquisitions was the difficulty in dealing with the managerial demands of owning and operating a local U.S business after acquisition. While the Japanese excelled as manufacturers and exporters of product, with Japanese executives sent around the world, the ability of the Japanese to manage non-Japanese businesses acquired in a short time frame was a great stress, for acquirer as well as those acquired. At certain businesses, the accusations of discrimination or unequal treatment of U.S. employees, while seemingly overblown, did not help. For the homogenous Japanese business culture, the ability to develop global management talent able to meld U.S. and Japanese business norms was greatly taxed and resulted in many failed ventures.

Similar challenges may face the Chinese as their investment spectrum broadens.

However, as a counterpoint, despite Japanese missteps, there were many success stories in the establishment of Japanese transplant manufacturing facilities throughout the United States and operated by a U.S. workforce. This was a great challenge that has been largely viewed as a success.

FAILING TO GAUGE THE POLITICAL CLIMATE

The phrase "Japan bashing" symbolized those early days. Political confrontation caused by U.S. high unemployment, U.S. loss of manufacturing competitiveness and incidents like the Toshiba Machine illegal export of technology to the Soviet Union, led to television images of national politicians sledge hammering Toshiba products and seeking broad restrictions on import of Japanese goods. With 20-20 hindsight, it was a failure to foresee the unprecedented poisonous U.S. political climate and xenophobia. The suspicion and threat of Japanese investment were also intensified at times by reactions from Japan as well. In the Japanese press, Japanese pride in their unprecedented economic growth and manufacturing prowess resulted in a view that the teacher, the United States, had suddenly become the student of Japan, further stoking U.S. resentment. In the end, while threats of trade wars were real, cooler heads prevailed, although "voluntary" trade restrictions on Japanese products were imposed. In addition, more scrutiny was imposed, including the review of nationally strategic acquisitions (well-known in China as "CFIUS") originated in this period.

The best lesson from this failure is to expect the unexpected, as few at the time anticipated the intensity of those disputes. It would appear that China is much more strategic and sensitive to the potential conflicts in any case. Furthermore, Japan's acquisitions in the 1980s, though global, were heavily focused on the United States, and China's broadly distributed global investment patterns may reduce political risk.

Cultural Issues

Cultural issues is a broad term and catch all for the overall relationship of the United States and Japan. In the 1980s, after the Vietnam War, the Japanese threat from an alien society was a new economic one to Americans, adding to the sense of fear. Despite the fact that European investment/acquisitions in the United States were greater at the time, the news headlines often seemed to portray a sinister Japanese plot.

As noted earlier, from the Japanese perspective, the tables had turned and the studious student was overtaking the respected but ailing teacher, the United States. Despite being a close ally in the post-Cold War world, Japan's cultural clashes with the United States escalated. The following chart shows the similarities and differences between the 1980s and now.

Comparison Chart

Factor	Japan 1980s	China 2011
Trade Imbalance	Yes	Yes
Export led growth strategy	Yes	Yes
Exchange Rate Policy	Floating but with market intervention; followed in 1985 with the Plaza Accord's planned and orderly USD devaluation (51% by 1987)	Fixed within a narrow range
Capital Controls	No	Yes
Industrial Policy	Yes (Japan Inc.)	Yes but even more so - Preponderance of State Ownership/SOEs
Inbound FDI restricted and highly regulated	Yes	Yes (although China is one of the top destinations for FDI, there are significant restrictions on the form of investment and the sectors where it is permitted)
Close political, strategic and military ally	Yes	No (the only one of America's top ten trading partners that is not)
Primary area of FDI interest	Manufacture locally; establish a U.S. manufacturing base providing local employment	Acquire international brands; acquire supply inputs (e.g. oil) and strategic technologies, resulting in little or no local employment

Source: Brian Beglin/Joel Moser

What Could Be Done?

At the time, colleagues dealing with Japanese investment issues were bombarded by requests for advice on what concrete measures could be taken. There was no panacea and only through years of effort at the U.S.-Japan business, government and public levels did relations reach an equilibrium. At the business level the following trends were notable.

Investment Structure

To deal with the criticism of trophy purchases, Japanese investment advisors increasingly advised that acquisitions be less "trophy" prominent and involve initial minority purchases with options or grants to increase effective control. Presumably, this gave the acquisition less news headline value. A most notable example of this gradual approach was the Sony acquisition of the New York AT&T headquarters building. Use of third parties or intermediaries, while subject to regulatory disclosure, was also seen as easing public and political concerns.

Be A Big U.S. Employer

Due to fear of tariff wars and sanctions as well as voluntary export restraints in the auto industry, Japanese companies were forced to increase local U.S. production, which had the benefit of greatly increasing U.S. employment. While most exports to the United States continued to be from Japan factories, the appearance of these new state-of-the-art manufacturing facilities throughout the United States balanced the debate. Japanese corporations' employment of U.S. employees grew to well over 600,000 and state governments throughout the United States scrambled to provide incentives to bring in such Japanese facilities.

Grass Roots

Grass roots local support of investment was a powerful counterbalance to fear and suspicion of Japanese investment. Not only Japanese transplant factory American employees but American suppliers, dealers and customers became key allies for Japanese corporations. Rather than have Japanese executives and Japanese corporations make the case for Japanese investment in the United States, the Japanese found such Americans to be the most effective advocates. Japanese government coordination and support of these private efforts, not only at the U.S. federal, but also at the state and local government level, were also effective.

These grass roots efforts may be of most interest to Chinese investors. With high U.S. unemployment, state and local government budgets strained, certain types of Chinese investment, if prudently presented, would be welcomed with open arms and provide a similar counterbalance.

Summary

The growth of Chinese investment in the United States will be welcome in the end, while there will be many bumps and obstacles down the road. In reality, if Chinese investment is unwelcome in the United States, it will go elsewhere. Furthermore, China has the added advantage of being the largest creditor of the U.S. government, as well as an extremely attractive market for U.S. businesses, in comparison to the closed Japanese market of the 1980s. Thus, trade wars would hurt such U.S. businesses more directly. Nonetheless, the mistakes of the Japanese, though often obvious in hindsight, can be of great reference in avoiding the unnecessary and damaging escalation of tensions in the 1980s.