KEIZAI DOYUKAI

Radical Changes are Key to Growth of Foreign Investment in Japan

— The Key is Commitment by Corporate Japan & the Government —

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Introduction

Japan’s flow of inward foreign direct investment (FDI) is very low. At the end of 2013, the nation’s inward FDI stock as a percentage of gross domestic product (GDP) stood at 3.5% (¥18.1 trillion), versus the average for OECD countries of 32.1%. Moreover, a report released by the United Nations predicts that Tokyo will remain the world’s largest urban agglomeration in 2030 but its appeal as a business and economic hub in the Asia-Pacific region is largely inferior to that of Singapore and Hong Kong.

Inward FDI has been the topic of numerous discussions. Thus far, various proposals and recommendations have been issued on the matter. The Japanese government has also been tackling the issue of expanding inward FDI for some time and has repeatedly adopted Key Performance Indicators (KPIs) to measure its progress. In 2015, the government has been upping its game to increase inward FDI. Taking into account the various recommendations and proposals made in the past on how to boost inward FDI, in February of this year, Prime Minister Shinzo Abe announced plans to create a system whereby the vice-ministers and parliamentary secretaries would be in charge of encouraging foreign companies to invest in Japan. In addition, the national and Tokyo Metropolitan government jointly set up the Tokyo One-Stop Business Establishment Center in April.

New developments are also underway in regions in Japan which have fallen behind in globalization. Prime Minister Abe, along with the mayors from various cities in Japan, attended seminars on investing in Japan that were held in London and New York in 2014. The mayors. who are actively looking to attract foreign companies to the area, took turns addressing the audience in English to promote the advantages of the area and its business environment. The City of Fukuoka is one such example. It intends to take advantage of its designation by the government as a special strategic economic zone to achieve its vision of becoming a global city that nurtures startups.

Furthermore interest in Japan is a rising among foreign companies and investors. After experiencing an extended downturn, Japan’s economy is finally embarking on a new growth trajectory, as the country pushes forward with structural reforms underpinned by catalysts such as Abenomics, the Olympic and Paralympic Games scheduled to be held in Tokyo in 2020, and the expansion of the free trade agreement (FTA) network. This rekindled growth, coupled with the yen’s depreciation in value against major currencies, has brought about a significant change to the “Japan Passing” trend, a phrase that was coined to imply that Japan is being left behind by a rapidly changing world.

This may very well prove to be Japan’s last real chance to promote foreign investment in the country owing to the opportune environment—the change in the local mind-set and increasing foreign interest in Japan. If Japan seriously plans to expand foreign investment inward, then now is the right time for the Japanese government to institute highly-effective initiatives in a timely manner.

The Japanese government also aims to raise its FTA coverage ratio to 70% by 2018 and is stepping up its FTA and EPA negotiations to move toward this goal. The basic principles for economic partnerships are bilateralism and reciprocity. Consequently it is not enough for Japan to merely increase foreign trade or investments in other countries. It will only begin to deepen these partnerships once it starts accepting foreign investment in Japan.

Given the awareness of these issues, we have decided to conduct interviews, primarily with the top management of global companies, on the appeal of the Japanese market and the obstacles companies face when newly entering the market or when expanding their business operations in Japan. We plan to identify common issues that transverse all industries and gain an understanding of these issues from the viewpoint of top management. We will then present to fellow management and the Japanese government the following recommendations regarding the issues and solutions garnered from our interviews.

Proposal: Ways of Further Enhancing Japan’s Allure

There are number of barriers for global companies to market entry into Japan and to business expansion after entry. The most frequently pointed out obstacles are listed below. These barriers have to be removed to further enhance Japan’s allure to foreign capital.

Through a series of interviews a number of barriers to inward FDI in Japan were identified, including the quality and liquidity of human resources, and corporate culture. These are all matters that we as top-level corporate executives can fix through radical changes. To this end, we put forth the following proposals to companies, society, and the government to address the radical changes and initiatives being sought out.

1. Companies and management should initiate overhauls on their own

Companies need to undergo “self-transformation” to create a positive cycle. The improvement of profit margins will lead to the development of innovations, which in turn will give rise to new business opportunities in an otherwise seemingly saturated market. In addition, this will provide more job opportunities and a broader range of working options, making risk-taking easier.

The question being posed to Japan’s top management is whether it is prepared to compete in the global arena. Should we choose a path whereby we shrink in tandem with the domestic market or should we strive to achieve globally optimal operations through self-transformation? The fate of corporate Japan relies on how fast we can answer this question.

(1) Overhauling hiring and personnel training

The tradition of hiring new graduates en masse has its benefits. Companies can secure talented human resources all at once and corporate culture can be instilled and passed on over a long period of employment. However, given the rapidly shrinking working-age population, each and every employee has to leverage and maximize their underlying potential to sustain a comfortable standard of living.

Consequently, to facilitate this, it is essential to enhance the flow of human resources between companies and industries. Companies should take the initiative to overhaul hiring and training systems to bring about a change in society and to corporate culture. This includes rethinking the predilection for the mass-hiring of new graduates and promotion of mid-career hires.

In addition, diverse human resources are indispensable. Companies require a broad spectrum of perspectives and opinions to be able to properly respond to various events and situations. There are a number of essential factors to effectively promoting diversity and integration. This naturally includes equal opportunities and fair evaluations, but also involves the reduction of extended work hours, flexibility to select work hours and location, an infrastructure that offers benefits such as child care support, and the fostering of role models internally.

(2) Strengthening corporate governance

Moving forward, Japan should gain equal footing with peers in the competitive environment overseas as it makes headway in free trade and economic partnership agreements (FTAs & EPAs). There is no question that Japanese-style corporate management has its strengths. However, as companies, markets, and the world in general become borderless, management will have no choice but to adapt accordingly. Japanese companies must immediately create an infrastructure that is conducive for competing in the global arena.

Here we highlight three areas in which Japanese management deviates sharply from the global norm: (1) mindset—the tendency to believe that fluctuation in share price is primarily attributable to market volatility and that, as long as it posts a profit, a company is in the clear no matter how low its profit margins; (2) poor awareness of corporate governance—management does not hold itself fully accountable to shareholders, and independent external directors do not fulfill the original roles expected of them; and (3) difficultly collaborating with global companies due to slow decision-making, despite a high average competency level among its employees.

These are all issues that we can and must deal with. We need to commit to maximizing our corporate value and capital efficiency, and pursue optimal management strategies, such as through the active use of independent external directors. In addition, it is essential that we offer explanations that fully satisfy our shareholders and society at large, so that they are persuaded that our intentions are positive.

(3) Expansion in scale though M&A and other measures

Due to ongoing cross-border industrial restructuring, the number of Japanese Fortune Global 500 companies is declining (71 in 2010, 68 in 2011, 68 in 2012, 62 in 2013, and 57 in 2014). To create companies and industries with sufficient strength to compete globally, it is vital that Japanese companies quickly free themselves from being entangled in excessive competition at home and abroad. We plan to expand the scale of our operations to suit that of a globally-ranking company by implementing integration and restructuring measures that include M&A.

(4) Restructure industries and corporate activities to boost productivity

In Japan, the rate for discontinuing or shutting down businesses is trending at just under 5%. This is overwhelmingly low in comparison with the US and major countries in Europe where the rate is around 10%. In recent years, the labor shortage has been worsening and companies, mainly in the service industry, are finding themselves shorthanded. The situation is likely to be further agitated by the acceleration of the decline in the working-age population.

Japan aims to shift to an industrial structure that boasts high productivity. However, to accomplish this, companies will have to boost their corporate metabolism. Going forward, companies will likely fortify the competitive strength of their core businesses and more efficiently allocate their resources primarily by restructuring unprofitable businesses.

(5) Reinforcing strategies for standardization

Superior technical prowess is Japan's strength. However, Japanese companies will find themselves left behind in the global market if they rely on this alone. Japan still has little recognition (a minimal presence) among organizations and institutions promoting standardization. In light of this, in addition to support from government policies, Japanese companies need place heavier emphasis on aligning with global standards.

2. Strengthening human resources

Japanese employees are highly praised for their teamwork, workplace capabilities, sense of responsibility, and diligence. However, there are four areas that need to be overcome to fully leverage these strengths in a global environment.

(1) Capability to acknowledge and utilize diversity

Japanese lack experience in working together with diverse human resources to produce results. This is true in the workplace, in society, and in school life. This has led to the inadvertent development of a culture that rejects anything different. This knee-jerk reaction puts limitations on creativity and how people think. Consequently, Japanese companies are not well-versed in producing innovative ideas, systems, or mechanisms that are used globally. In addition, Japanese people are not used to asserting themselves, as evidenced by a

Japanese proverb that literally translates as “nails that stick out will get pounded down.” In other words, keep your head low and remain unnoticed. Japanese employees rarely apply for internal job postings for a promotion, a system prompted by the adoption of global standards. The result is foreign employees dominating all the major posts.

Even if transitional measures are instituted for the time being, to address this issue in the medium/long term, it will be necessary to educate children from a young age in Japan, as well as society at large, to recognize individual talents and to be creative and assertive.

(2) Nurturing a culture that allows for failure

In contrast with global standards, Japanese companies have focused on excessive product customization and quality management. This is in part due to the needs of Japanese consumers. However, it is expensive to put a far-reaching system into place that covers all bases (i.e. tries to rule out irregularities). This leads to low investment efficiency and profit margins.[1] It also results in a weak fail safe. The system is unable to deal with irregularities and other unexpected events.

Companies should develop a culture that allows for failure, and stop aiming for perfection. The first step is to tackle a challenge and allow for a number of small mistakes, and then to use what was learned from these mistakes to take on bigger challenges.

(3) Changing Japan’s mindset

Companies are gradually introducing more initiatives to give women more opportunities in the work place. However, the structure of companies and society overall in Japan is predicated based on being Japanese, male, and a career employee. There is little flow (liquidity) of human resources which makes talented human resources hesitant to change jobs and making it difficult for companies that have newly entered the market to secure necessary talent.

It is crucial that we stamp out society’s negative image associated with changing jobs. In addition to boosting liquidity in the labor market, individual workers also need to hone their capabilities by planning their own career paths and thinking about what skills they need to acquire. Workers should

[1] In the food industry, given the insurmountable obstacles to market entry and increased food safety awareness among consumers, “ultra-premium” market has evolved that well exceeds global standards.

emerge a winner in their professional lives owing to their own strengths and capabilities. This is the type of strong spirit that needs to be nurtured.

The guarantee of equal opportunities and fair evaluations, mainly related to mid-career hires, promotions, and training, is essential to boosting this motivation among workers.

(4) English skills necessary to utilize global best practices

A common issue that was pointed out was the lack of personnel with English presentation and communication skills and who are global minded.

English, which is the accepted language for doing business globally, is a weak point for many Japanese. This limits access to best practices and knowhow that is accumulated through operations carried out around the world. Japanese companies are also unable to optimally position personnel globally. Although personnel at overseas offices can be transferred to Japan, employees in Japan are unable to take on responsibilities overseas due to the language barrier. These and other issues place substantial restrictions on companies with the potential to enter Japanese markets.

3. Seeking government's overhaul of regulations and systems

Thus far we have discussed what companies, society, and individuals need to do to further enhance Japan's appeal to foreign capital. The current social frameworks and systems have been in place for an extended period and have reached a state of equilibrium or balance. Consequently, the overhaul of regulations and systems requires a vast amount of energy.

The most practical and successful way to boost effectiveness is to carry this out concurrently with government overhaul of regulations and systems. This will not only contribute to the expansion of inward FDI in Japan but will also largely contribute to improving productivity at Japanese companies.

(1) System overhaul to boost the flow of human resources

Japan's mindset, which we discussed earlier, was formed over a long period of time and was formed based on labor laws, the pension system, and other factors that underpin the hiring of new graduates en masse and life-time employment. Although the flow of human resources is improving in some areas of the service industry, a drastic turnaround in Japan's mindset will only be brought about through government overhauls of regulations, including revisions to various labor laws and improved pension portability.

(2) Tax system that will attract talents professionals

The corporate tax rate is slated to be lowered.[2] Nonetheless, even after this Japan's corporate tax rate will stand substantially higher than Singapore's 17% and Hong Kong's 16.5%. In addition, the high maximum income tax rate, coupled with other high costs, including educational costs for children, provide no incentive for talented foreigners to work in Japan and hinder multinationals from setting up their Asian headquarters in Tokyo. To spark Japan's economy and to encourage many talented foreign professionals to come to Japan to work, the government needs to implement radical measures, such as raising the minimum income to which the maximum tax rate is applied to over ¥100 million. At a time when regaining fiscal health is an urgent issue, we understand the difficulties of overhauling the tax system as a reason for encouraging FDI. However, in the absence of this type of commitment, we do not expect to see positive results from measures to expand inward FDI.

In May 2012, a point system was introduced with the goal of encouraging highly-talented foreigners to work in Japan. However, given the intense international competition to hire skilled personnel, the system did not provide the necessary incentive for foreigners to choose to work in Japan. To encourage exceptionally talented foreigners to come work in Japan, the government will have to offer benefits, including unrestricted permanent residency rights that will be more appealing than those offered by other countries.

(3) Regulatory overhauls to provide consumers with more options

Japan's regulations related to consumer goods are very strict. There is a pronounced gap with requirements stipulated by global standards.

For example, under the Household Goods Quality Labeling Act, Miscellaneous Manufactured Goods Quality Labeling Regulations state that it is mandatory for manufacturers to state the size of an umbrella in centimeters. However, regulations for mattresses stipulate that size is to be stated in millimeters while newton is the mandatory unit to measure firmness. These regulations not only do not help consumers in selecting a product but they result in increased costs for companies for data collection and labeling.

In addition, tariff quota system, state trading, import system and procedures

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[2] In fiscal years starting on or after April 1, 2015, the corporate tax rate is to be lowered to 23.9%, from a current 25.5%. Reflecting this, the effective tax rate will be lowered by 2.51% in 2015 and by 3.29% in 2016.

for food and agricultural products are not only complex and confusing but reduce consumer benefits. In this era of mega FTAs, aligning these various rules and regulations with global standards will provide benefit overall to the lives of the general populous.

(4) Further use of special economic zone designations to revitalize local economies

One issue that was pointed out by companies is that despite the potential for investment in regional SMEs (small and medium-sized enterprises) investors are not being directed in the right direction. This is in part due to a lack of information and because it is unclear who should be contacted.

The government launched a project to support local companies that are looking to enter the global market by utilizing local resources. Measures include connecting JETRO to a database (Chiiki-no-genki sozo Platform Official Website) that is shared by all municipalities. However, not much thought was put into the use of this database. Not only is there no English version but it does not even list contact information for inquiries.

There has been some progress in other areas, such as the establishment of the Tokyo One-Stop Business Establishment Center, which we discussed earlier. However, smooth and speedy progress needs to be made toward providing the latest information on regional areas in multiple languages to encourage inward FDI in these regions.

Also, obstacles caused by bureaucratic rivalry also need to be eliminated, to prevent efforts such as the One-stop Center from being turned into a one-time publicity stunt by the government. Encouraging investment, developing new businesses and market should not be the sole mission of JETRO. It should also be clearly positioned as the mission of our ambassadors. The government needs to quickly establish a system that extends across all ministries and agencies.

Meanwhile, inward FDI in Japan from countries in Asia has been small thus far. However, working toward the achievement of the Free Trade Area of the Asia-Pacific (FTAAP), as FTA and EPA negotiations are carried out, it will be necessary to increase mutual investments (Asian countries in Japan and Japan in Asian countries) to deepen and create true economic ties. In addition to strongly pushing forward with diverse policy that utilizes the special economic zone system to encourage FDI and contribute to the revitalization of local economies, the government should also look to expand the range of investors, mainly through the use of ODA, so that the government and companies can offer support to ambitious mayors and other local leaders.

Conclusion

We and the government both recognize that now may be the last chance to increase inward FDI in Japan, given Japan's willingness to shed its deflationary mindset and due to the depreciation of the yen's value. Thus far, many of the country's regulations and systems have been identified as barriers to inward FDI.

Neighboring countries are competing with Japan for these investments. In addition to strengths such as market scale and ready access to other areas, neighboring nations are also boosting their competitive edge, mainly through deregulation, to enhance the appeal to foreign investors. Given the inferior appeal of Japan's market due to its maturing economy and declining population, unless the government is willing to go all out and remove the barriers created by regulations and systems, it is only a matter of time before Japan is thoroughly defeated.

Through our series of interviews, we discovered that of the many obstacles to inward FDI in Japan, those factors pertaining to human resources and corporate culture represent the major barriers. The need for the globalization of Japanese companies and Japan's society has been pointed out for some time. In recent years Japanese companies have been speeding up their overseas expansion. However, with the exception of certain companies, most are not making progress in promoting domestic globalization.

In addition to enhancing the appeal of Japan's markets to outsiders, an improvement in per-capita productivity via the establishment of a global business model is essential for achieving a better standard-of-living for the Japanese people. To this end, investments by global companies will bring about changes to human resources and corporate culture, revitalize companies and industries, and accelerate innovation. In addition, the overhauling of various systems to increase inward FDI will also trigger other changes. In other words, by effectively using inward FDI as a catalyst, it will possibly lead to a virtuous cycle for the Japanese economy.

Appendix 1: Japan's appeal

We believe the following appealing characteristics are noteworthy as global companies that overcame the aforementioned obstacles, entered the Japanese market and were successful likely viewed these areas as being attractive.[3]

In addition to self-transformation, it is important that corporate Japan and the government hone these appealing market traits and conduct an accurately-targeted PR campaign in order to increase inward FDI.

1. Market scale

One issue is market saturation due to a declining population, low birth rate, and aging. Despite the economy's prolonged sluggishness, Japan is still the world's third largest economy. The nation's individual financial assets stand at around ¥1,694 trillion. The size of the premium market is of particular appeal. Also, depending on the industry or sector, there is potential demand unique to a mature market such as Japan, owing to an extended healthy life expectance and personalized social security.

2. Technological prowess and brand strength

Japan's *monozukuri* craftsmanship, especially its parts manufacturing technologies, is second to none. In Asia, brands made in Japan boast high reliability and name recognition.

3. Quality of human resources

Japanese companies possess strong organizational capabilities, team strength, and factory capabilities. In addition, Japanese are highly praised for their sense of responsibility and diligence.

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[3] According to the results of the 47th 2013 Survey of Trends in Business Activities of Foreign Affiliates (final data) conducted by the Ministry of Economy, Trade, and Industry (METI), the top three responses for "Attractiveness of Business Expansion in Japan" (Multiple answers: top 5 responses per company) are as follows: No. 1 was "Income levels are high. Customer volume for products and services is high" (62.5%); No. 2 was "Extensive infrastructure (transportation, energy, communications, etc.)" (50.2%); and No. 3 was "Sensitive to added value and trends in products and services. Proving ground for measuring competitiveness of new products and services." (48.6%).

4. Stability of the state and society

Delays in regaining fiscal health and unclear energies policies are issues that Japan is currently confronted with. However, the country has a high-level legal system and distribution infrastructure. There are little in the way of economic and social risks. Also, the country is highly praised for its safety and hygiene.

Appendix 2: Benefits of an increase in FDI in Japan

The expansion of inward FDI will deepen Japan’s true economic ties with other countries as well as bring about macro and micro economic benefits.

1. Macroeconomic perspective

For Japan’s economy to sustain growth despite its rapidly decreasing working-age population, the following are crucial: (1) become a winner in global competition by utilizing Japan’s strengths in the global value chain; (2) boost both the ratio for business openings and closings, and create new markets in Japan by adopting ideas introduced by companies that newly enter the market; and (3) promote internal globalization by drawing in people, assets, capital, and knowhow from around the world, to improve productivity.

Given that self-transformation is not a strong point of Japanese companies and people, that language is a natural barrier with foreign talent, and that the current account surplus is shrinking, inward FDI will act as a catalyst for overhauling industries and companies, and be a source of investment capital in the medium/long term. The benefits for Japan are significant.

At the same time, inward FDI is also important for securing quality personnel in regional areas to rebuild local economies. By taking advantage of the special economic zone designation system and leveraging the technological expertise of medium-cap companies and SMEs, as well as the strong reliability of Japanese brands, encouraging inward FDI will also be largely beneficial in boosting productivity by promoting the globalization of regional areas and connecting local and overseas markets.

2. Microeconomic perspective

M&A by a global company involves organizational restructuring and integration of corporate cultures. A certain level of friction and costs are par for the course. However, companies that have gone through this process have made positive comments on being incorporated into the operations of a global company. This includes (1) clearly defined positioning within the group and target market owing to a shift from domestic to globally optimal operations; (2) enhancement of competitive strength in core businesses owing to withdrawal from unprofitable non-core businesses; (3) improvement in productivity reflecting access to group’s best practices; and (4) the use of English as the universal language within the group, which leads to an improvement in global communication skills of the employees. These companies believe that had they not been a part of an M&A deal, many employment opportunities would have been lost due to a deterioration in the scale of their business, and there would have been increased strain on operations due to delayed overhauls.

Individual companies are not the only one to benefit from market entry by a global company. Global entities create employment opportunities that offer higher salaries than local companies. In addition, in the life insurance and retail industries, there are instances where the industry was revitalized by the global company's introduction of new products and services. This led to more employment opportunities, the creation of healthy, competitive innovations between companies, and companies were more effectively able to satisfy consumer needs. Ultimately, this brought benefits to the lives of the Japanese public overall.

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