EU-Japan Centre for Industrial Cooperation

Investing and localizing in Japan

An analysis based on interviews of European investors and investment facilitators

Tokyo, October 2011

Disclaimer

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List of abbreviations

ACCJ	American Chamber and Commerce in Japan
ACTA	Anti-Counterfeiting Trade Agreement
ASEAN	Association of South-East Asian Nations
EBC	European Business Council
FDI	Foreign Direct Investment
FTA	Free-Trade Agreement
GDP	Gross Domestic Product
IBSC	Invest Japan Business Support Center
IP(R)	Intellectual Property (Rights)
JETRO	Japan External Trade Organization
JIC	Japan Investment Council
METI	Japanese Ministry of Economy, Trade and Industry
MNC	Multinational Corporation
NIE	Newly Industrialized Economy
OECD	Organization for Economic Co-operation and Development
SME	Small and Medium Enterprise

Contents

A.Introduction

The purpose of this report is to offer prospective investors a practical and updated assessment of the attractiveness of Japan as a location for inward FDI in the following context: 1) increasing competition from neighbouring Asian countries to attract inward FDI, and 2) the impact of the March 11 Tohoku Earthquake on the Japanese economy. The report starts with a background description of inward FDI in Japan (section B) followed by key findings (section C) - based on the analysis of a summary of interviews of European investors and investment facilitators, performed in the course of summer 2011 – and conclusive remarks (section D).

1. Background

Having a significant head start in economic development, Japan was long the natural location in Asia for European companies to base their regional operations. However, in recent years, newly industrialized economies such as the Four Tigers,[1] ASEAN[2] as well as the two giants of China and India have increasingly moved up the value and knowledge ladder, challenging Japan in areas where it has long been the undisputed regional leader. As a result, several companies have gone so far as to relocate not only production facilities but also Headquarters (HQ) and R&D functions away from Japan. Moreover, the multiple disasters of March 11 inflicted not only direct damages on the Japanese economy, but could also have a detrimental effect on the overall investment climate.

The government of Japan has recognized that Japan has much to gain from foreign investment. The long-continuing economic downturn, coupled with the recent developments above, have led to a sense of urgency that proactive measures need to be

[1] Hong Kong, Republic of Korea, Singapore and Taiwan (Province of China).

[2] Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

taken in order to attract investors and keep those who are already established in Japan. Along with a proposed corporate tax cut, the Government of Japan is launching a series of initiatives under its Inward Investment Promotion Program, including a subsidy program for Asian site location, Comprehensive Special Zones and immigration system reform to increase the attractiveness of Japan as an investment target. It is also deepening its ties to the world economy by pushing forward plans on Free Trade Agreements with a number of economies, including the European Union.

2. Purpose of study

While not gaining as much attention as developing Asia, Japan remains a leader in a number of fields and provides a unique offering to investors. The main purpose of this report is to present what factors are driving foreign companies to continue investing in Japan.

Attention will be given to Japan's comparative advantages in the region, where several actors have emerged in recent years and are actively promoting inward FDI. Moreover, possible effects of the March 11 disaster and its aftermath on foreign companies' views on Japan will be explored. These should not be limited to negative effects, considering that such crises often force needed change that is hard to achieve under regular circumstances. Lastly, the foreign community's view on recent FDI promotion programs undertaken by the Japanese Government will be assessed in order to find out whether these initiatives are in line with the needs of foreign investors.

Since the goal is to understand how foreign investors reason when making investment decisions, qualitative data was gathered through interviews with European firms and related organizations. Two thirds of all interviews were conducted face to face and the rest were divided evenly between telephone or E-mail, depending on the availability of the respondent.

In total, 12 firms and 6 organizations were interviewed for the study. Participants represent 12 countries, all of which are EU members or associated countries. Companies' Japanese operations represent all stages of market entry and commitment, ranging from exports to representative offices, joint ventures, R&D facilities and wholly-owned subsidiaries to Japanese firms established by European nationals. Firm size and time of first investment in Japan varies accordingly, from newly established ventures to deep-rooted MNCs with several decades of experience. Moreover, companies were selected to reflect as many different industries as possible. Participants represent electronics, medical products, fashion, food, telecommunications, transportation and business services, among others.

3. Investing in Asia

FDI in Japan is not only the result of the domestic investment climate, but is largely dependent on its relative attractiveness in the region. Japan has never been any significant recipient of investment in cost-cutting, labor intensive production which has been the main objective for foreign firms investing in Asian NIEs. However, as these economies grow, they have been increasingly challenging Japan as a host for investment in high value-added functions. It is clear that convergence is in process: according to World Economic Forum, all Asian Tiger economies but Taiwan have already reached the third stage of development, becoming "innovation driven" economies.

Stage 1	Stage 2	Stage 3
• Brunei*	• China	• Hong Kong (SAR)
• Cambodia	• Malaysia	• Japan
• India	• Taiwan (China)*	• Rep. of Korea
• Indonesia*	• Thailand	• Singapore
• Philippines		
• Vietnam		

Figure 1. Development stages of Asian economies. Asterisks indicate economies in transitional stages. Source: World Economic Forum (2010).

The fact that firms think regionally when investing is clear: in recent years, a number of companies have chosen to close down their Japanese operations in favor of other Asian countries. 2008 saw Swiss pharmaceutical giant Novartis move its Japanese R&D center to Shanghai. The following year, P&G and Medtronic relocated their regional headquarters to Singapore, causing further concern that Japan may be losing out to the local competition (METI, 2010c). In order to find out about Japan's attractiveness among other Asian countries, the Japanese government has launched a number of surveys. The two main surveys, on which this section will be based, are the annual *Comparative Survey of Investment-Related Costs in Major Cities and Regions in Asia* and the *Japan Attractiveness Survey.* The two cover statistical data on business costs and investment attractiveness in the eyes of foreign companies, respectively.

China getting increasing attention

As can be seen from the table below, it is clear that China and its remarkable economic growth is gaining worldwide attention. In regard to labor intensive production facilities, China has long been foreign investors' host country of choice, primarily because of the low wage levels.

	Regional headquarters		R&D center		Logistics center		Production center	
Rank	**2007**	**2009**	**2007**	**2009**	**2007**	**2009**	**2007**	**2009**
1	Japan	China	Japan	China	China	China	China	China
2	Hong Kong	Singapore	China	Japan	Hong Kong	Singapore	India	India
3	China	Hong Kong	India	India	Japan	India	Rep. of Korea	Rep. of Korea
4	Singapore	Japan	Singapore	Singapore	Singapore	Hong Kong	Hong Kong	Hong Kong
5	India	India	Hong Kong	Rep. of Korea	India	Japan	Japan	Singapore
6	Rep. of Korea	Rep. of Korea	Rep. of Korea	Hong Kong	Rep. of Korea	Rep. of Korea	Singapore	Japan

Table 1. Attractiveness of Asian economies by type of investment. Source: METI (2010d).

The same rings true for logistics centers, which tend to be located in close proximity to production. However, in recent years, China has become the most attractive host for investments not only in production and logistics centers, but also in R&D and regional headquarters. Also, Japan has found itself surpassed by the financial centers of Singapore and Hong Kong (SAR) regarding attractiveness for regional headquarters.

Tax levels

One of the main reasons for choosing to invest in developing Asia, apart from low labor costs, is the competitiveness of corporate tax rates. Hong Kong (SAR), Singapore and more recently Taiwan (Province of China) could be regarded as tax havens with a corporate tax rate at 16.5-17 percent (OECD, 2011a). The Republic of Korea, China and the ASEAN countries have a corporate tax rate at 25 percent, while India has positioned itself higher, at 33 percent. Japan, however, has the highest corporate tax rate in the region at approximately 40 percent. In fact, it has the second highest corporate tax rate among OECD members, after the United States.

A number of Asian economies are offering a variety of incentives to sweeten the deal for prospective foreign investors. The Republic of Korea and Singapore both have subsidies as well as a preferential tax treatment to attract investors (METI, 2010c). While the Japanese government has offered practical help through its Investment Support Business Centers, preferential tax treatment has traditionally been in the hands of local governments.

Increasing business costs in developing Asia

As explained above, the undisputed main reason for investing in developing Asia is to benefit from lower operational business costs. However, one inevitable result of economic development is increasing business costs, not the least by higher wage levels. Asian NIEs are no exception to this rule, as real wages for manufacturing workers are increasing by over 10 percent per year (Chow, 2011). Indian wages are growing at an even more rapid pace, and the same trend can be seen in ASEAN member states (JETRO, 2010a).

History tells that investment driven by low wages tends to be fickle and move as soon as wages rise. Also, foreign investment in labor intensive, low value added production rarely results in the desired technology transfers and knowledge spillovers that developing economies seek when attracting foreign investment. Therefore, it is unclear how desirable investment driven largely by low wages is in the long run.

Moreover, land prices are on the rise all across developing Asia. In the 2010 JETRO survey on business costs in Asian cities, Yokohama was found to have lower housing costs than 12 of the 29 targeted cities[3]. This rampant rise in housing prices is a tell-tale sign of speculation and expectations on these economies, which may or may not be realized.

4. The March 11 Tohoku earthquake and tsunami

The Tohoku earthquake of March 11, 2011 was the most powerful earthquake in Japanese history and, coupled with the resulting tsunami, the country's most severe disaster of the post-war era. Moreover, it led to the Fukushima nuclear crisis which is yet to be fully resolved and may alter the views of the general public on nuclear power worldwide.

Humanitarian and infrastructure damages

The disaster led to a casualty toll of more than 20,000 and approximately 300,000 refugees in the affected regions (National Police Agency, 2011). Damages on electrical

[3] Cities with higher housing costs than Yokohama: Beijing, Shanghai, Guangzhou, Dalian, Shenyang, Singapore, Jakarta, Hanoi, Ho Chi Minh, New Delhi, Mumbai, and Karachi.

infrastructure left 4.4 million households without electricity, and a reduced supply of electricity forced electric utilities to implement planned blackouts. However, recuperation efforts and voluntary reduced electricity use alleviated the need for blackouts. Also, ten days after the earthquake, electricity had been restored to 94 percent of all households that initially lost electricity. New homes were provided for two-thirds of all displaced during the first three months following the disaster.

Economic impact

The earthquake and tsunami led to considerable damage on social infrastructure, housing and private firms' fixed capital. On the day after the earthquake, the Government of Japan estimated the direct material damages at 3-5 percent of GDP (OECD, 2011a). The Bank of Japan was not late to react and downgraded its assessment of the affected regions, while injecting 15 trillion yen as an emergency measure to ensure financial stability.

The northern Tohoku region, which was most heavily affected by the disaster, accounts for approximately 8 percent of Japan's GDP and a large number of factories were completely or partially destroyed by the earthquake and tsunami. Three months after the disaster, 30 firms in the directly affected areas had been forced into bankruptcy, and an additional 179 Japanese companies cited the earthquake as the main reason for their closing down.

Reconstruction and recuperation

While it is still too early to tell whether the measures taken are sufficient and how well the reconstruction process will progress, previous experience of similar disasters in developed countries inspires hope. The Northridge earthquake in 1994 and the Kobe earthquake the following year were both followed by a drop in industrial production, only for the local economies to rebound when reconstruction picked up speed and consumers started to replace their lost property.

B. Inward foreign direct investment in Japan

The following chapter will present an overview of inward foreign direct investment in Japan. After explaining historical developments and Japan's evolving attitude toward foreign investment, a summary of recent initiatives that have been taken to increase Japan's attractiveness as an FDI host will be presented.

1. Chronology of inward FDI

Traditionally low levels of inward FDI

Japan has a long history of regulating trade and investment in the country. Following the Meiji Restoration (1868), after which the country committed to trade liberalization and as a result quickly industrialized, foreign investment remained negligible. Instead, technology was acquired through visiting engineers and licensing contracts (Fukao & Amano, 2003). This development did not change dramatically after WWII, when the Foreign Exchange and Foreign Trade Act was more or less offset by a licensing system that, by allocating foreign exchange, continued to limit inward FDI.

The accession of Japan to the OECD in 1964 marked another opportunity for increased inflows of FDI. Capital liberalization was dealt with in a six-year program, which theoretically paved the way for foreign investors. However, Japanese companies took protectionist measures by setting up cross-shareholding schemes in order to avoid mergers, acquisitions and buyouts by foreign firms (Sakamoto, 1989). Especially in industries where domestic companies had not yet become internationally competitive, investment was efficiently delayed or obstructed (Fukao & Amano, 2003).

Japan's catching-up in manufacturing continued, and by 1980 most domestic industries were competitive enough not only to hold their ground at home but also to gain market shares abroad. During the 1980s, further FDI liberalization was realized and while there was a marked increase in investments, especially in wholly foreign-owned subsidiaries, many foreign investors were still encountering difficulties when taking on the Japanese market. Facing fierce competition in manufacturing, foreign investment turned to the non-manufacturing sector which overtook manufacturing as an FDI destination in 1989 (JETRO, 2011b).

The burst of the bubble as a turning point

The burst of the bubble economy in the early 1990's led not only to low growth and what would become known as the "lost decade", but also to positive developments for inward FDI. Many Japanese firms, including large financial institutions, were forced to file for bankruptcy or make redundancies, resulting in increased labor market liquidity. This was welcomed by foreign investors, who had had difficulties in recruiting highly-skilled Japanese employees because of the life employment system (EU-Japan Centre for Industrial Cooperation, 2010a). Moreover, the Japanese financial "big bang" of the early 2000's, with widespread deregulation of not only the finance sector but also telecommunications, services and retail, opened the door for further inward FDI (Fukao & Amano, 2003).

Proactive FDI promotion during the past decade

The wake of the burst bubble also gave birth to active FDI promotion in Japan. 1994 saw the establishment of the Japan Investment Council (JIC), which was comprised of not only Japanese officials but also representatives from Europe (EBC) as well as the US (ACCJ). Five years after its establishment, JIC formulated seven recommendations for inward FDI promotion. These recommendations dealt with measures necessary to establish an FDI-friendly climate, and further deregulation followed. In 2003, the JIC announced its goal to double Japan's inward FDI stock in the five-year period between 2001 and 2006 (Copenhagen Economics, 2009). In order to facilitate for foreign companies to enter and invest in the Japanese market, the Japan External Trade

Organization (JETRO) changed its focus during the early 2000's from supporting Japanese exports to promoting inward FDI in Japan. Among other measures, Invest Japan Business Support Centers were set up in six locations. Each year, over 1000 foreign companies - of which two-thirds are contacted by JETRO - make use of these offices' consulting services and temporary office space to get their Japanese operations started (EU-Japan Centre for Industrial Cooperation, 2010a).

Subsequently, the JIC objective of doubling Japan's inward FDI stock was realized in 2006. Its next goal was more ambitious: to double the relation of the inward FDI stock to GDP by 2010. As can be seen in the figure below, the stock grew rapidly, surpassing the target value before the 2008 global financial crisis, which slowed down investments not only in Japan but worldwide.

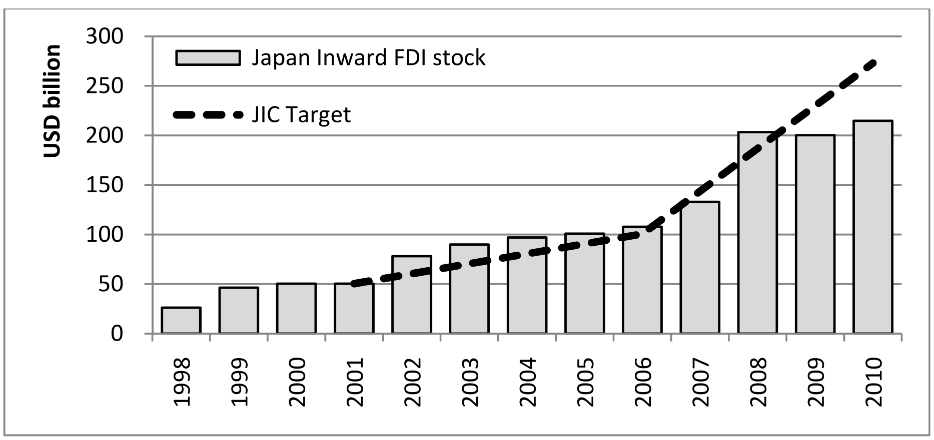

Figure 2. Inward foreign direct investment stock of Japan and JIC target values.
Sources: UNCTAD (2011); JETRO (2011b).

2. Recent initiatives to attract inward FDI

FDI promotion in Japan has been for a long period in the hands of prefectures and municipalities. Howver, in the past few years, the Government of Japan has shown increased commitment to attract inward FDI on the national level and drafted a number of measures. This section is not exhaustive and should be seen as a summary of a selection of measures that are happening during the time of writing of this report. For up-to-date details regarding each initiative, please consult with the JETRO website.

Five Recommendations Toward the Drastic Expansion of FDI in Japan

In 2008, the JIC was succeeded by the Expert Committee on FDI. The same year, five recommendations were formulated that would set the stage for coming FDI promotion activities in Japan:

- Enhancement of system toward the facilitation of M&As
- Comprehensive studies on Foreign Direct Investment regulations
- Establishment of priority strategies by sector
- Reduction of business costs and improvement of system transparency
- Regional revitalization by foreign capital, strengthening of appeal that foreign capital is welcome, etc.

Table 2. Five Recommendations Toward the Drastic Expansion of FDI in Japan.
Source: Invest Japan (2008a).

While the aforementioned seven recommendations put forth by the JIC in 1999 dealt mainly with consolidating the business environment by revising laws and regulations, the current agenda is focused on actual FDI attraction. The recommendations are accompanied by a 91-point action plan, detailing the necessary actions to attract and keep foreign direct investment (Invest Japan, 2008b).

Inward Investment Promotion Program

In August 2010, newly appointed Prime Minister Naoto Kan directed METI to draft a program for promoting inward FDI and creating new jobs (METI, 2010c). The result was the Inward Investment Promotion Program, which consists of the following four points:

■ Establishment of a “Regional Headquarters for Inward Investment Promotion”
■ Establishment of the “Factory Location Consulting Desk”
■ Nationwide Application of Best Practices
■ “Pro-growth” Reform of Location Regulations

Table 3. Inward Investment Promotion Program. Source: METI (2010c).

Subsidy Program for Projects Promoting Asian Site Location in Japan

One of the tasks above was addressed by the 2010-2011 Subsidy Program for Projects Promoting Asian Site Location in Japan, which is geared toward localization of foreign companies' regional HQ and R&D sites (JETRO, 2010a). The two different functions are defined as follows:

- **Asian HQ:** Deploying skilled personnel and making business decisions for the Asia region with regard to marketing, corporate planning, sales, distribution, R&D and other functions.
- **R&D base:** Utilizing innovative technology and skilled personnel to carry out R&D, or developing innovative technology and products for the global market through collaboration with Japanese universities, SMEs, etc.

Table 4. Definitions of Asian HQ and R&D base to be used in the Subsidy Program for Projects Promoting Asian Lite Location in Japan. Source: JETRO (2010a).

Foreign companies that fulfill the requirements are to apply to the program. Applications are then screened by JETRO who ultimately decides which companies may take part in the subsidy program. Accepted firms receive a number of benefits, including the following:

- A 20 percent corporate income tax deduction for five years
- Preferential income tax: Same tax treatment for stock options from the foreign parent company as given to those from Japanese companies
- SME patent fees reduced by half for certified R&D operations
- Expedited immigration procedures
- Faster investment procedures: Halving of the inactive period
- Financing support by the Small and Medium Business Investment & Consultation Co.
- Shorter statutory inaction period (from 30 days to 2 weeks) after prior application for inward direct investment

Table 5. Subsidy Program for Projects Promoting Asian Site Location in Japan.
Source: JETRO (2010a).

Comprehensive Special Zones

Another recent initiative is the Comprehensive Special Zones, which was presented in December 2010 and passed the Diet in June 2011. Two different zone types have been proposed: (1) one in each prefecture for rural revitalization and (2) Zones for International Strategy (JETRO, 2010b). The main objective for the latter is to offset the "hollowing out" of the Japanese economy by attracting foreign investment and strengthen the international competitiveness of Japanese companies. Among the incentives offered will be:

- Corporate income deductions, enabling corporate income tax deductions of 20%
- Investment tax credits or special depreciation when acquiring assets such as machinery and buildings
- Special depreciation ratio: 50% of acquisition price (25% for buildings)
- Tax credit ratio: 15% of acquisition price (8% for buildings)
- Credit surplus carryover limit: 1 year

Table 6. Comprehensive Special Zones. Source: JETRO (2010b).

Immigration system reform

Several changes to the Japanese immigration system are planned to take effect in the coming years. The New Immigration Control Act will be enforced by July 2012, leading to an overall liberalization of the immigration system (EU-Japan Centre for Industrial Cooperation, 2010b). Among the changes is an extension of the maximum period of stay from 3 years to 5 years, no more need for a re-entry permission when re-entering Japan within one year from departure and an abolition of the current Alien Registration Card, which will be replaced by a Residence Card.

Moreover, a point system for immigrants has been proposed by a special committee (Cabinet Secretariat, 2009). The general idea behind the system is that points will be awarded for immigrants based on a set of different criteria, including educational background, work experience, salary and Japanese language skills. High-scoring individuals will then enjoy expedited immigration procedures when entering the country.

Corporate tax cut

As explained in the section on regional competition, the corporate tax in Japan is considerably higher than elsewhere in the region. The Government, aware of the implications regarding Japan's FDI attractiveness, has proposed a corporate tax cut of five percentage points for 2011 (METI, 2010e).

Ernst & Young (2011) considers this decision as a bold move, considering the recent 95 percent dividend exemption which would further heighten the attractiveness of Japan. Moreover, lowering taxes while running a budget deficit shows firm determination to promote inward FDI. Needless to say, a decrease in the corporate income tax rate would also lighten the tax burden of Japanese companies.

EU-Japan cooperation

In addition to domestic initiatives, measures are also being taken on bilateral as well as on multilateral bases. Most importantly for EU-Japan relations, in May 2011, an agreement was signed to commence a scoping study of a long-awaited Free Trade Agreement that would boost trade and investment flows in both directions (Council of the European Union, 2011). While negotiations will take years, hopes are high and the experiences of the Japan-Switzerland FTA of 2009 as well as the EU-Republic of Korea FTA of 2011 could help in the negotiations.

C. Findings

In this chapter, primary information gathered in the interviews will be presented alongside relevant secondary information. Since the interviews were semi-structured and aimed at probing for qualitative data based on each interviewee's experiences, the results have not been quantified.

In total, 12 firms and 6 organizations were interviewed for the study. Participants represent 12 countries, all of which are EU members or associated countries. Companies' Japanese operations represent all stages of market entry and commitment, and vary in size as well as time of first investment. Moreover, companies were selected to reflect as many different industries as possible.

1. Investment drivers

Market

The respondents to the study all agreed that the main reason for European companies to invest in Japan is the lucrative market. While accounting for only 3 percent of Asia's population, approximately half of the regional retail demand can be found in Japan (JETRO, 2009b). Moreover, it has to be remembered that Japan's export propensity, i.e. its reliance on foreign markets, is modest at approximately 15 percent (World Bank, 2011; UNCTAD, 2011). While Japanese companies have become famous for exporting standardized products such as electronics and cars all over the world, Japanese growth has, by a large part, been driven by the domestic market.

The Japanese market is not only large but also sophisticated. Several participants from widely different industries referred to the Japanese market as a starting point for global trends. Customer attention - or customer innovation - is high in Japan, and provides valuable input for foreign companies to learn and improve their products or services.

The Japanese consumer has traditionally had different demands than the average European consumer, making it necessary to heavily adapt products geared toward the Japanese market. Moreover, there have been signs of the “Not Invented Here” syndrome, in which consumers avoid foreign products. However, this has not been a major problem for European companies, since “made in Europe” is seen as a seal of quality. Also, there are signs that convergence in consumer behavior is taking place. Salsberg (2010) highlights four different trends that are currently shaping the mindset of the Japanese consumer:

- Hunting for value
- Spending more time at home
- Buying products differently (less in department stores, farther from home and on the Internet)
- Being health- and environmentally-conscious

Table 7. Changes in Japanese consumption behavior.
Source: Salsberg (2010).

These developments are bringing the Japanese consumer closer to foreign firms’ offerings and there are clear examples of companies that have benefitted from these changes. After a foray in the 1970’s which ended in a withdrawal from the Japanese market, furniture giant IKEA made a second try in 2006 and was welcomed by the new, value-conscious Japanese consumer who spends more time at home, resulting in an increasing interest in affordable furniture.

The changing mindset of Japanese consumers is leading to growth in so far underdeveloped markets. One respondent in the organic food business mentioned that the company is doubling in revenue each year as the market is growing. Also, certain business services are showing large potential as Japanese companies divest non-core operations - one participant mentioned that one main obstacle in making business in Japan was finding experienced Japanese staff, because of the lack of local competition.

Moreover, Japan's ageing population is leading to a growing market for the elderly. This is not limited to medical services, since the country's healthcare is of a good standard and Japanese consumers are expected to live an active life for decades after retirement. While an ageing society is a serious issue in macroeconomic terms, it provides an opportunity for foreign firms to get a look at how the demands of an aged society look like, and prepare for when other markets' demographics reach the same stage.

Business and industry

Attention to details is not only on the consumer side but also extends to industry. Japanese companies have become renowned for their production and quality assurance systems, with Toyota being the most famous example (Liker, 2003). The rigorous quality demands of the Japanese have helped several of the respondents improve their production systems worldwide by implementing input from Japanese engineers, resulting in more efficient operations.

Japanese companies are very active in research and development. R&D expenditure relative to GDP is the highest in the world, as well as the number of patents applied for.

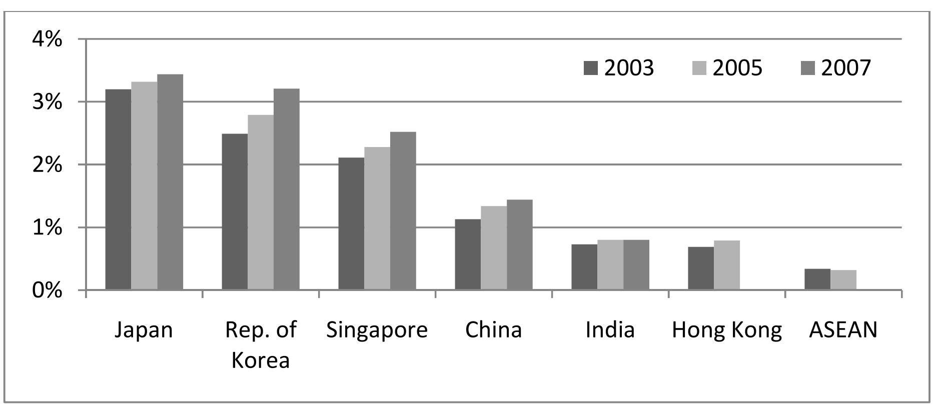

Table 8. R&D expenditure, as % of GDP. Source: World Bank (2011).

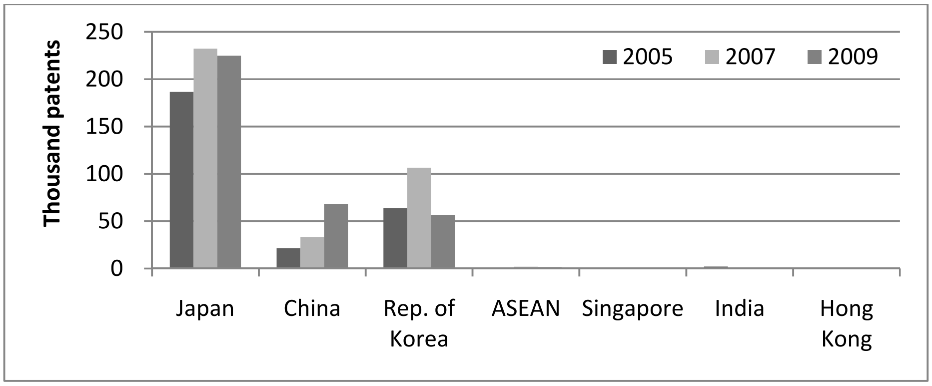

Table 9. Patent application filings. ASEAN, Singapore, India and Hong Kong (SAR) did not exceed 2,500 patents during the observed period. Source: WIPO (2011).

Lately, Japanese companies have been increasingly engaging in strategic alliances and joint research ventures with European firms, in order to gain mutual knowledge transfers. A study found that among foreign companies that conduct R&D in Japan, 40 percent cite research and intellectual achievements as a reason for choosing Japan (JETRO, 2007). One respondent representing a foreign telecommunications firm which has an R&D center in Japan mentioned that their Japanese counterparts are more willing to cooperate with foreign actors, since they do not compete in each other's markets.

The Japanese business culture is characterized by long-term cooperation, fair negotiations and mutual trust. While negotiations may take longer time than is usual in Europe, business partners show commitment in their relationships. As put by a participant with 30 years of business experience in Japan, "if you demand one-hundred percent effort from your Japanese partners, you often get 150 back".

Respondents were united in their belief that a physical presence is essential to succeed in Japan. Commitment to the market and one's business partners is highly valued, and needless to say, one has to be located in Japan in order to benefit from input from customers, business partners and competitors. In fact, a presence in Japan may be crucial to be globally competitive, seeing the number of globalized, market-leading Japanese firms. In the words of another participant with several decades of experience, "You cannot ignore the Japanese, and the best way to understand them is to have your feet on the ground here."

Institutions, social factors and infrastructure

Not only compared to developing Asia but also to other high-income countries, the Japanese society is characterized by a high standard of living and public safety. Infrastructure, both for transportation and communication, has a very high standard - the *shinkansen* bullet trains have been running since 1964 with only one derailment (during the 2004 Chuetsu earthquake) that caused no casualties. Moreover, health and primary education is ranked 9th in the world (World Economic Forum, 2010), and crime rates are famously low. Japan is widely considered to be a comfortable place to live, which is a factor that is important for investment decisions albeit difficult to quantify.

2. Challenges met when investing in Japan

Foreign firms invariably meet challenges when entering foreign markets, and Japan is no exception. While obstacles to investment vary across industries, the three main issues that foreign companies investing in Japan have to tackle are language, taxes and labor costs[4] (JETRO, 2008a). These three areas were echoed by the participants in the study when asked about the main challenges when doing business in Japan.

English proficiency is largely related to staffing for foreign companies that rely on expatriate managers and daily communication being carried out in English. While EF (2011) ranked Japan's proficiency in the Moderate Proficiency group along with Switzerland, Hong Kong (SAR) and France, many foreign firms claim difficulties in

[4] For a complete overview of issues targeted by the European community, please refer to the annual European Business Council (EBC) White Paper.

finding English speaking staff. This is also related to the aforementioned traditionally low liquidity of the Japanese labor market, where many have been guaranteed job security in the life employment system. However, as explained earlier, career management is gaining in popularity in Japan. A respondent at a firm specialized in finding Japanese talent for foreign firms stated that foreign firms are still considered more risky than Japanese companies, though European ones have a reputation of being more secure than their American counterparts. Needless to say, foreign firms also have their advantages in the minds of Japanese job seekers, such as higher levels of responsibility, international exposure and higher salaries.

Another trend in staffing is to increase the ratio of local Japanese staff to expatriates. By doing this, firms not only save on labor costs but also allow themselves to stay closer to the Japanese market, avoiding the various liabilities of foreignness. Several respondents mentioned the importance of having Japanese nationals on the board of directors and in managerial positions.

Being a high-income country, Japan is characterized by relatively high operational costs. However, profit margins tend to be higher than in the European market, offsetting the negative impact of higher costs. Several respondents in the retail sector mentioned that their products sold in Japan are both more expensive and have higher profit margins than in their respective home markets.

The Japanese market is marked by tough competition, and it is crucial for foreign firms to ensure that there is strategic fit in order to succeed. Care has to be given in order to position oneself correctly and show sufficient market commitment - as one respondent put it, “bad management will show in Japan”. The Japanese market is notorious for taking time to succeed in - few foreign firms see profits in the first three years, with five not being unusual. Several participants admitted to having to change their strategy half-way, after realizing that things could not be done in the same way as in other markets.

In order to minimize discrepancies between expectations and the Japanese reality, firms use a variety of sources to conduct market research prior to entry. Business consultancy firms or Chambers of Commerce are widely used, as well as existing business partners. Approximately one-fourth of all respondents used JETRO's Investment Support Business Centers to set up their Japanese operations. All were satisfied with the services offered and state that while it was not a decisive factor behind their investment, it certainly helped with legal advice and office space. Some respondents that did not use ISBCs would have preferred doing so, had they known of their existence. Regarding incentives from their respective home countries, some participants were granted financial assistance.

3. Alternative host countries in Asia

When asked about Asia as a region, most respondents answered that the differences in culture, politics and economic development remain too large as to warrant Asia being called more than a strictly geographic region. The reasons for investing elsewhere in Asia are different from the reasons for investing in Japan, and thus the different economies are seen as complements to each other rather than competitors.

Many participants have operations in several Asian economies, acting as separate entities and tending to their respective markets. While only a few have regional headquarters in Asia, there seems to be a trend to locate such functions in Hong Kong (SAR), Singapore or China. Considering the geographical and logistical advantages in such localizations, as well as the number of Asian economies currently going through the same phase of economic development, it may be justified to localize any Asian headquarters to this part of Asia. For the same reasons, managing Japan from another Asian country could have its problems.

Japan is often mentioned as a gateway to Asia, and this is evident when looking at the internationalization pattern of many multinational companies. More often than not, Japan is the first Asian market to be entered, before taking on other countries in the region. While being substantially different compared to its neighbors, experience built up by doing business in Japan can, to some extent, be used when expanding one's operations. Moreover, Japanese products are highly regarded in Asia, and any company that is established in Japan will find it easier to succeed in other Asian markets. Therefore, while market entry in Japan is done to tap into the Japanese market, it paves the way for future expansion in the region.

4. Effects of the March 11 disaster

Short-term effects

Two of the respondents suffered direct damages to their fixed assets. A fashion retailer had to close its two stores in the affected area for a total of three weeks. After reopening the two stores, sales quickly picked up and the company does not expect any further negative effects from the disaster. Another company, in the medical equipment industry, had to close its Japanese factory for two weeks as a result of soil liquefaction. The company was allowed to import similar products from its plant in Europe during the factory's downtime, without having to go through the additional procedures required to import such equipment.

A study by Foreign Chambers in Japan (2011) conducted one month after the disaster found that a fairly small number of companies relocated their offices or staff after the disaster. In total, 5 percent temporarily relocated their offices within Japan and 1 percent relocated abroad. Firms' reactions varied with the conduct of their information sources, which was mostly foreign media, Chambers of Commerce and embassies. Several respondents expressed dissatisfaction with the coverage of foreign media, which may have led to overreactions. However, one month after the earthquake, 96 percent of the companies were back to normal operations.

In the weeks following the disaster, there was a dip in supply from the affected areas. Firms who were tied to a small number of suppliers, distributors or customers in the affected areas had to postpone orders while waiting for reconstruction to take place, but overall, the short-term effects were not significant for foreign companies in Japan.

Long-term effects

While it may be too early to conclude anything decisive regarding the long-term effects of the disaster, investors' worst case scenarios have not been realized. Most of the foreigners who fled Japan in fear that the Fukushima nuclear crisis would get worse returned within a month, requiring no large scale recruitment. The above-mentioned survey by the Foreign Chambers in Japan found that just above half of all respondents thought that the disaster would have a negative influence on business.

It is still uncertain if the disaster led to any shift in prospective investors' view of Japan, but as long as the recovery efforts go as planned, there is hope that the long-term effects will be limited. At the time of the interviews, some respondents were still unsure whether some postponed order would ultimately be cancelled or not, while others saw a rise in sales in connection with the recovery effort.

Firms with global production networks could rely on overseas factories when facing downtime in Japan. Many Japanese companies and their supply chains were focused on a small number of suppliers and short lead times, resulting in efficient operations as long as everything went as planned. These companies were hit hard by the disaster, which highlighted risks in such production systems. A chairman of the Japan Business Federation concluded that corporate Japan has "gone too far in pursuing economic efficiency", and that companies should diversify risk by spreading out production bases (The Nikkei Weekly, 2011).

As mentioned earlier, a number of Japanese companies were forced into bankruptcy by the disaster and its aftermath, and many are still facing difficulties. This could be seen as M&A opportunities by foreign investors, considering that the reason why these companies are struggling is an external shock and not strictly business related.

Many respondents agree that the March 11 disaster could be a chance for reforms to be carried out in Japan. Looking at Japanese investment history, the burst of the bubble economy led to FDI promotion in the early 1990s. While the recent disaster may not have such wide-spread effects on the economy, its psychological effect may act as a catalyst for change. One participant stated that the disaster has unified the Japanese people and led to an increase in motivation.

5. Future prospects

General outlook

The Foreign Chambers in Japan survey found that in spite of the circumstances, 65 percent of foreign companies in Japan expect further growth and only 6 percent believe that they will scale down their Japanese operations. As for external factors, some respondents are hoping for political change, while others rely on organic growth and further development of budding markets.

Evaluation of recent initiatives

A 2008 study found that the top three changes requested by the foreign community in Japan are tax reductions, more flexible labor regulation and simpler administrative procedures[5] (JETRO, 2008a). When asked whether the current initiatives are enough or if more should be done, most respondents replied that while one can always ask for more, any initiative is welcome. No one incentive is decisive when choosing where to invest, but adds to the investment climate and shows that there is willingness from the government to attract and keep foreign investors.

Not surprisingly, the proposed corporate tax cut was seen as good news by all respondents. Corporate tax is easily comparable between economies and has been a major disadvantage for Japan when making investment decisions based on hard data. A five percent cut would not put Japan in the lead when it comes to corporate taxes, but it has to be remembered that cost cutting is not any major driver for investing in Japan.

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[5] For a detailed list over the issues addressed by the European Business Council, please refer to the annual White Paper available at http://www.ebc-jp.com.

Regarding the Special Economic Zones and other measures to attract foreign capital to other areas than Tokyo and Yokohama, many argued that almost all foreign companies will still want to make their initial investment in or around the capital. Other urban or rural areas may be more suitable for secondary investments or M&As with local firms. However, to date, measures are limited to new entrants and greenfield investments. According the respondents, M&A should be given more attention since it is the prevailing form of market entry of today.

Liberalization of the Immigration Law is seen as positive by European investors, although most have no direct complaints with how immigration is dealt with at present. Since most foreigners working in European firms come as intra-company transfers and have university degrees, few have had problems entering and staying in Japan. Still, any measure to simplify immigration procedures is welcome.

Regarding closer cooperation with the European Union, investors have high hopes about the forthcoming FTA which could be the most important initiative in EU-Japan history. While a free trade agreement would mostly cover exports, it has to be remembered that most firms internationalize in an incremental manner where exports are the first step. Following export success, firms turn to distribution in the new market, gaining from its new experiences. Market commitment is then slowly deepened until a local subsidiary is established. Therefore, any initiative to facilitate trade between two economies is likely to initiate a snowball effect that results in increased cross-border investments and strengthened economic ties. This was the case after Japan concluded FTAs with ASEAN members and the same is likely to happen with the European Union.

D. Conclusions

1. Why invest in Japan?

The main reason to invest in Japan is the large and dynamic Japanese market. Consumers are notoriously demanding and product life cycles short, urging firms to innovate in order to compete effectively and keep their customers. Many foreign firms rely on the discerning Japanese customer to find areas of improvement and scope out new trends. Products adapted to the Japanese market often prove successful in other markets as well, highlighting the Japanese market as a trend setter.

Foreign firms can also learn from their Japanese competitors, not the least in quality management and operational efficiency. Several foreign firms have opted for joint ventures in Japan, in order to tap into local knowledge. Regarding undesirable knowledge spillovers, intellectual property rights are strong in Japan. Once the Anti-Counterfeiting Trade Agreement is put into force, Japan will be a member together with the European Union, Unites States and eight other economies.

For being such an advanced economy, there is a surprisingly high number of underdeveloped markets that are expected to grow as the needs of the Japanese consumer converge with those of its Western counterparts. In these markets, European firms can reap first-mover advantages. Moreover, the emerging elderly market is a place to learn for the future to come in Europe. This is not only promising for the medical industry, since the new elderly are expected to live actively for decades after retirement.

Entering the Japanese market should be a long-term undertaking and one must have the time and patience needed for significant market commitment. Each firm's strategy may have to be adapted to fit the Japanese market, and profits are unlikely to be realized for the first few years. Showing market commitment involves considerable expenses and a good understanding of the local business culture, but there are substantial rewards as well. Once established, the foreign firm will have reliable, long-term business partners.

Succeeding in Japan is a sign of a competitive product or service, and facilitates market entry into other economies, in particular developing Asia.

2. Is Japan being overtaken by its neighbors?

The current economic growth in developing Asia is impressive, and there is widespread speculation on just how much of the world economy that is going to shift from the EU-Japan-US Triad toward Asia, with China and India being the two giants. Other Asian NIEs are taking proactive measures to attract investment: there is a race in lowering corporate taxes, where Hong Kong (SAR) is the current leader at 16.5 percent.

Several countries offer preferential tax treatment and other incentives for foreign investment, especially in targeted sectors and regions. Republic of Korea, whose economic journey is much like that of Japan, was the first Asian country to reach an FTA agreement with the European Union, removing nearly all tariffs between the two economies. Moreover, negotiations between the EU and ASEAN members are underway.

However, while the Asian Tigers have reached the innovation-driven stage of development, India and China still have a long way ahead. Foreign direct investment flows reflect this fact, with the main investment driver for these economies being cost-cutting. Such investment tends to be short-term, since economic development invariably results in rising wages and land prices.

While there is a clear catching-up effect, developing Asian countries have a number of issues to resolve before they can offer secure investment climate with strong intellectual property rights and low political risk. Such factors are not easily quantifiable and may not show up when evaluating countries' attractiveness based on hard data, but they have a profound effect on a firm's performance when investing in a new market.

3. How did the March 11 disaster affect the investment climate?

The March 11 Tohoku earthquake and tsunami was Japan's most severe disaster of the post-war era, resulting in terrible human losses. Moreover, the resulting crisis at the Fukushima nuclear plant led to widespread public fear and an outflow of foreigners who chose to evacuate as a safety precaution.

However, the feared exodus of highly skilled foreigners turned out to be a temporary evacuation, as most returned to Japan in the following weeks after the disaster. Almost all affected foreign companies had returned to business as usual within one month after the disaster, reporting few mid- or long-term effects. It has to be remembered that most damage was caused by the resulting tsunami, which was large-scale, but still limited geographically.

It is still too early to tell what the long-term effects will be, but reconstruction is well underway and the respondents to this survey did not note any major inconveniences, except the occasional postponed delivery or order. Firms relying on global production networks went largely unaffected throughout the crisis, which highlighted the importance of diversifying risk in different locations.

4. What is being done to attract investment?

The increasing competition from Asian NIEs, low growth rates at home and the March 11 disaster have all added to a sense of urgency within the Government of Japan. It could be argued that this situation is similar to the early 1990's, where an economic crisis ultimately led to efforts for institutional reform and deregulation aimed at leveling the playing field for foreign companies and setting the scene for inward investment. These efforts, combined with active FDI promotion by JETRO and its Investment Business Support Centers, enabled Japan's inward FDI stock to grow by 300 percent in the past decade.

Several of the FDI promotion initiatives proposed in the 2010 Inward Investment Promotion Program have already passed the Diet and are expected to be put into force in the coming year, accelerating the influx of FDI. This has been made possible by an increased awareness that more proactive measures need to be taken in order for Japan to keep its foreign companies and attract new ones.

Moreover, efforts are made to strengthen Japan's ties with the world economy. For European investors, the proposed EU-Japan FTA/EIA is of utmost interest. Increased trade often results in increased investment, as firms tend to enter new markets through exports before gradually deepening their market commitment.

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Appendices

Appendix A. Interview guide for organizations

- Staying in Japan
  - Advantages of being present in Japan
  - Discrepancies between companies' expectations and the Japanese reality
  - Alternative host countries in the region

- Effects of the Tohoku-Pacific Ocean Earthquake and its aftermath
  - Short-term effects (relocation of staff, electricity shortages)
  - Long-term effects (relocation of functions, further economic downturn)
  - Future positive effects (M&A opportunities, reconstruction, sense of urgency leading to reforms)

- Recent initiatives of the Japanese government
  - Corporate tax cut
  - Inward Investment Promotion Program
  - Relocation subsidy program
  - Special economic zones
  - Eased immigration procedures
  - Closer cooperation with the European Union
  - The future

- Changes needed in order for Japan to increase its FDI attractiveness

Appendix B. Interview guide for companies

- Background information
    - Location of HQ/R&D functions
    - Time of first investment in Japan
    - Type of operations in Japan

- Investment decision
    - How did you decide on Japan as a host country?
    - What was the primary driver of your Japanese investment?
    - Which other host countries did you consider?
    - Did you use any third-party facilitators? (government-led or private)
    - Did you receive any incentives? (Home/host country, importance for decision)

- Staying in Japan
    - Have there been any major discrepancies between your expectations and the Japanese reality?
    - What are the advantages of being present in Japan?
    - How did you tackle the challenges that foreign firms meet in Japan?
    - Have you expanded, maintained or scaled down on your Japanese operations? (Future plans to do so?)
    - Which are the most attractive host countries in the region at present?

- Effects of the Tohoku-Pacific Ocean Earthquake and its aftermath
    - Short-term effects (relocation of staff, electricity shortages)
    - Long-term effects (relocation of functions, further economic downturn)
    - Future positive effects (M&A opportunities, reconstruction, sense of urgency leading to reforms)

- The future
    - Effects of recent initiatives of the Japanese government
    - Where do you see your company’s Japanese operations in the mid-term future?
    - What changes would you like to see in order for Japan to increase its FDI attractiveness?