

Economic Prospects for Small- and Medium-Sized Enterprises

By Hayashi Koichi

The Japanese economy is facing its most serious turning point since World War II. Small- and medium-sized enterprises, which have always been industrial pillars, have been seriously challenged by the bursting of the economic bubble. To survive into the 21st century, several hurdles must be overcome: upgrade working environments and develop human resources; respond to increased international exposure; and deal with global environmental problems.

In discussing the future of small- and medium-sized businesses, it is necessary to examine postwar developments, divided into three periods: postwar recovery (1945 to 1954); high growth (1955 to 1972); and stable growth (1973 to present). Much of our discussion will be based on the 1993 *White Paper on Small- and Medium-sized Enterprises*.

During the postwar recovery period, the economy, marked by lack of energy and industrial materials, chronic food shortages, and pervasive inflation, reproduced on a diminishing scale for the first few years due to the devastation of war.

To break this vicious cycle, production was given priority and scarce resources and funds were heavily concentrated on coal, steel, and chemical fertilizer production. While this policy laid the foundation for Japan's industrial reconstruction, it, in effect, allocated the limited resources and funds disproportionately to major companies, leaving small- and medium-sized businesses, which had mushroomed amidst the postwar social chaos, gasping for them.

The outbreak of the Korean War in 1950 was a boon for the Japanese economy, triggering special procurement. But a backlash recession left small- and medium-sized companies mired in depressed sales and shrinking

funds. In the late 1950s, major corporations were pressured into reducing costs, supplementing insufficient capital and labor, and minimizing cyclical risks through diversification. Thus the need for subcontractors increased, especially in the processing and assembling industries. Accordingly, many minor enterprises were set up, steadily proliferating.

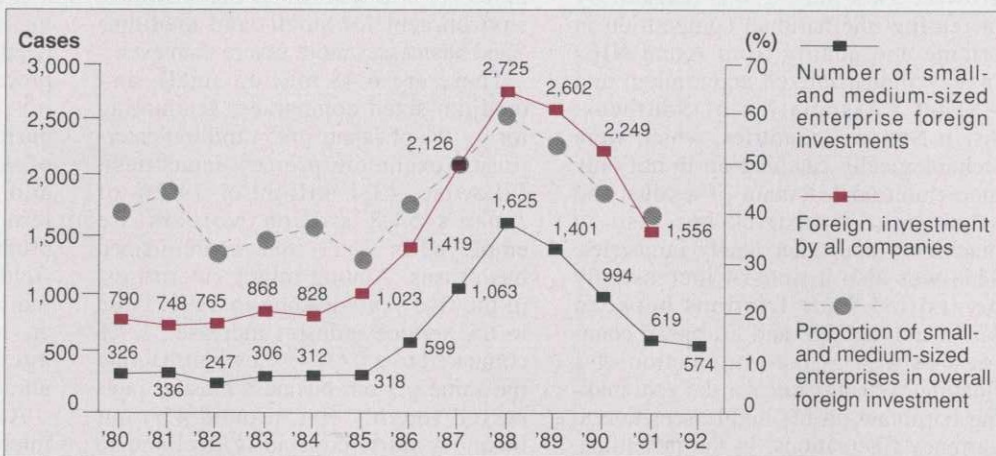
Following 1955, the economy entered a period of high growth. By the late 1950s, economic activity recovered roughly to prewar levels—per capita national income levels by 1955, and trade levels in the years 1957 to 1958. On the road to recovery, however, the gap between major and minor companies widened considerably in productivity, wages, technology and capital-raising capacity. Alongside modern major corporations were small- and medium-sized businesses with pre-modern labor

relations, family enterprises and farmers. Thus Japan's dual economy—with substantial wage and technological discrepancies—emerged.

In the 1960s, as even greater economic growth was realized, per capita income began to approach that of the advanced nations. In addition, exports increased, gradually internationalizing the economy through more imports and fewer capital restrictions. Meanwhile, manufacturing industries became further processing orientated with more companies, both minor and major, engaging in the processing business.

Among small- and medium-sized companies, labor shortages and higher wages, in addition to stronger domestic demand and the subsequent need for increased supplying capacity, meant increased capital investment in rationalization and labor savings. Thus, the gaps between major and minor enter-

Chart 1:
Trends in Japanese Foreign Investments



Source: Figures for all companies from the Ministry of Finance; figures for small- and medium-sized enterprises from the Ministry of International Trade and Industry

- Notes: 1. Figures include only new security purchases (setting up new local subsidiaries or new equity participations).
2. Investments by small- and medium-sized enterprises include joint investment with big companies and private investments.
3. These numbers are not consistent as the minimum amount of investment was raised from ¥3.88 million to ¥10 million in April 1984, and again to ¥30 million in 1989.

prises seen in the late 1950s to early 1960s narrowed somewhat. Also, increased expertise and advancement in production technology allowed some minor subcontractors to specialize in certain parts production.

On the other hand, technological advancement and diversified demand resulted in a proliferation of product types, machines and parts, more complicated manufacturing processes and ultimately stronger needs for subcontractors. Moreover, intensified competition in price and quality in both the domestic and international market meant companies had to streamline and rationalize their manufacturing processes, heighten job division and for major corporations, some management functions were farmed out to larger subcontractors. As a result, subcontractors were increasingly divided into a pyramid-shaped multilayered structure (the so called subcontractor job division structure) with the parent company on top.

Transformation

However, the first oil crisis in 1973 ended the high growth period and the economy entered an era of stable growth. This period was marked by increasing international competition in pricing and quality from Asian NIEs (newly industrialized economies) and ASEAN (Association of Southeast Asian Nations) countries, which were technologically catching up in not only their traditional domain of textiles and other light industries but also in machinery and other heavy industries. This was also a time of increasingly diversified trade frictions between Japan and the U.S. and European countries, as well as the introduction of a floating exchange rate for the yen, making corporate profits highly sensitive to currency fluctuations. In the meantime, the domestic economy had become heavily service oriented, with corporations expanding their service division and outsourcing as well as a stronger demand for service from households.

Rapid innovations in information technology allowed a higher use of information for small- and medium-sized companies in offices and factories.

As well, in response to demands from increasingly prosperous consumers for higher-quality and diversified goods, companies shifted from simple mass production to varied small-lot production. Moreover, companies were faced with a myriad of problems: surging oil and energy prices in the first and second oil crises, and increased attention to the environment which increased corporate expenses.

The 1985 Plaza Accord resulted in a sharp rise in the yen and a subsequent recession in 1986 leading to a consensus that the path to further economic growth in Japan lay in domestic demands. Trade frictions and increases in export prices due to the stronger yen made overseas production more attractive, with even small- and medium-sized enterprises establishing factories abroad, especially in Asia. At the same time, the subcontractor pyramid established during the high growth period was transformed into a more loosely integrated network after 1985.

The economy enjoyed a boom resulting in what became known as the economic bubble. But its eventual collapse led to the current recession, which began in 1991, and has made the business environment for small- and medium-sized businesses more severe than ever.

There are 6.48 million small- and medium-sized companies, accounting for 99.1% of Japan's 6.54 million enterprises (excluding primary industries). Likewise, 43.4 million or 79.2% of Japan's 54.8 million workers are employed in small- and medium-sized businesses. Among minor enterprises, in the five years leading to 1991, those in the service industry increased 6.9% compared to a 0.6% rise overall. During the same period, business closure rates stayed roughly flat, around 4%, but business starts constantly declined to about the same level. This may have been due to the increased requirements for management resource for starting a business, more start-up costs and the labor shortage. There was much concern that the weakness in new business starts would eventually lead to a decline in Japan's economic vitality.

The business environment for small-

and medium-sized companies entered a correction phase in late 1991 after a four-year boom and remains mired to this day.

The burst bubble—caused by a collapse in stock and real estate markets—has raised serious concern about the stability of the financial system and has put pressure on corporate balance sheets. This deterioration has been felt across the board from major corporations to small businesses. Those hardest hit are manufacturers, especially auto, steel and electrical machinery makers. As these industries are typically dependent on subcontractors, restructuring in major companies has profoundly affected minor subcontractors.

Future tasks

Small- and medium-sized companies, while dealing with the ongoing recession, must come to grips with the structural problems and divine a direction for long-term growth as independent enterprises. The first task is to improve working conditions and develop human resources. Broad questions about the welfare of employees are more important than ever for small enterprises and may be the key to long-term growth. To make the urgent need for reduced working hours a reality, new approaches are needed: improving the manufacturing process and business operations through investing in rationalization; revising business partner relations; rescheduling of work shifts, and securing, training and more flexibly utilizing human resources. A shift to higher value-added products and entrance into new business fields to enhance productivity is also indispensable. In short, serious changes are necessary at the root level of management to make companies more attractive to ensure a stable work force.

Another task is to deal with increased internationalization and global environmental concerns. Globally, rapid changes are occurring, with China, ASEAN and other Asian countries becoming production bases as well as burgeoning markets, not to mention the integration of the European Union. Although Japanese overseas investments have decreased since 1989—after surging as a result of the 1985 Plaza

accord—small- and medium-sized businesses have redoubled their efforts to expand operations internationally, partly due to the restructuring efforts of major corporations amidst the current recession. To facilitate this, minor enterprises should implement long-term plans, including expanding business ties-ups at home and abroad, gaining greater

insight into partners' business activities and market positioning, developing human resources and adjusting internal operations to better respond to global activities.

Regarding the environment, small- and medium-sized companies must make positive efforts to improve the situation. Chlorofluorocarbons (CFC),

widely used by minor enterprises as a product detergent, are to be completely banned by 1996. Progress has been made in CFC reduction, but drastic measures aimed at complete elimination have yet to be taken due to limited capital, dissatisfaction with alternatives and a lack of knowledge and information. A quick response is needed.

In regards to global warming, (namely energy saving measures), energy efficiency has improved somewhat in small- and medium-sized businesses but they lag in major corporations. Measures needing expensive facility replacement have been postponed. Industrial and household waste still needs to be reduced and recycling implemented. For this, an approach which integrates manufacturing, office and marketing operations is necessary.

The final task is to respond to industrial structural changes. The recession has sparked considerable change in the manner of sourcing parts and subcontracting.

Increased sourcing outside *keiretsu*, selective product offerings, and the increased use of common parts has led to widening gaps and intensified selection among small- and medium-sized companies. The global production system is also being revised.

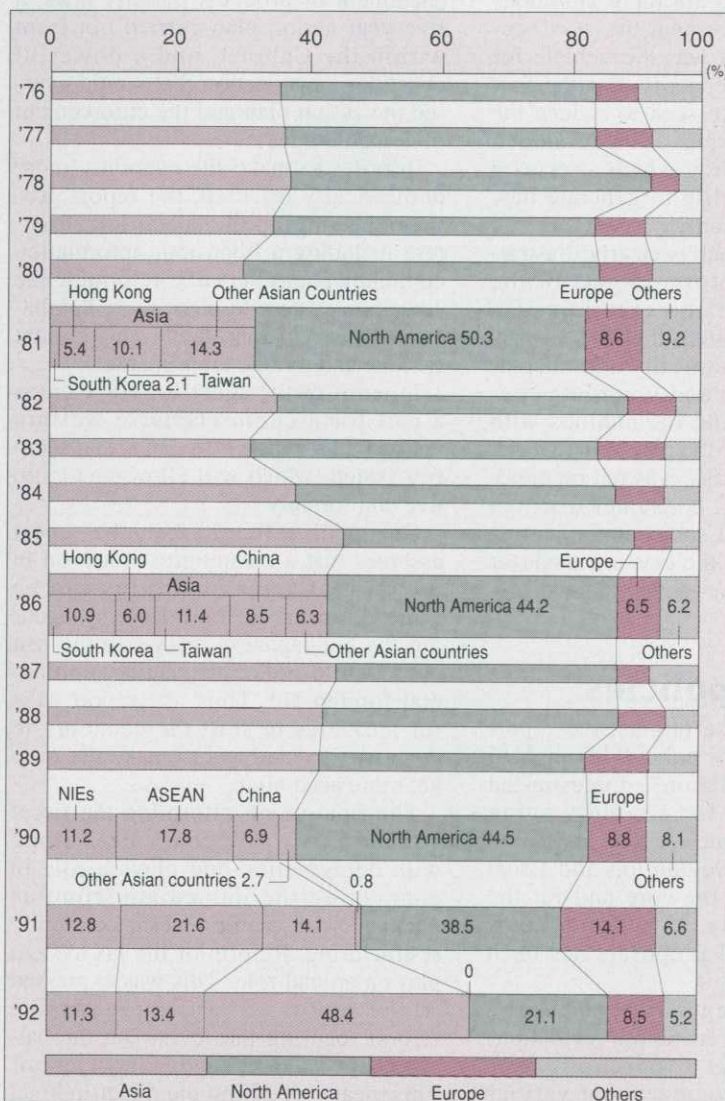
Partly due to a reluctance on the part of young people to enter industry, there is concern over the future weakness in the human resource base and decline in basic manufacturing techniques. Minor enterprises play an important role in supporting Japan's manufacturing industry. Thus they need technological accumulation now more than ever to establish their own technology guaranteeing their survival. Also they need to diversify their business fields through exchanges with companies in other areas which will allow them to establish an independent business base.

Minor retailers are suffering from weak sales during this current recession. Moreover, they are facing tremendous changes within the industry including diversifying consumer demand, intensified competition among shopping areas due to changing city structures and transportation systems, relaxation in the large retail store regulations, proliferation of discount stores and non-store retailing. Minor retailers must make efforts to strengthen their buying power and upgrade sales floors to make their independent business base stronger, as well as to create an attractive shopping area.

A group effort for area planning in line with urban planning would eventually bring about unique shopping areas.

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Chart 2:
Foreign Investment Regional Breakdown
(Small- and Medium-sized Enterprises)



Source: Ministry of International Trade and Industry

Notes: 1. Same as notes 1, 2, and 3 of Chart 1

2. Asian NIEs comprise South Korea, Hong Kong, Taiwan, Singapore. ASEAN is comprised of Thailand, the Philippines, Malaysia, Indonesia and Brunei