Deregulation set to Ease Entry into Japanese Market

By Rupert Naylor

Japan's image as an investment location has been knocked in recent years. Trade Disputes, sensationalist reports of bubble-era prices, *sokaiya* scandals and sluggish domestic demand have all contributed to Japan's image as a difficult market.

On the basis of recent surveys, this view is justified. 4Cs' "Survey Report on Foreign-affiliated Companies" showed that 64% of companies thought that "Japan is more difficult to operate in than other countries." The reasons for this are common across surveys; a MITI survey, in cooperation with FIND (the Foreign Investment Development Corporation), found that the most commonly cited difficulties faced by foreign companies in Japan were cost, labor market flexibility, Japanese business practices, and changing standards and regulations, in that order. The 4Cs' survey, although asking slightly different questions, had similar results.

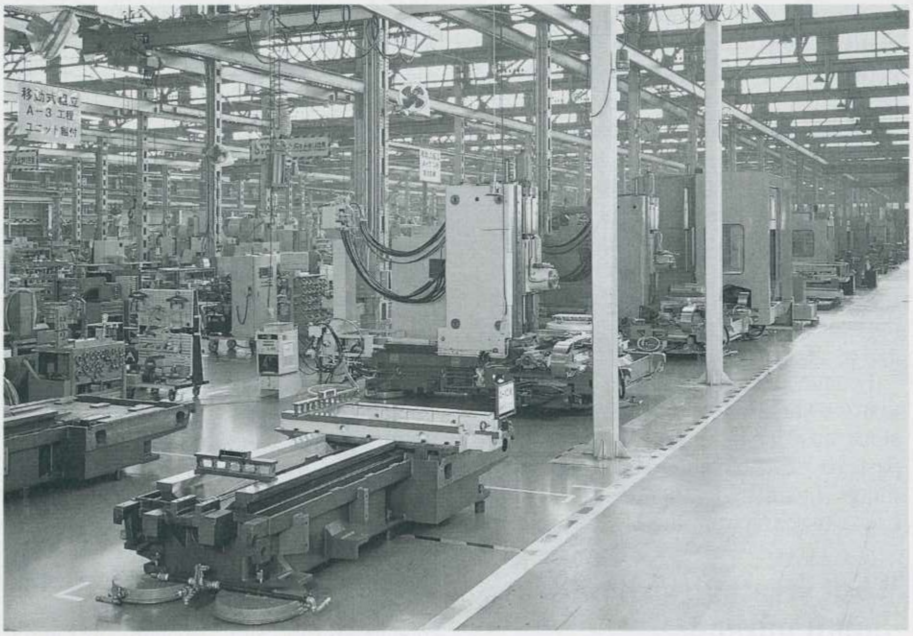

Photo: Mitsubishi Heavy Industries, Ltd.

Technological advancements: A high level of demand and a secure employment system have strengthened Japan's domestic market

The industrial machinery companies that I spoke with all experienced such difficulties, but this was rarely seen as "the fault of the Japanese," rather as integral to the business environment. In thinking how to improve the inward investment climate, it is necessary to consider how this environment may deter potential inward investors. But first I will look in more detail at some of these particular difficulties. Cost is the most commonly cited reason for not being able to make a profit in Japan, but the reaction of Nihon Meditronic typified the pragmatic approach, "it is cost inconvenience, not cost barriers." It is generally appreciated that "it is the same for everyone, there are no special disadvantages for foreign firms." However, the high initial capital costs associated with setting up in Japan discourage small firms and even large firms must show considerable patience before seeing any return. The cost adds up in several ways: real estate prices; labor costs; freight charges, which are borne by the supplier, unlike in other countries; high service requirements; demands for "specials" and other minor alterations; and the drawings required when bidding for a contract.

While regulatory and governmental barriers featured in both surveys, they were more prominent in the 4Cs' survey. This does not reflect the experience of industrial machinery companies. Although some, including a European transport machinery maker, complained at length about the iniquities of Japanese regulations, companies found it difficult to pinpoint specific regulations which were discriminatory or acted as barriers. As Toi Yoji of Cooper Automotive said, "basically Japan is very open—there are no tariffs, no tax differentials and the government is encouraging imports." Certain bureaucratic requirements, such as the demand for detailed circuit diagrams when importing products with electrical parts, can provide headaches in relations with head offices which consider this information confidential. Generally, however, policy makers are left with difficulty in pinpointing offending regulations.

Of course, enthusiasm for more general deregulation and structural reform remains high, and deregulation of port practices and the distribution industry are key to bringing down cost. In a recent article, Toyota president, Toyoda Shoichiro, said "Japan must shift from an economy burdened by regulations and bureaucracy to one in which the private sector can operate unfettered." There have already been successes—changes to the shaken regulations have brought openings for parts makers, which has helped foreign firms. Continuing the deregulation program, without allowing interest groups to water it down, can only open up further opportunities. Japan is blessed with a high-quality, well-educated labor force with a commitment to hard work and customer service. The problem, it is said, is that these high-quality people avoid foreign firms, which provide less job security and have lower status in Japanese society. There is some evidence for this. One large controls manufacturer, which has only a small operation in Japan, described how they received no applicants for a job advertised in a trade magazine. Even when they changed the advertisement, emphasizing the international aspects of the work, few of the applicants met their expectations. Moreover, finding people, especially engineers, with sufficient ability in English, especially outside of the major metropolitan areas, remains a problem.

On the other hand, increasing numbers of Japanese are interested in foreign culture. The problem, it seems, is that many foreign companies in Japan are small. Inward investors with small operations do not recruit new graduates annually and so cannot build up strong relationships with universities. Advertising in magazines aimed at new graduates is prohibitively expensive. But there are other ways to attract candidates; several companies recruited senior employees of Japanese companies overseas who wanted to return to Japan but could not do so with their employer. The European Job Fair in April 1997, held by the Chambers of Commerce of eight member states of the EU and featuring 37 companies was aimed at graduates. Attendance far exceeded expectations, with the organizers having literally to force people out of the door so that they could close the show. While it can be a struggle, most companies end up satisfied and the start of English teaching from elementary school level should help to improve English ability.

Japanese customers are regularly acknowledged as the most demanding in the world. A survey of Asian firms in Japan by Nikkei Research Institute showed that these demands, on both price and quality, formed the biggest barrier to profit. Several companies said they undertake their most stringent quality controls in Japan, controls that must go beyond a product's performance. Horst Bauer, president of SEW Eurodrive explains how they must ensure that the cases of their gear-motors are unscratched, even though this would have no effect on performance. Companies also find the delays before the paperwork on a deal is completed, and long payment terms difficult. Suppliers are sometimes forced to act almost like banks—customers that insist on credit terms of 30 weeks are not unknown. On neither of these points is the practice deemed discriminatory, but they are key elements in the difficulty of the market. It is thought that organizations set up to improve imports tend to focus exclusively on the demand side. Almost all companies were in agreement, however, that once you had secured good business partners and customers, "you have to do something pretty stupid to lose them."

Even if companies become accustomed to these practices, the requirement to produce products specifically for the Japanese market can cut heavily into margins and discourages some companies from investing altogether. Of course, there is no point producing products that are not wanted in the market, left-hand drive cars being a famous example. Medical devices, for example, need to take into account different average heights in the West and Japan. But companies felt that some industries, particularly those with large-scale plants, tend to be standard-paranoid and inflexible, requiring small alterations to products that will not affect performance. In contrast, semiconductor manufacturers and companies in dynamic and growing industries concentrate on cost/performance and Japan's recent improved commitment to international standards should help improve the situation in other industries in time.

Domestic companies dominate Japan's industrial machinery industry in a way not found elsewhere, and many became globally competitive at a speed that surprised their competitors. The dramatic rise of the yen in 1994 and 1995, which forced major restructuring and cost-cutting by exporting industries, including industrial machinery, increased competitiveness further. However, the high yen opened up markets to foreign firms, as Japanese firms sought to maintain quality while reducing price. One engine maker suggested that "it would be useful to have short periods of a high yen from time to time." The reverse side of having strong domestic companies is that Japan is often the source of technological innovations and new product development. This also makes Japan an excellent training ground for young engineers.

Of the other issues cited in the surveys, supply of finance and patent registration were only occasionally problematic. Many companies had secured low-interest long-term loans, though the cumbersome patent process was criticized by several firms as limiting effective patent protection. Lack of knowledge about Japan, another key difficulty, manifested itself in attitudes toward head office. Where Japanese nationals headed the office, they tended to be frustrated by the difficulties of communicating with head office and making them understand how business is done in Japan. On the other hand, Westerners tended to side with their head offices in bemoaning the Japanese market. There were logistical problems in communicating—email is favored where possible. Almost all successful companies are allowed considerable operational freedom. None of these problems is insurmountable. Government can help by continuing the structural reforms and deregulation program, which will be key in bringing down costs, though with barriers to investment largely removed and discriminatory regulations virtually gone, the focus must be on promotion of investment and considering incentives that might entice companies in spite of the difficulties. I will look at some of the options in more detail in the next issue.

JJTI

Rupert Naylor is a career civil servant working in the Regional Cooperation Division of MITI, on 18-month loan from the Department of Trade and Industry in the U.K. He was previously based in London working on European Single Market policy.