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Competition in the Japanese Distribution Market and Market Access from Abroad

Motoshige Itoh

4.1 Introduction

The distribution system in Japan in the post-World War II period developed quite differently from those in other industrial countries.[1] One of the distinguishing features of the Japanese system is that retail and wholesale distribution is dominated by small and medium-size firms and that many goods go through long tunnels of wholesalers before they reach consumers.

The distribution channel policy pursued by manufacturers has been affected by this particular characteristic of the distribution system. When the retail sector is dominated by small retail stores, wholesalers have great influence over what goods are sold in the retail sector. Small retail stores, which do not have enough information about goods or the capability to procure goods by themselves, depend heavily on the services of wholesalers. Because there were many small retail stores, there had to be many small wholesalers. It was these small wholesalers that offered advice to retail stores and delivered goods in small lots. As a result, distribution channels had a vertically segregated structure, in which each category of goods went through a different wholesale system; for example, processed foods, fresh foods, confectioneries, paper products, dairy products, frozen foods, books, liquor, and rice were distributed by different wholesalers. Furthermore, many wholesalers were local firms, and few large wholesalers covered the entire national market. There were a large number of wholesalers in Japan.

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1. See Ito and Maruyama (1991) and Itoh (1991) on the basic structure of the Japanese distribution system.

Under this structure manufacturers engaged in strengthening their relations with wholesalers. Close relations between manufacturers and wholesalers were called *keiretsu* relations in Japanese. A number of measures were introduced by manufacturers for developing *keiretsu* relations. These included vertical restraints such as resale price maintenance and closed territories, as well as various forms of rebate systems. Manufacturers sometimes even supplied sales staff to retail stores.[2] By these methods manufacturers constructed their *keiretsu* distribution channels. In extreme cases, such as home electric appliances and cosmetic goods, manufacturers had their own *keiretsu* retail store chains.

Several factors were responsible for the particular structure of the Japanese distribution system. The motorization process was slow in Japan, and most consumers went shopping on foot until the mid-1970s. The population was concentrated in urban areas. These factors did not allow large retail stores to spread rapidly. At the same time, small retail stores were heavily protected by various regulations. Under the Large Scale Retail Store Law, large retail stores faced high barriers to entry into local markets. This law, by retarding the spread of large retail stores, slowed structural change in the distribution system.

The Japanese distribution system had many problems from the viewpoint of competition policy. The distribution channel practices of manufacturers such as the ones mentioned above often imposed high prices on consumers. Such products as cosmetic goods, home electric appliances, and pharmaceutical products were sold under manufacturer-controlled prices in small retail stores. Discounting of these prices by large retail stores was often interrupted by manufacturers. The *keiretsu* relation established between incumbent manufacturers and wholesalers often became an entry barrier to newly introduced manufactured goods including imported goods.

Foreign manufacturers as well as foreign retailers who intended to sell their products in Japan faced this barrier. The distribution system as a barrier to market access became a trade negotiation issue. It arose in Japan-U.S. trade negotiations in individual product areas such as color film and automobiles. The Large Scale Retail Store Law was negotiated with the United States in the Structural Impediment Initiative talks of 1989–90. As a result, the Japanese government announced the deregulation of the retail sector and the reform of the Large Scale Retail Store Law.

Market access issues have also attracted attention inside Japan. It was pointed out by many people that the prices of various goods were much higher in Japan than in other countries and that the Japanese distribution system was responsible. According to this argument, if sound arbitrage

2. Although some of these measures are in violation of antimonopoly law in Japan, the law had not been enforced strictly until recently. Manufacturers were also skillful enough to apply these measures without violating the law.

mechanisms worked through distribution channels, the inflow of low-priced goods from abroad would have filled the price gaps. The fact that the price gaps were not filled implied that the distribution system was a barrier to imports.

The Japanese distribution system has actually been in the process of rapid structural change in the past ten years or so. The deregulation mentioned above has been a driving force behind this change, but other factors have also contributed to it. Although motorization in Japan was about fifty years behind that in the United States,[3] the number of cars in Japan has increased rapidly since the 1970s. The motorization process has contributed to an increase in the number of large retail stores and shopping centers in the suburbs and to a weakening of traditional shopping areas in towns.

Another important factor causing structural change in the distribution system has been an increase in imports, which was triggered by yen appreciation. Imports of manufactured goods have increased in particular; the share of manufactured goods in the total imports of Japan increased from 30 percent in 1985 to 60 percent in 1995. Import goods often came through newly established distribution channels and thus contributed to the growth of these new channels.

The distribution system of Japan is now in the midst of great change. Traditional channels and newly emerging channels now coexist. In spite of its rapid change, the structure of Japanese distribution is still quite different from that in the United States and in other countries.

The purpose of this paper is to explain how the traditional distribution system emerged, to analyze the mechanisms behind the structural change in the system, and to consider the implications for competition policy of the present changes in the distribution system. I will also discuss the market access issue.

The structure of this paper is as follows. Section 4.2 explains how the traditional distribution channels emerged in Japan and what implications the system has for competition. Section 4.3 then discusses the role the Large Scale Retail Store Law played in the distribution system. Section 4.4 then discusses the present structural change in the Japanese distribution system and its implications for competition policy. Brief concluding remarks are given in section 4.5.

4.2 Basic Structure of the Traditional Japanese Distribution System

Table 4.1 shows some of the basic characteristics of the Japanese distribution system as compared with those in other industrial countries in the mid-1980s. The table confirms that, as mentioned in the introduction, one

3. There was one car for every 5.3 people in the United States in 1930, while there was one car for every 7.5 people in Japan in 1973.

Table 4.1 **Comparison of Distribution Markets among Major Countries**

	Countries				
	Japan, 1985	West Germany, 1985:3	United States, 1982	France, 1986:1	United Kingdom, 1984
Retailers					
Shop density					
No. of shops per 1,000 km^2	4,311	1,636	205	1,018	1,406
No. of shops per population of 10,000	135	67	81	102	61
No. of workers per shop	3.9	5.8	7.5	3.9[a]	6.8
Wholesalers					
Shop density					
No. of shops per 1,000 km^2	1,093	505	40	290	
No. of shops per population of 10,000	34	21	16	29	
No. of workers per 1,000 retailers	85	309	196	285	
No. of workers per shop	9.7	7.0	12.6	9.9[a]	
W/R ratio	4.2	1.8[b]	1.9	1.6[a]	

Source: Ministry of International Trade and Industry (1988). Data: *Annuaire statistique de la France, Statistisches Jahrbuch, Retailing Business Monitor, Statistical Abstract of the United States, Census of Business,* and *Commercial Statistics of MITI.*

[a]1983.

[b]1984.

of the distinguishing characteristics of the traditional Japanese distribution system was the dominance of the retail and wholesale sectors by small and medium-size firms. In Japan the number of shop outlets per given population was large and the number of workers per 1,000 retailers was small. Note that the *W/R* ratio at the bottom of the table shows the ratio of total wholesale transactions to total retail transactions. The high *W/R* ratio for Japan indicates that there were a large number of wholesale transactions before goods reached retail stores.

One can think of several reasons why the distribution sector was dominated by small firms. The transport system is a crucial factor in determining the shape of the distribution system. Japan lagged behind other industrial countries in the motorization process, while public transportation, such as the railway system, subway system, and bus system, was well developed. Japan was also characterized by high population density with most of its population in urban regions. Most consumers did their routine shopping on foot and used the public transportation system for occasional shopping in larger shopping areas near a railway station or in the center of a large city. Responding to these shopping habits, a large number of small shopping zones, which consisted of many mom-and-pop stores selling such items as drugs, fresh vegetables, fish, and meat emerged near residential areas. Larger shopping areas near railway stations or in the centers of large cities sold such products as clothing, jewelry, books, and home electric appliances.

There were also a large number of small wholesalers supporting these small retail stores. Most small retail stores were mom-and-pop stores, where family members spent most of their working time in the store serving customers. Thus they depended on the services of wholesalers for delivery of products, pricing suggestions, and sometimes even for the display of goods in their stores. Without the heavy support of wholesalers, they would not have been able to run their stores.

Most of the wholesalers were also small—the better to serve small retail stores: the type of services small retail stores were seeking could not be provided by large wholesalers. Just like small retail stores, most small wholesalers specialized in some category of goods. Thus there were many segregated distribution channels, each of which specialized in some category of products.[4]

Wholesalers were classified according not only to categories of goods but also to regions. Although Japan is a small country geographically, most wholesalers were regional and not many were national.[5]

It is important to realize that the distribution channel policy of manufacturers depended on these characteristics of the Japanese system. Establishing close and often exclusive relations with wholesalers was essential for manufacturers to have better control over the retail market, since wholesalers influenced retail stores in their product choices. So-called *keiretsu* distribution channels were set up by manufacturers.

For wholesalers too it was crucial to establish intimate relations with national manufacturers. Manufacturers often offered volume rebate schemes under which wholesalers were given rebates according to the amount they sold.[6] Under this rebate system wholesalers had an incentive to sell as much as possible of one manufacturer's products rather than diversifying their sales effort to several manufacturers. Wholesalers having good relations with manufacturers were also treated favorably in the supply of goods. In the period of rapid economic growth of the 1950s and

4. I once conducted a field study of the distribution channels for local supermarkets (Itoh 1995). One of the striking features of the wholesale distribution network for supermarkets is that each category of product is carried by a different wholesaler. This contrasts with the situation in the United States, where most products are carried to supermarkets by a limited number of wholesalers who deal with all kinds of products.

5. In fact, the wholesale system often was a multilayer system, in which goods were sold by national-level wholesalers to local wholesalers and then by local wholesalers to local retail stores.

6. In table 4.2 below, I give a typical example of a volume rebate system for the case of cosmetic goods.

1960s best-selling products were often scarce and not all wholesalers could receive their full orders of these goods. Manufacturers discriminated among wholesalers according to how close they were to the manufacturers. This type of intimate relation sometimes went as far as the situation, as in the case of beer, where many wholesalers dealt only with a particular manufacturer's products. In Japan, even now, almost no wholesalers deal with beer from all four major manufacturers.[7]

This kind of control of distribution channels by manufacturers sometimes went as far as exclusive relations between retail stores and manufacturers. Typical cases of control of small retail stores by manufacturers involved home electric appliances and cosmetics. The largest manufacturer of home electric appliances in Japan, Matsushita, organized twenty to thirty thousand small retail stores around the nation: the majority of the sales in these stores were Matsushita products. Matsushita provided these stores with various kinds of support, such as favorable rebates (the amount of rebate increases with the store's sales of Matsushita products), favorable supply of products, and other assistance. These stores were called "Matsushita chain stores" and were located in local shopping areas. The owners of these stores had intimate relations with people in the neighborhood through various local activities. During the period when maintenance service was important for electric appliances people tended to use these neighborhood stores, which they could trust. Other manufacturers of home electric appliances followed marketing approaches similar to Matsushita's.[8]

Leading cosmetic manufacturers took an approach similar to that of home electric appliance manufacturers. They organized small retail stores all around the nation as their "chain stores": most of these stores sold only some leading manufacturer's products or at least the majority of their sales consisted of those products. Although these stores were mom-and-pop stores and therefore had no ownership relation with manufacturers, manufacturers supplied various services—for example, sales clerks. Very favorable rebate schemes were another crucial sales policy used by manufacturers. Table 4.2 illustrates the rebate schedule of one of the leading companies. The amount of rebate is quite large: up to 15 percent of the order price is returned to a retail store when the order exceeds a certain amount. Under this type of accelerating nonlinear rebate schedule retail stores have strong incentives to sell the products of one particular company.

7. When Suntory, the fourth-largest beer manufacturer in Japan, entered the beer market, it had difficulty finding wholesalers to deal with its products because all beer wholesalers were part of the *keiretsu* network of some incumbent beer manufacturer.

8. It should be noted that when Matsushita started its production and sales of such home electric appliances as TVs and washing machines, it could not find a well-developed distribution network for its products. Thus Matsushita constructed its own distribution channels by asking small local stores, such as radio repair shops, to become "Matsushita chain stores."

Table 4.2 **Rebate Scheme Example**

Amount of Procurement per Month (ten thousand yen)	Rebate Rate (%)
> 500	15
> 240	14
> 120	13
> 90	12
> 60	11
> 40	8
> 30	6
> 15	4

Source: Shukan Daiyamondo (Diamond Weekly; Tokyo), 3 July 1993.

The cases of home electric appliances and cosmetics, where even retail stores were organized into *keiretsu* networks by manufacturers, may be extreme. However, for many other products, one could observe manufacturers' *keiretsu* distribution channels to some extent, and manufacturers introduced various measures to support *keiretsu* networks.

Among various measures that manufacturers introduced to affect the incentives of retail stores and wholesalers, the vertical price structures the manufacturers set and the resulting retail margins were the most important tools. By vertical price structure I mean the relative position in the distribution channel of various prices, such as the manufacturer's sales price, the wholesaler's shipping price and the retail price. In the literature on vertical restraint (see, e.g., Tirole 1988, chap. 4), the importance of retail margin as an incentive mechanism is pointed out by many people. The manufacturer-wholesaler-retailer relation can be considered one type of principal-agent model, where manufacturers are principals and wholesalers and retailers are agents. Retail stores and wholesalers as agents sell products for manufacturers. Manufacturers set the retail margins of their products strategically so that retail stores and wholesalers had incentives to sell their products.

The pharmaceutical industry is perhaps where competition in retail margins went to the extreme. Table 4.3 shows retail margins for some national brand cough medicines when they were sold at the suggested price (the data are based on interviews I conducted with retail stores). It should be noted that the margins for two products are as high as 60 percent of their retail prices, whereas the margins for the other products are around 40 percent. One can imagine that retail stores had strong incentive to suggest these two high-margin products to customers. It was said that many customers coming to drugstores would ask the store pharmacist for a suggestion. Thus drugstores had strong influence on consumers' product choices in Japan.

The manufacturers selling the two products with relatively small retail

Table 4.3 **Retail Margin under Suggested Price for National Brand Cough Medicine**

Brand	Retail Margin[a] (%)
Benza-ace	40
Lulu-A	38
Sutona	60
Pavlon	64

Source: Based on author's interviews.
[a]The percentage share of the retail margin in the total sales price.

margins had established their shares of the market and formed close relations with wholesalers before the other two entered. Thus the other two, the entrants, decided to sell their products directly to retail stores and bypass the wholesale system, recognizing the difficulty of penetrating *keiretsu* wholesale networks. These two entrants chose to set high retail margins in order to give strong incentives for retail stores to sell their products.

Needless to say, a high retail margin always induces discount stores to sell at lower prices. The pharmaceutical industry in Japan was no exception. However, there were two obstacles for discounters. One was severe government regulation of the opening of new drugstores. This regulation protected traditional mom-and-pop drugstores and made the expansion of drugstore chains and sale of pharmaceuticals in large retail stores difficult (these regulations are going to be removed soon).

Another barrier to discounters was the difficulty of obtaining enough product from the manufacturers. The many mom-and-pop drugstores were an important distribution channel for manufacturers. Thus manufacturers did not like their retail margins to shrink due to discounting. So manufacturers did not supply enough product to retail stores selling at discounted prices.[9] This kind of manufacturer behavior of course violates antimonopoly law. But there are many subtle ways to discourage discounting behavior without explicitly violating the law. Moreover, the Fair Trade Commission in Japan did not regulate this behavior severely.

So far, I have been discussing the structure of the traditional Japanese distribution system by focusing on small stores. However, even large retail stores, such as department stores and general merchandising stores (GMS), which had a crucial position in the postwar distribution system in Japan, followed practices similar to those discussed above.

To understand the role of department stores in the traditional Japanese distribution system one must note the complementary relation between

9. Retail stores could obtain some products from other retail stores or from independent wholesalers. However, manufacturers sometimes put pressure on these retail stores and wholesalers not to sell their products to discounters.

department stores and small retail stores, mentioned above; that is, most consumers visited neighborhood shopping zones containing small retail stores for daily shopping and larger shopping areas in the centers of large cities for occasional shopping for such products as seasonal clothing, furniture, and some luxury goods. Department stores were in the larger shopping areas.

Due to this complementary relation between small shopping areas and department stores, department stores dealt with goods that mom-and-pop stores did not carry and stocked quite a large variety of goods. *Hyakkaten,* the Japanese expression for a department store, means "the store selling a hundred goods": in Japanese a hundred means a lot. The typical department store in Japan sold a far wider variety of goods than department stores in other industrial countries.

The size of the department store reflected the size of the city. Department stores in larger cities were much larger than those in smaller cities. Department stores in wealthy neighborhoods carried more expensive goods than other department stores. The contents of the department stores thus varied greatly depending on the characteristics of consumers in the neighborhood. It was therefore almost impossible in Japan to run department stores as chain operations. Each store was operated quite independently. The procurement of goods was not centralized and depended heavily on wholesalers and manufacturers, just as in the case of small retail stores. A large portion of department store sales were under consignment. Under consignment arrangements, department stores did not take any risk for sales because wholesalers or manufacturers took the risk of unsold goods. Prices were also set by wholesalers and manufacturers under consignment. Furthermore, more than half of the sales clerks in department stores were employees of wholesalers or manufacturers. As did small retail stores, department stores depended heavily on wholesalers and manufacturers.

GMSs grew rapidly during the 1960s and 1970s. GMSs, typically smaller in scale than department stores and with smaller customer bases were run as chain operations. The relations between GMSs and wholesalers were not like those between department stores and wholesalers. GMSs used their own sales clerks, took their own risks and set prices by themselves. The independent position of GMSs allowed them to be less influenced by manufacturers' market channel controls, and it was often the case that these GMSs played a role in changing the traditional distribution system.[10] However, as will be discussed in the next section, expansion of GMS chains has been regulated by the Large Scale Retail Store Law.

10. The conflict between Matsushita, the largest home electric appliance manufacturer, and Daiei, the largest GMS, regarding the pricing policy of Daiei was famous. Daiei's discounting of Matsushita products induced Matsushita to cease selling to Daiei.

Until the mid-1970s most Japanese consumers did not use automobiles for shopping. Most GMSs had their shop outlets near railway stations. Although they were chain operated, the Japanese GMSs had many of the features of department stores. They sold not only food and sundries but also many other goods, such as home electric appliances, apparel, and furniture. Compared with a chain store in the United States, the typical Japanese GMS sold a much greater variety (though not amount) of goods. For example, if one compares Wal-Mart, the largest chain in the United States, and Daiei, the largest chain in Japan, in the mid-1990s, the former sold about three times as much as the latter in value, while it had about ten times the number of the shop outlets. This means that sales per outlet for Daiei were about three times as large as for Wal-Mart. If one compares a typical Daiei store with a typical Wal-Mart store, one can understand why Daiei's sales per store were far larger than Wal-Mart's. Daiei carried a far greater variety of goods than Wal-Mart, which enabled Daiei to sell more in value per store.

The Japanese-style GMSs, which sold a large variety of goods and as a result sold smaller amounts of each item, could not have the level of independence that American chain stores enjoy. Japanese chain stores depended on the services of wholesalers, unlike American chain stores whose procurement is far more centralized and who often have their own centralized distribution centers. Thus, in spite of rapid growth, the Japanese GMSs did not replace the traditional wholesale system; they rather coexisted with the traditional system.

4.3 Structural Change in the Distribution System and the Large Scale Retail Store Law

The Japanese distribution system started changing rapidly in the mid-1980s. The most important driving force behind this change was the motorization of Japanese society. Although Japan lagged behind other industrial nations in the motorization process, the number of automobiles owned by people suddenly started increasing at the end of the 1970s. Many people now use automobiles for shopping. They prefer stores with parking spaces, and they now can go to stores they could not have reached on foot. In large cities the young generation, who are forced to live in suburban areas due to high land prices in the city centers, shop in stores located in the suburbs. In smaller cities and towns where the population is below fifty thousand, large shopping centers are often built in the middle of two or three of these cities to attract consumers from these cities: in Japan where residential land is constrained and the population is dense, a large shopping center can attract consumers from more than two neighboring towns. Large retail stores responded to this changing environment in the distribution industry. They opened large stores and shopping centers with large parking lots in suburban areas. By contrast, traditional mom-and-pop stores could not adjust to these changes.

However, there was a big barrier to this change. That was the Large Scale Retail Store Law, as well as other regulations on opening new store branches. Under the law, the government reconciled regional small store owners with large retail stores, concerning the opening of large store outlets in the region. Before a large store could open, there had to be approval from local store owners, and the negotiation process was controlled by the government under the law.

This law had several problems. First, it took a long time to complete the negotiation process. The length of the negotiation process depended on how strongly local shop owners resisted. It was more than usual for negotiations to take two to three years. In some cases negotiations took ten years. The long negotiation process not only retarded the opening of new shop outlets but also increased the cost of such stores.

Another problem with the law was that as a result of negotiations, the large retail store often made concessions regarding the size of the store and its opening hours. Store sizes were curtailed and stores were forced to close at seven o' clock or seven-thirty. In other words large stores were regulated in size and business hours.

Some stores bypassed these regulations by opening stores smaller than the size specified in the Large Scale Retail Store Law. Many "roadside" stores followed this strategy and opened smaller stores in the suburbs. These stores were obviously smaller than was optimal, and they faced serious problems when regulation was relaxed and larger stores entered the market.

Regulation under the Large Scale Retail Store Law was criticized by many people: academics, large retail store owners, and the mass media. However, political lobbying by small shop owners was strong enough to retard deregulation. Only when the American government requested abolishment of the law following the entry of the large U.S. toy chain store, Toys "Я" Us, was reform of the law initiated.

It should be noted that the Ministry of International Trade and Industry (MITI), which was in charge of the law, was not necessarily in a position to resist deregulation. In spite of the fact that most in MITI thought deregulation necessary, political pressure from small shop owners was strong enough to discourage reform of the law. American pressure for deregulation was actually a good chance to initiate reform.

The law has been reformed twice since then. As a result of these changes, the process of negotiation was speeded up and the business hours of large stores were extended. The reform of the law apparently hastened the structural change in the distribution system.

In spite of this deregulation it should be emphasized that not all regulation was removed. Store size is still curtailed and business hours are restricted. Further deregulation was requested both from inside and outside.

The case of the law was brought to a panel of the World Trade Organization. Before a decision was made by the panel, the Japanese government decided to abolish the law. The decision was made at the end of 1998 to abolish the Large Scale Retail Store Law and introduce a new law, the Large Scale Retail Store Location Law.

Under the new system of the Large Scale Retail Store Location Law, store size and opening hours are no longer negotiated between large stores and small local stores. However, the new law mandates that the entry of new, large retail stores be checked from the viewpoint of their environmental effects on their neighbors—including such effects as traffic congestion and noise. Although the new law is quite different in purpose from the old, there is some concern that local retail stores may use the new law as an excuse to block the entry of large stores. However, since the law has not yet been enacted as of May 1999, its effect on competitive conditions in the distribution system is yet to be seen.

4.4 Structural Change of the Distribution System and Market Access

Structural change in the Japanese distribution system triggered by motorization and deregulation made market access from abroad far easier than before. The rapid increase in the imports of manufactured goods reflected this change.

Another factor that is important when one discusses changes in market access conditions is the yen appreciation since 1985. The yen-dollar exchange rate appreciated from around 250 yen per dollar to 100 yen per dollar in the mid-1990s. The yen also appreciated in terms of its real effective exchange rate with respect to all currencies.

Yen appreciation promoted an increase in Japan's imports. Not only did the volume of imports rise, but the share of manufactured good imports also rose substantially. The share of manufactured good imports in total imports increased from about 30 percent in 1985 to about 60 percent in 1996. Before 1985 the majority of Japan's imports were primary goods that did not go through the distribution channels discussed here. But most manufactured goods imported did go through the distribution channels.

The structural change caused by motorization and deregulation obviously encouraged the expansion of imports. But at the same time, import expansion as a result of yen appreciation was a strong driving force for structural change in the distribution system. They went hand in hand.

Large stores and chain-operated stores, which are more independent of traditional distribution channels than small stores, are eager to import inexpensive foreign goods. Severe competition among these stores induces them to jump to foreign goods.

It should be noted that the new type of chain-operated stores emerged not only in suburban areas but also inside cities, the location of traditional retail stores. One of the important features of the Japanese distribution system is that many stores are still located inside cities. A large portion of the population still lives in urban areas. Although the number of mom-and-pop stores is decreasing at a rapid rate, what Japanese people call "convenience stores" are increasing in number rapidly. Most of the convenience stores were transformed from traditional mom-and-pop stores through a franchise system: the owners of the stores became members of a national franchise system of convenience stores. Under this system even small shop owners became less dependent on the traditional wholesale system.

Let me explain the case of Seven-Eleven Japan, the largest convenience store chain in Japan. This chain operation has about seven thousand stores all around the nation as of 1998. Most are run as mom-and-pop stores, but most of such services as procurement, pricing, and store management assistance are provided by the franchiser, the central office of Seven-Eleven Japan. Each store sells about three thousand items in small shops with frequent delivery of products. Some fresh foods are delivered three to four times a day. It is obvious that this system cannot use the traditional wholesale system, which is vertically segmented among different categories of goods. Thus this chain constructed a new wholesale network system by asking some wholesalers to participate. This wholesale system was constructed on the initiative of retailers, and the influence of manufacturers was weakened substantially.

Chain-operated stores—small convenience stores as well as large chain-operated stores—face strong price competition from each other. The situation is quite different from when small mom-and-pop stores were serving local consumers. Chain-operated stores cover wider regions and thus have many competitors. Furthermore, since competition is not among individual shop outlets but among chain systems as a whole, price competition is much more severe. Under this kind of rigorous price competition retail stores have little incentive to follow manufacturers' suggested prices. Retail stores now have their own pricing strategies. Due to this change in the behavior of retail stores, in some goods such as home electric appliances and processed foods, the traditional policy of manufacturers' suggested prices at each vertical stage of distribution has shifted to an "open price scheme" under which manufacturers offer no price suggestions and retail stores set their own prices freely.

Another important change in the retail sector is the emergence of many specialty retailers in such areas as music software, sporting goods, home electric appliances, books, and apparel. These retailers have many similar chain-operated stores; thus, just like large chain stores, these specialty chain stores are also relatively independent from traditional wholesale networks. They usually open their store outlets in shopping centers, and the number of shopping centers is increasing rapidly following the reform and abolishment of the Large Scale Retail Store Law.

Over all, the changes described above have increased accessibility from abroad to the Japanese retail market. Furthermore, increasing competition among retail stores as well as weaker control by manufacturers in the distribution system provides consumers with a more competitive environment. These changes certainly enhance consumer welfare.

4.5 Concluding Remarks

The traditional distribution channel in Japan was characterized by a large number of small retail stores and wholesalers. The influence manufacturers exerted through *keiretsu* distribution channels was quite strong and made access from abroad difficult. This paper has explained some of the important features of *keiretsu* distribution channels such as rebate systems, enclosure of wholesalers and retailers, and high retail margins as incentive mechanisms.

These features of the Japanese distribution system were partly due to constrained land, high population density, and a slow motorization process and partly due to various regulations enforced by the government. Although the system was efficient within the traditional economic environment, it is no longer so in the changing economic environment. Furthermore, the traditional system set high barriers to imports from abroad.

The distribution system is now, however, undergoing rapid structural change. Motorization and the resulting changes in consumer behavior triggered structural change in the distribution system. The emergence of new types of retailers accelerated the change, and the competitive environment in the distribution system made foreign access to the Japanese import market far easier. Yen appreciation since the middle of the 1980s also contributed to the change.

Deregulation of various measures, especially the abolishment of the Large Scale Retail Store Law, arose as an important policy issue for the government. It was also regarded as an important trade issue in negotiations with Japan's trade partners. Following various stages of deregulation, the Large Scale Retail Store Law was finally removed and a new law, the Large Scale Retail Store Location Law, was enacted. Since the new law has not yet gone into effect, the influence of this system change has yet to be seen. However, the increasing degree of competition among retail stores and the aggressive entry of foreign firms into the market is expected to further improve accessibility to the Japanese market.

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Comment Thomas Gale Moore

During my time on the President's Council of Economic Advisers I became familiar with the hypothesized relationship of the distribution system in Japan to imports. The Reagan administration certainly pressured the Japanese to change their system. I am glad to learn that they are making progress on opening up their distribution system, particular with the gradual liberalization of their Large Scale Retail Store Law. Freeing up their distribution system and allowing more efficient types of retailing to flourish is in the interest of the Japanese consumer.

I do not believe that it will have much effect on U.S.-Japanese trade. It may shift somewhat the composition of trade, but the imbalance between exports and imports worldwide is a result of saving and investment balance. Japan saves much more than the United States, and a portion of the Japanese funds come to the United States as investment. We gain by this, but we *pay* for it with more imports and less exports. The actual trade deficit between the United States and Japan is a meaningless number to economists, but not to politicians.

Nevertheless, it is desirable for all that the Japanese economy continue to prosper and that its people reap the gain. A more efficient distribution system would raise the living standard of the people of that island. That might lead them to buy more goods from us, but the effect would probably not be large.

In reading Motoshige Itoh's enlightening paper, I was unsure that his statistics and arguments proved what he alleged was true. For example, Itoh cites Matsushita as having a series of chain stores that feature that manufacturer's products. These are small neighborhood stores. However,

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Matsushita faces competition from other manufacturers. Department stores and general merchandising stores also sell electrical appliances. Thus, if the system of small shops is so inefficient, how come Matsushita employs it and why do these other outlets not bankrupt Matsushita or at least put the small stores out of business?

These small outlets probably provide considerable information to purchasers about the products. And while a shop owner has a strong incentive to push the brand names of the manufacturers that he or she handles, the proprietor must keep local customers happy. The merchant cannot sell inferior merchandise or overprice products. The local store owner and salespeople probably live close to most of their patrons and probably know them by name. Consequently, the store is likely to be very sensitive to the interests of its clientele. The existence of large rebates from manufacturers suggests that competition is keen.

Itoh argues that general merchandising stores sell a greater variety of goods than the typical American chain store. They may, but I am not convinced that his statistics demonstrate that fact. He calculates the average sales per shop for the largest chain in Japan, Daiei, and compares that to average sales at a typical Wal-Mart. What exchange rate did he use to make this conversion, a market rate, purchasing power parity, or what? But even if we agree that the sales volume is larger in a chain store in Japan, it does not follow that the variety of goods is greater. The individual items may be more expensive or the volume of sales for any one good may be higher.

As Itoh showed, the system of small retailers grew up in a market where consumers walked to local shops, especially in large cities. In the downtown part of large U.S. cities, local stores tend to be small because people find it more difficult and costly to use cars. As long as the Japanese people live in concentrated cities, shops will tend to be small. The Wal-Marts of this world are a product of suburbia with land cheap enough that large parking areas can be built. Consequently, even if the Large Scale Retail Store Law is totally repealed we would not expect that Japanese retailing would look like U.S. shopping centers.

As I mentioned earlier, the Large Scale Retail Store Law is being adjusted slowly. Nevertheless, adjustment is taking place. If the Large Scale Retail Store Law were repealed, would local government step in to protect small retailers? Probably some would: they do in the United States. However, in the United States competition for retail dollars limits the willingness of cities to exclude large retailers. In Palo Alto where I live, one of the largest retailers is Fry's, an electronic and computer store. Many residents would like to rid the city of the store, but it brings in too much money. Competition among cities does work.

I am not sure what table 4.1 shows. The data on shops per 1,000 square kilometers are meaningless; much of the United States is uninhabited. The number of shops per 10,000 people in Japan is somewhat higher than any other country listed, but as I said, Japan is a very urban country where we would expect more small shops. The number of workers per shop is the same in France and Japan. The number of employees in wholesale establishments is higher in the United States and France and lower in West Germany than in Japan. Are German wholesalers more efficient or smaller? Are U.S. wholesalers less efficient or bigger?

Finally, in the United States about 10 percent of all nonfood and nonauto retail sales are mail order. Is there much mail order in Japan? That would clearly increase competition. Basically, the evidence that Itoh presents suggests that competition is alive and well in Japan, but that the government has been trying to limit it.

Comment Ching-hsi Chang

In this paper, Motoshige Itoh delineates the distribution system for manufactured products in Japan after World War II. The distribution market before 1970 can be characterized as a vertically separated system in which retail stores were controlled mainly by closely related wholesalers and to some extent by manufacturers. This structure was due to the characteristics of the transportation system and restriction by the government. The former included a lag in motorization, convenient public transportation systems, and densely populated urban areas. The latter took the form of the Large Scale Retail Store Law. While large retail stores faced severe barriers to entry in local markets under the law, the retail sector was dominated by small family-type retail stores serving their neighbors. Corresponding to the retail stores, a lot of local wholesalers, each in charge of a single product, had strong influence on the retailers. In extreme cases, retail stores were enclosed by manufacturers such as Matsushita and Shiseido, who had specific counters in department stores where the sales clerks were the employees of wholesalers or manufacturers. The measures that manufacturers used to control retailers were price discrimination (rebates) based on the amount of orders and order privileges during product shortages. Control by manufacturers was so effective that there was no arbitrage to exploit price margins or cheating in price collusion. Only general merchandising stores operated independently of wholesalers and manufacturers.

Since the mid-1980s, the vertically separated system has gradually been dismantled. In the late 1970s, Japan became increasingly motorized. People were able to shop in stores located in suburban areas. While the

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Large Scale Retail Store Law still curbed the development of large shopping centers, the appreciation of the Japanese yen encouraged imports. To promote its exports, the United States initiated pressure to liberalize Japanese domestic laws.

The product distribution system is important because gains from division of labor and specialization are only realized through exchange. An effective distribution system permits greater specialization and division of labor and consequently higher economic growth. Itoh's paper on the Japanese distribution market is very informative. I am especially impressed by similarities between Japan and Taiwan. Taiwan has a similar distribution system because some Japanese companies, such as Shiseido, introduced their distribution systems to Taiwan with their products. Interestingly enough, it was also American pressure that helped deregulation in Taiwan (see my paper, chap. 7 in this volume).

I have several questions about this paper, however. First, I would like to know whether the vertically separated system before 1970 in Japan was the best distribution system or not. The question arises because small retailers were heavily protected by the government under the Large Scale Retail Store Law. What would the alternatives have been had there not been such a law? Second, the vertically separated system does not seem to be necessary for affiliations with small retail stores because close relations between wholesalers and retailers also prevailed in the department store system. In other words, a few large nationwide wholesalers could have been associated with many small retail stores. There is a fundamental question about the meaning of the separated system. Is it a product-separated or brand-separated distribution system? Since many goods go through long tunnels of wholesalers, and either wholesalers or manufacturers control the tunnels, it must be a brand-separated system. However, if people have to shop on foot, would it not be more advantageous to sell as many brands as possible in one store? On the other hand, it is not necessary for retail stores to be small under a brand-separated system because they could sell many products, each a single brand, in one retail store.