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Japan-India Economic Relationship: Trends and prospects

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Abstract

This research paper tracks Japan-India trade and investment relations. India's potential as a market for Japanese companies is now well understood by the business community, which is particularly interested in the rising middle class.

Analysis of the significance of the Comprehensive Economic Partnership Agreement (CEPA), which took place in August 2011, is provided in addition to present-day characteristics of Japanese investment in India, including mergers and acquisitions (M&A) and interest in the IT industry as well as other service industries such as finance and retail. Japanese small- and medium-sized enterprises (SMEs) are also increasingly turning their eyes to India. Another recent trait in Japanese business strategy has been to diversify regions for investment from the area surrounding the national capital, Delhi, to southern cities such as Chennai.

The research also addresses the remaining obstacles that challenge investors. The extent and time scale for tariff reduction following CEPA is one concern, as is the continuing problem of land acquisition.

The paper concludes, however, that while 2011 was challenging for the Japanese economy, prospects for greater economic cooperation with India remain. Japanese companies are gradually adjusting their business models to suit the nuances of the Indian market, providing opportunities for both the Indian and Japanese economies.

Keywords: Economic relations, India, Japan
JEL classifications: F14, O53

TABLE OF CONTENTS

LIST OF ABBREVIATIONS

ASEAN	Association of South-East Asian Nations
CEPA	Comprehensive Economic Partnership Agreement
EPA	Economic Partnership Agreement
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
JBIC	Japan Bank for International Cooperation
JETRO	Japan External Trade Organization
M&A	Mergers and Acquisitions
METI	Ministry of Economy Trade and Industry
MNC	Multi-National Corporation
RIICO	Rajasthan State Industrial Development & Investment Co. Ltd.
SEZs	Special Economic Zones
SMEs	Small- and Medium-sized Enterprises

LIST OF FIGURES

Introduction

The present-day importance and future prospects of India for Japanese companies is well-understood by the business community. Although GDP growth rate has been falling in the last three years, India still represents one of Japan's best hopes for rejuvenating its export-dependent economy whose own growth rate has remained stagnant at around 1 percent.[1] India has the fastest-growing middle-class society in Asia, expected to grow by almost 20 percent in the next five years.[2] The need to diversify from politically volatile reliance on the Chinese market serves as further impetus.

This research paper tracks Japan-India trade and investment relations. India's potential as a market for Japanese companies is now well understood by the business community. They are particularly interested in the rising middle class. Attention is given to characteristics of Japanese investment in India, including M&A, SMEs and diversification of investment regions.

The paper also addresses the remaining obstacles, which challenge investors, especially after the economically challenging year of 2011. Nevertheless, prospects for greater economic cooperation with India remain. Japanese companies, it is argued are gradually adjusting their business models to suit the nuances of the Indian market, providing opportunities for both the Indian and Japanese economy.

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[1] M.Kondo "Growing Economic Relationship between Japan and India", *Contemporary India Forum Quarterly Review*, No.5, 2010

[2] Prince Mathews Thomas, "Why Japanese Steel Companies Are In India," *Forbes India,* 21 February 2011, http://forbesindia.com/article/breakpoint/why-japanese-steel-companies-are-in-india/22432/1#ixzz1p64mLi7c

Overview of the India-Japan economic relations

Rising trade and the conclusion of CEPA

Indo–Japanese economic relations are exhibiting a new surge. The number of companies entering the Indian market has been steadily rising, spurred by the conclusion, after five years of negotiations, of the Japan–India Comprehensive Economic Partnership Agreement (CEPA), which entered into force on August 1 2011.[3]

Japan–India trade has been trending upwards since around 2003, and exports from Japan to India in products such as steel, automobile parts, processing machinery have increased. Although there was a decrease in 2009 due to the global downturn and currency fluctuations, a return to expansion is expected (see Figure 1 below). In early 2011 when CEPA was signed, trade stood at approximately $10 billion with aspirations to reach $25 billion by 2014.[4]

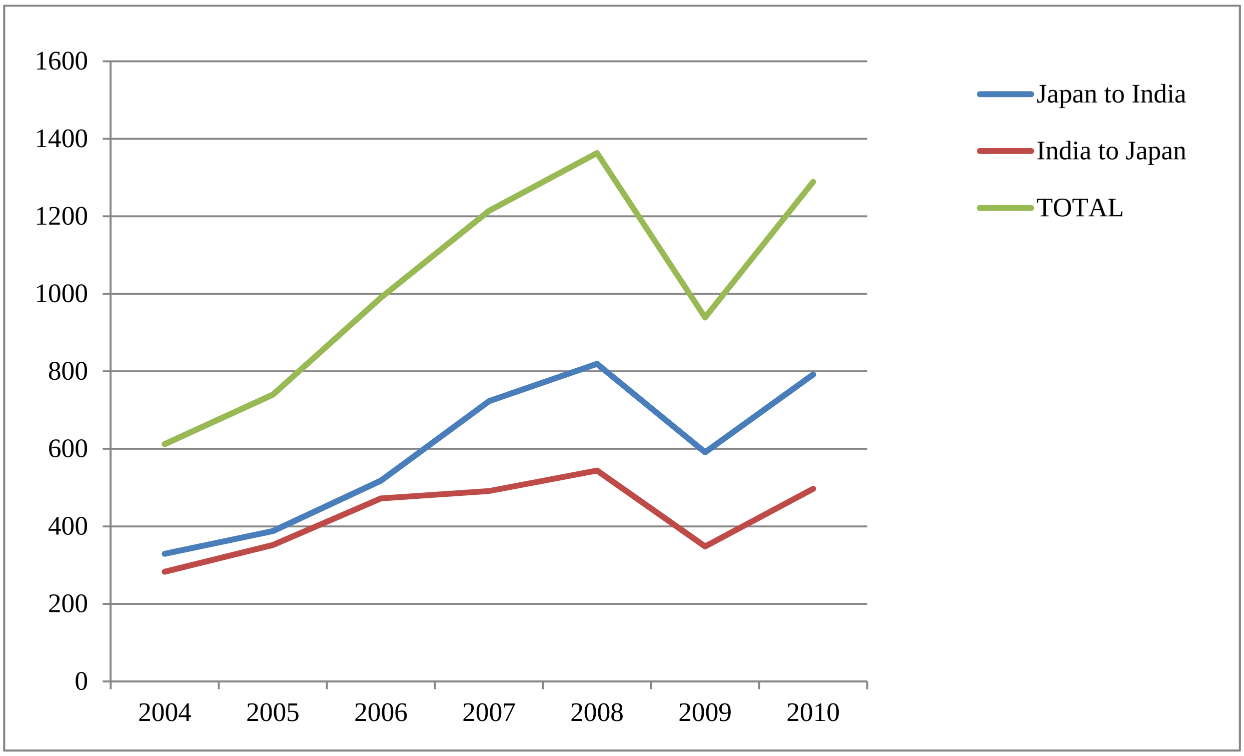
[3] In this Japan–India EPA, tariffs on goods making up 94% of the value of bilateral trade will be abolished over a period of 10 years. Items covered are 97% of Japanese imports from India and 90% of Indian imports from Japan. The agreement was considered particularly noteworthy for its inclusion of services, elevating its title to 'comprehensive' and differentiating the accord from others. "Japan-India Economic Partnership Agreement," *Ministry of Foreign Affairs, Japan,* http://www.mofa.go.jp/policy/economy/fta/india.html

[4] Between India and South Korea in contrast, trade stands in 2012 at $20 billion with a target of $40 billion by 2015. Siddharth Varadarajan, 'As trade soars, India and Korea push 'strategic' side'', *The Hindu,* 25 March, 2012, http://www.thehindu.com/news/national/article3222762.ece

Figure 1: Japan-India Trade (Yen: billion)

	2004	2005	2006	2007	2008	2009	2010
India to Japan	283	352	472	491	544	348	497
Japan to India	329	388	518	723	819	591	792
TOTAL:	612	740	990	1214	1363	939	1289

(Source: Japanese government documents, http://www.mofa.go.jp/region/asia-paci/india/index.html)



The major items of market access improvement from India to Japan include industrial products, generic drugs, durians, sweet corn, curry, black tea, lumber and shrimp. From Japan to India items which benefit in the industrial sector are automobile parts such as engine-related parts and mufflers, steel products such as various types of steel plate, electric/electronic goods such as DVD players and video cameras. Industrial machinery such as tractors and bulldozers also gain from the agreement, as do agricultural, forestry, and fishery products, bonsai, Chinese yams, peaches, cherries and persimmons.

Potential obstacles following CEPA

Some potential hurdles remain, for example when dealing with intermediary trade and rules of origin. If the 35% added-value criterion and the change in HS code at the 6-digit level criterion are not simultaneously met, a certificate of origin at the exporting country cannot be obtained.

Another problem is the number of years required before lower tariffs take effect. Many Japanese corporations are concerned that since in the Japan–India EPA the reduction in tariffs in many items will occur in the final tenth year, there will be no benefit during the first nine. It has also been noted that there is a large number of items excluded from tariff reduction related to automobiles and automobile parts where Japanese corporations had the highest hopes during negotiation.

Meanwhile, from India’s perspective, there is no significant effect other than an expansion in generic drug exports. Other fields such as the movement of people including the dispatching of nurses and caregivers are under separate discussion. The reduction in tariff rates has also been cited by Indian business leaders as merely a neutralizer to the strong yen which has a far greater impact on the attractiveness of Japanese products.

However, despite these complaints and whilst it remains too early to acquire reliable figures, the number of Japanese corporations acquiring certificates of origin for exporting to India as of August 2011 is positive. In the Indian market, where cost competition is already intense, for Japanese companies to compete while the yen is high, there is a large benefit to even a miniscule cost reduction. In particular, it is thought that there will be a benefit to capital-intensive industries for which international prices have been established. Products with a large technological edge and which require continuous research and development need the support of low tariffs.

In addition, Japanese companies have sought to benefit from India's activism in signing FTAs with other economies with which Japan already holds strong economic ties. The India-ASEAN Free Trade Agreement is one such example. In August 2009 in the culmination of India's 'Look East Policy' an FTA was signed with ASEAN, ratified in August 2011. Between 2010 and 2012, India-ASEAN trade increased by 30% with prospects of reaching $70 billion in 2012.[5] Japanese companies' established production networks are being utilized as springboards or at least facilitators into the Indian market.[6]

Expansion in investment

Trade has consistently provided a disappointing record in India-Japan relations. Where trends have proven more positive is direct investment which grew from ¥59.7 billion in 2006 to ¥178.2 billion in 2007 and ¥549.2 billion in 2008 (see

[5] B. Muralidhar Reddy, "India-ASEAN connectivity is our strategic objective, says Manmohan", *The Hindu,* 19 November, 2011, http://www.thehindu.com/news/national/article2641786.ece

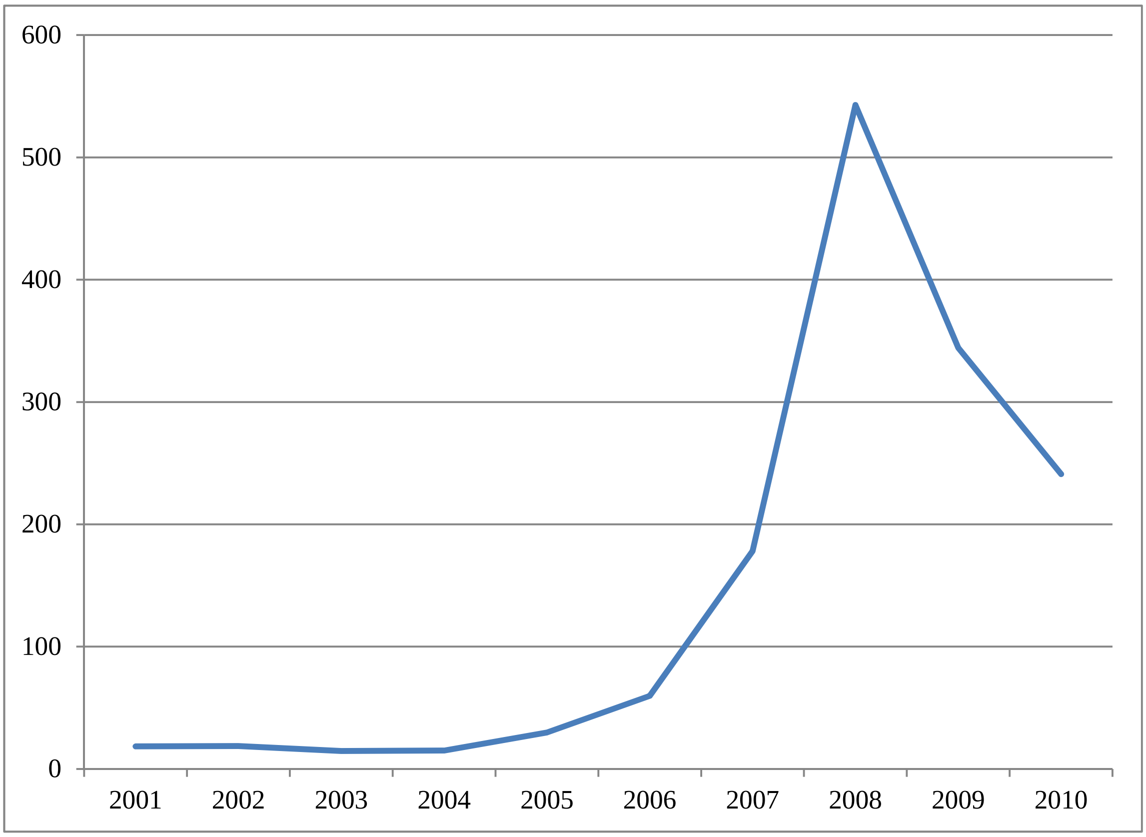
[6] “Japan-India Economic Partnership Agreement – summary and comparative analysis with India-Korea CEPA", ("Nihon Indo Houkatsutekikeizairenkeikyotei – sono gaiyo to kanin ETA•AIFTA tono hikaku”, Mizuho Research Institute, March 2011, http://www.mizuho-ri.co.jp/publication/research/pdf/policy-insight/MSI110510w.pdf

Figure 2 below).[7] Although this decreased in 2009 (to ¥344.3 billion),[8] there is no mistaking that India has become one of the three largest investment destinations in Asia, alongside China and the ASEAN six majors.

Figure 2: Direct Investment from Japan (Yen: billion)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
18.4	18.7	14.6	15	29.8	59.7	178.2	542.9	344.3	241.1

(Source: Japanese government documents, http://www.mofa.go.jp/region/asia-paci/india/index.html)



In the annual survey "Investment Destination Countries/Regions Important to Japanese Corporations" conducted by the Japan Bank for International Cooperation

[7] "India", *Ministry of Foreign Affairs, Japan,* June 2012, http://www.mofa.go.jp/mofaj/area/india/data.html
[8] By 2010 the figure was ¥241.1 billion. Ibid.

(JBIC), India continues to rank in the top class alongside China.[9] It is also often heard that the number of inquiries regarding business expansion at banks and think tanks that relate to India exceeds that for any other country.

Studies of the Indian market by Japanese businesses have also developed. Just a few years ago, the majority of companies took a ‘wait and see’ attitude, conducting studies into the market which rarely progressed further. The likelihood of entry following market research is currently greater than continued deferral. Whilst difficult to accurately quantify, a gradual change in mindset among Japanese executives is apparent. From a situation in which business strategists sought to bide their time regarding India until GDP per capita more closely resembled that of Southeast Asian countries, with whom Japan had profitable relations, firms have become more active.

A number of conditions can explain this development. Continued domestic economic stagnation and comparatively steady increases in India’s GDP growth have been major conditions, but so too has the success evident from South Korean corporations. South Korean firms entered the Indian market early in the country’s economic liberalization experiment, gaining market share and expertise. By focusing on localization of production and low-priced, market-specific goods, Korean firms have set an example Japanese counterparts are eager to replicate. This subject will be discussed in greater detail below.

2 – Recent characteristics of Japanese investment in India

[9] M. Kondo "Growing Economic Relationship between Japan and India", *Contemporary India Forum Quarterly Review*, No.5, 2010

Merger and Acquisition (M&A)

A significant characteristic of recent investment in India has been a rise in large-scale investments in the form of M&A. Representative examples include the ¥50 billion acquisition of electrical materials heavyweight Anchor Electricals by Matsushita Electric Works (now Panasonic) in 2007, the ¥485.4 billion acquisition of the major pharmaceutical company Ranbaxy by Daiichi Sankyo in 2008 and the ¥264.9 billion capital participation in Tata Teleservices by NTT DOCOMO the same year. In addition, in 2010 there was a ¥97.6 billion capital participation in steel heavyweight JSW Steel by JFE Steel, ¥55.5 billion in the Reliance Life Insurance Company by the Nippon Life Insurance Company and the ¥6.5 billion acquisition of stationary heavyweight Camlin by Kokuyo in 2011.

Investment in India previously concentrated on the automobile sector. The increase in M&A, however, has diversified the nature of direct investment. Daiichi Sankyo's entrance in India's pharmaceutical sector in 2008 and NTT DOCOMO's investment in communications in 2009 greatly increased the total value of investment in India. To Japanese corporations, with their late start in India, acquiring strong local companies through M&A and engaging in capital participation even when in the minority have proven effective means to make up lost ground.

Panasonic Electric Works in particular can be cited as successful example among the M&A cases by Japanese companies in India. Anchor Electricals, which was bought by Panasonic, manufactures and sells primarily household electrical equipment such as wiring instruments, circuits, electrical wire, ceiling fans, lighting lamps and lighting fixtures. It operates a nationwide sales network as the largest company for writing instruments with a 37% market share. Panasonic Electric Works engaged in a capital participation in this company in 2007, claiming 100% subsidiary by 2009. Currently Panasonic Electric Works is improving production processes by sending Japanese employees to the local sites, becoming a new model for success for Japanese corporations.

NTT DOCOMO also deserves consideration. This company agreed to capital participation with Tata Teleservices, part of the Tata Group, in 2008 and invested ¥250 billion in 2009 to acquire 26% of their stock as well as 12% of the stock of the related Tata Teleservices Maharashtra. NTT DOCOMO launched the brand “Tata DOCOMO” in India, started offering innovative services such as “one paisa per second” (1 rupee=100 paisas) and “one paisa per SMS character” immediately upon starting with a cellular service plan. Despite starting late in GSM, it now is holding the top spot in terms of net increase in users.

Diversification of industries for investment

Japan is now making its presence known in IT service industry. At first, manufacturing was considered the primary field of interest but as a result of NTT Data’s acquisition of US-based Intelligroup and Fujitsu’s acquisition of US-based Rapidigm in 2006, a base has been established in India. With a subsidiary in Pune, Fujitsu has started offering offshore services to Japanese corporations. The use of Indian IT engineers is also on the rise. It is expected that the number of technicians that NTT Data has in India will exceed 10,000 within a year. Fujitsu is implementing a plan to increase its number of Indian technicians to 5000 in three years. Hitachi also plans to have a 6000-person organization in the future. The major IT companies such as Accenture and US-based IBM already have nearly 100,000 technicians in their bases in India, and despite this order-of-magnitude difference, it seems Japanese businesses have finally become serious about taking advantage of Indian IT.

In other service industries, Japanese businesses are placing priority on India. In finance, Nomura Securities acquired the Asian branches of the fallen Lehman Brothers in 2008, and has as a result attracted high-quality staff in India. Mizuho Bank is also clearly setting forth with an emphasis on India. In the retail industry, aiming for the opportunities resulting from the opening up to foreign capital of the multiple-brand sector, Lawson and Daiso are proceeding with plans to expand into India.

Machinery-related SMEs

Japanese small- and medium-sized enterprises (SMEs) are also increasingly turning their eyes to India. Most Japanese SMEs that have expanded to India are local automotive-related subcontractors for companies such as Suzuki, Honda and Toyota. There remain only a few Japanese SMEs that are opening up India’s local or export markets. With legal, finance problems and market access difficulties, India poses a high hurdle to Japanese SMEs, which despite having a high level of technology are deficient in other types of knowhow.

Yet even amidst these circumstances, Igarashi Electric Works has been an exceptional example of a successful Japanese SME. This global enterprise develops, produces, and sells compact DC motors. Ten years after establishing a production base in China, another was opened in Chennai. As a result of an invitation by a US trading company partnered in Hong Kong, Igarashi Electric Works has a joint venture with India-based Crompton Greaves called Igarashi Motors India. The number of employees currently exceeds 400 and is listed on the local stock exchange. Igarashi Motors India produces for itself as well as manufacturing parts and finished articles requested from customers. Occasionally Japanese technicians give guidance to Indian staff but only one Japanese staff is resident locally. The top leader of Igarashi Motors India is also concurrently a director of the Japanese parent company. Localization is part of Igarashi Electric Works' overall strategy, for example of 2000 employees in China, only four are Japanese.

SMEs related to agriculture and food products

A number of Japanese SMEs related to agriculture and food products have also entered the Indian market, though their record of success is less prevalent. Satake engages in sales and after-sales services for mechanized equipment and plant related to grain and food products such as rice, wheat, corn, and lentils in India. The products it handles are grain hullers, grain selectors, rice mills, rice polishers, and color selectors, which are especially used as processor/selectors for export rice. Based on past success, in 2006 the Delhi branch was upgraded to a local corporation. Satake is now aiming at sourcing materials and installation construction duties locally in addition to enhancing its total engineering and after-sales services.[10]

Where Satake has found success has been through deploying strategies, which other SMEs have also found beneficial (and will be addressed in more detail below). These include employing a top-down administration of ownership, specialized technology that is not exposed to cost competition within the industry and maintaining a strong track record in alternative markets. Satake for example, concurrently operates bases in China, Thailand, Myanmar, Brazil, Australia, the US, Canada and UK in addition to India.

Diversification of regions

The diversification of investment destination regions is also a prominent development. The bases for Japanese corporations had been largely collected in the Delhi national capital region, where factories for Suzuki and Honda are located. Toyota had established a factory in Bangalore but otherwise Japanese companies risked over-concentration. Recently however, Japan has extended its reach to the south in Chennai and Mumbai.[11] Chennai in particular is seen by Japan as a possible springboard for production to Southeast Asian markets. Chennai is also known as a hub for electronics and IT production, dubbed the 'Detroit of India'. Given the circumstances, the Japanese Ministry of Economy, Trade, and Industry (METI) is planning an industrial corridor between Chennai and Bangalore. Following an initial proposal in 2011, the following year during economic talks in Delhi, plans for

[10] Satake's emergency provisions (Magic Rice) were notoriously useful following the Gujarat earthquake in 2001.
[11] D. Matsushima, "Accelerating Japanese FDI into India under the Upgrading DMIC", Contemporary India Forum Quarterly Review, No.9, 2011, http://www.japan-india.com/pdf/forum/45-1.pdf

a BCIC (Bangalore-Chennai Industrial Corridor) were discussed further.[12]

Furthermore, it was recently reported that Suzuki is planning to build a new factory in the state of Gujarat. Previously few Japanese corporations expanded into Gujarat, but since the administrative efficiency of the provincial government has proven increasingly favorable and infrastructure such as harbors and electric power developed, other Japanese corporations may well follow Suzuki's lead.

New obstacles to investment

The above consideration of Japan's improved appreciation of the merits of the Indian market, cannot defer however, the reality that whilst potential exists, obstacles for Japanese corporations in India are also diversifying. Until recently, the top three problems for Japanese corporate investment in India centered on undeveloped infrastructure, bureaucratic 'red tape' and labor problems. In response, the Japanese government repeatedly requested improvements from the Indian government with little success. Additional problems have now surfaced in the form of intense competition from South Korean companies and land acquisition disputes.

The acquisition of industrial land has proven particularly troublesome to Japanese corporations. Many hastily forayed to the vicinity of Delhi and Gurgaon where securing space for new industrial parks is highly problematic, encouraging Japanese corporations to use local corporations as dummies to prevent a sudden jump in land prices. India remains a seller's market with negotiating power firmly in

[12]"Bangalore-Chennai industrial corridor gets nod", *Deccan Herald,* 30 April, 2012, http://www.deccanherald.com/content/246055/bangalore-chennai-industrial-corridor-gets.html

the hand of the supplier. Reports have even surfaced that whilst land might be available; owners refuse to disclose their status, thereby making it impossible for corporations to make a bid.[13]

The Japanese government has attempted to mitigate some obstacles and encourage the private sector by supporting industrial parks exclusively for the use of Japanese corporations. One such exists in Neemrana, Rajasthan through an agreement between the Japanese METI, the Japan External Trade Organization (JETRO) and the Rajasthan State Industrial Development & Investment Co. Ltd. (RIICO). METI and JETRO are also planning a similar enterprise in the state of Tamil Nadu. Japan's trading companies thus far had not been earnest about setting up industrial parks or Special Economic Zones (SEZs) in India. Overall, Japan's trading houses have thus far been hesitant to set up industrial parks or Special Economic Zones (SEZs) in India. One exception however, is the Sojitz Motherson Industrial Park (SMIP) in Tamil Nadu, the first of its kind. The 115 hectare of industrial park is intended to attract Japanese companies by the summer of 2013 and be completed in 2014, following an initial investment of 5 billion yen.[14]

Where economic relations stand today

The year 2011 was disastrous for the Japanese economy. The giant tremor that struck in the Pacific Ocean off the Tohoku region on March 11 was the strongest in Japan's recorded history. Just a few months later, Thailand – an important

[13] "A study of Japanese small and medium industries into Indian Market" ("Chusho kigyo no Indo shinshutsu wo kanngaeru", *India Business Environment Study Group Report, JETRO*, March 2012, http://www.jetro.go.jp/jfile/report/07000855/reports.pdf

[14] "Sojitz to Establish Industrial Park in Outskirts of Chennai, India", *Press Release, Sojitz Corporation,* 28 November 2011, http://www.sojitz.com/en/news/releases/20111128.html

overseas production base for Japanese companies – suffered severe flooding, halting the supply-side production belt.

Confidence in Japanese business remains low. According to a Bank of Japan (BOJ) Tankan Survey in April 2012, pessimism persists among Japanese manufacturers wary of continued strength in the yen and stalled economic recovery. Reports of a possible slowdown in the Chinese economy and the deficit crisis in Europe add to Japanese business concerns.[15]

Fortunately amidst these circumstances, business in India for Japanese companies has been relatively unaffected. After the Great Eastern Japan Earthquake, Suzuki's corporation in India had three months' supply of automobile parts from Japan so continued relatively unscathed. Toyota, which had been planning a factory opening ceremony in Bangalore on March 15, postponed the ceremony on account of the earthquake and reviewed the production and sales plan for compact vehicles. Earlier in 2008, following the Lehman Shock, India's rural economy remained strong, reinforcing the perception among Japanese companies that India provided an important "risk hedge" for the future.

There was also some recent progress on a previous sticking point in bilateral economic relations regarding social security payments. Following the fourth round of negotiations in May 2012 an agreement was made on a social security convention, under which workers migrating on short-term contracts between the two countries do not have to pay into the pension schemes of both countries

[15] "Japan's Tankan survey shows business morale remains low", *BBC News,* 2 April, 2012, http://www.bbc.co.uk/news/business-17580984

simultaneously.[16] This had previously limited human exchange by imposing an additional financial burden on individuals and corporations.

The Great Eastern Japan Earthquake also did not significantly affect intergovernmental negotiations towards a Japan–India Civil Nuclear Cooperation Agreement, underway since June 2010. Although investigations of safety with respect to location are already being conducted for existing nuclear power plants as well as new proposals in India, the Indian government is not undertaking a large review of nuclear power plant expansion. As there is no Japan–India Civil Nuclear Cooperation Agreement at present, Japanese corporations cannot export the relevant materials to India, but US and French companies are hoping for Japan to export materials to India so they too can benefit from the complex corporate structure in which major power corporations share technology. METI will likely gradually ease trade regulations in order to placate domestic concerns over the use of nuclear power whilst concurrently capitalize on India's energy demand. To Japan's nuclear power plant component manufacturers, facing a clearly shrinking global market, India remains an attractive market.

Conclusions

The Indian facet of Japanese enterprise models are entering a new era. Investment in India by Japanese corporations is rapidly expanding and diversifying in scope, industry and geographical location. An increase in corporate acquisitions resulting from large-scale M&A is a recent significant characteristic of Japanese

[16] "Substantial Agreement on Negotiations with respect to an Agreement between Japan and India on Social Security", *Ministry of Foreign Affairs of Japan,* 30 May, 2012, http://www.mofa.go.jp/announce/announce/2012/5/0530_01.html

companies. Although it is necessary to pay thorough attention to corporate governance of partner Indian companies, as in the case of the enormous losses tallied by Daiichi Sankyo, this direction is not itself mistaken and should be maintained.

The difficulty and riskiness of investing in India, such as the infrastructure and bureaucracy have been noted for decades. However, the importance of India as a global risk dispersion base has drawn ever greater attention, especially following the dual natural disasters of 2011 in Tohoku and Thailand.

Investment in India by Japanese SMEs will furthermore increase in addition to that by multinational corporations such as automobile and consumer electronics manufacturers. Japanese SMEs that quickly carry out top-down decision-making and are able to find suitable partners are also expected to rise.

The story of Japanese firms in India is not all one of missed opportunities. As noted above, FDI has accelerated in the past several years. Ingenuity and technological aptitude remain in several firms who are learning the lessons of previous years. Firms acknowledge that their prices were too high and products misdirected and are making efforts to narrow the gap with their Korean rivals. As Japanese firms gradually gain market share, they too are able to exploit their production assets such as an emphasis on quality and efficiency. Indo–Japanese economic relations, having entered a new stage in their development are likely to further progress in the future. The story of Japanese corporate activity in India is only beginning.

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