

JAPAN MOVES TO IMPROVE EFFICIENCY OF SERVICE SECTOR

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While media attention is largely focused on political and macroeconomic trends, the economic revitalization of Japan is being achieved largely on a sector by sector, company by company and individual basis.

The changes that have taken place in Japan since the Action Plan for Economic Reform was announced in late 1996 are substantial. Comprehensive reform and a changing economic environment have dramatically altered the incentive structure and both the way business is conducted as well as consumer expectations and behavior.

Of special significance are opportunities in Japan's rapidly changing financial, healthcare, retail and other service industries as well as ICT and other technologies that are driving new efficiencies and change. It is also worth noting the changes arising as new small and medium enterprises (SMEs) are achieving success, further driving change and innovation in Japan.

To enhance the development of more efficient and competitive service sector and the operating environment for firms of this kind, Japan's Ministry of Economy, Trade and Industry (METI) recently formed a study group of leading academics, researchers, and industry representatives. The result of their work has helped to identify a number of important obstacles and constraints as well as policy recommendations that are now being examined in an effort to resolve these problems.

Japan is a Very Different Place Today than Only Ten Years ago

Whereas once Japanese corporations and banks maintained control through extensive cross-shareholdings, these holdings fell substantially throughout the 1990s and early 2000s when compared

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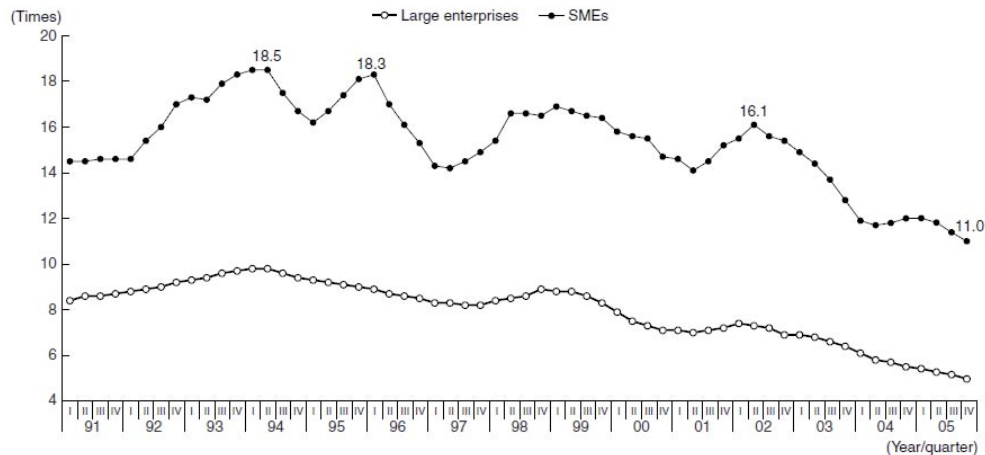
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to the 1980s. Many of these shares were sold to foreigners, who now own a much larger share of the Japanese stock market than they did in the past. The effect of this change in ownership to foreign investors, who possess a tradition of corporate activism, from the old system in which managements used cross-shareholding to govern with minimal restraints from outside parties should not be underestimated. Specifically, foreign investors now own 28 percent of Japanese stocks compared with 26 percent in 2006 and a meager 5 percent in 1990. Japan not only has welcomed this investment in shares, but also foreign direct investment into a wide variety of sectors. As of the end of 2006, foreign direct investment in Japan totaled ¥12.8 trillion (\$110 billion), which was 94% larger than in the year 2001. These investments have taken place in many areas where foreign investors previously had little presence. Examples include Proofpoint Japan KK which develops software for computer protection against spam emails, Tetra Tech, which provides consultation services concerning the environment, and eRide Asia Pacific Limited which develops and markets IC chips and supersensitive low-power Global Positioning Systems (GPS).

On a macroeconomic level, Japan remains an export powerhouse, yet domestic consumption has increased in importance. This is a result of a strengthening economy, a more buoyant stock market, improving dividends, confidence from increased corporate profitability and other related trends. Compared to the past, the Japanese economy also is much more closely linked with Asia—both in terms of exports and imports—and Japanese firms now routinely consider India and Southeast Asian countries when evaluating investment destinations. Indeed Japan has become a key driver of growth in Asia as a market, investor, and source of knowledge.

Another development of note is the renewed strength and vigor of SMEs, which have long been important players in the Japanese economy -- but went through extremely tough times in the 1990s. This is especially true among companies who have well-defined niche strategies and proprietary technologies. They have experienced near continuous improvement in their confidence levels, domestic and international shipment performance, profitability, and balance sheets.

Fig. 1-1-22 Trend in debt redemption period of SMEs
SMEs move to eliminate excess debt



to take advantage of these shifting risk proclivities, HSBC Investments created the first pure Russian equity fund for Japanese investors in July 2007. For their part, Japanese institutional investors such as life insurers, pension funds, and non-life insurance companies are also increasing their investment in private equity, in some cases doubling their investment of plan assets as well as other alternative asset vehicles.

This desire for higher returns is by no means confined to investors. Japanese managers are well aware of the need to shift away from a focus on market share and production volumes to boosting profitability and shareholder returns. This is leading to new efficiencies, the elimination of excess capacity through consolidation, and greater shareholder buybacks and dividend increases. In terms of consolidation, 2006 represented a watershed year as the first-ever hostile takeover bid by one Japanese blue-chip company (Oji Paper Company) for another (Hokuetsu Paper Mills Ltd.) took place. Though it ultimately failed, this event opened the door to a more intense M&A environment moving forward.

Consumer expectations and behavior have also changed. The greater diversification of lifestyles and exposure to other cultures have caused Japanese consumers to become less uniform in their preferences and they are now more receptive to a wider range of services and product offerings. This includes more acceptance of Western food products such as soft drinks, cereals, and wine as well as Western fast food chains such as the ubiquitous McDonalds, Subways and Starbucks. In addition, Japanese consumers have become more willing to embrace value pricing or goods which offer good quality at low cost versus high end or upscale brand goods. The emergence of retail chains, such as Fast Retailing's UNIQLO, which combines Japanese design and style to products sourced in China and other lower cost production venues as well as outlet stores created by developers such as the Chelsea Property Group are examples of this trend. In UNIQLO's case, it opened its first urban store in the trendy Tokyo neighborhood of Harajuku in 1998 and now has about 700 stores in Japan, and since 2001 has begun its overseas expansion through the opening of additional stores in the UK, US and Hong Kong.

The transformation of these shareholding patterns, Japanese macroeconomic features, SME

structures, investor preferences, management objectives, and consumer preferences is leading to dramatic changes in corporate and consumer practices. This is coupled with a rising demand for a far more robust, efficient, and diverse service sector.

The Service Sector Accounts for Almost 70% of the Japanese Economy

As in all developed economies, Japan's service sector, which includes healthcare, leisure services, distribution, software services, and a host of other activities, has increased in importance. It now accounts for almost 70% of economic activity whether measured in terms of GDP or employment. Going forward, it is likely to become even more important due to demographic changes such as Japan's shrinking birthrate and aging population. This creates a rising demand for new services, outsourcing certain aspects of the manufacturing process out of Japan, and a range of deregulation and privatization measures. This is creating a range of new opportunities for domestic and foreign private businesses. Moreover, the ongoing development of Japanese financial markets, as both government and business seeks to reduce the cost and increase the availability of capital for new business formations, restructurings, and expansions, will bolster the demand for legal and financial services. Finally, the need for Japanese business to move up the value added chain through branding and innovative design ideas should fuel the development of service businesses in areas such as design, marketing and other relevant corporate services.

Japan's service sector, however, has lagged in terms of productivity growth when compared to sectors such as telecom, finance and insurance and manufacturing. Between 1995 and 2003, it achieved only 34% of the productivity growth rate of the U.S. and only 62% of the productivity growth rate of the U.K. Given the rising importance of this sector, Japan will need to take steps to improve service sector productivity to sustain its ongoing economic recovery. Initiatives to increase innovation otherwise enhance the business environment for services are also becoming a real priority.

Study Group Identifies Constraints and Steps to Improve Japan's Service Sector

To address the obstacles that have been impeding growth in Japan's service sector and to identify policy recommendations and other actions that can address these and other constraints, Japan's Ministry of Economy, Trade and Industry (METI) formed a study group, comprised of leading academics, researchers, and industry representatives.

This study group recognized early in its work that it was desirable to think about productivity not only in terms of reducing the costs of inputs, but also in terms of raising the "quantity" of output—e.g., by improving the quality of services delivered to consumers. This richer way of framing productivity allowed the study group to identify a wider range of factors impinging upon productivity improvements as well as to develop a wider range of policy suggestions.

The results of their work were released in a report [*Towards Innovation and Productivity in Service Industries*](#), which was released by METI in Japanese in April, 2007 and in English last July.

In this report, the study group specifically highlighted factors such as a lack of foreign and domestic competition, a dearth of service-oriented R&D activity, inadequate attention to the development of human capital, and an absence of well defined standards and benchmarks. Benchmarks and standards are important because they give consumers confidence and trust in the quality of the services they receive. This helps to dispose them to do more business with service providers whose products they might not otherwise consume due to uncertainty and lack of information.

The study group also noted insufficient use of IT, a variable which Research Institute of Economy Trade and Industry (RIETI) faculty fellow Tsutomu Miyagawa stressed as holding back the productivity of Japanese service industries such as the distribution, transportation, and hotel industries. Beyond this, the study group directed attention to the business

environment as a factor hindering the expansion and renovation of the service sector.

To tackle these and other problems confronting the service sector, the study group called for a multitude of measures. One is regulatory reforms that would promote competition, cooperation between industry and academia to improve service related R&D. This will help to increase service efficiency and quality, and to enhance information flows and the quality, quantity, and availability of service benchmarks and standards.

Furthermore, the study group recommended that the government establish centers for R&D of service engineering, support demonstration products where scientific and engineering approaches had been successfully utilized in the service area, and to create structures within existing organizations to help SMEs introduce more advanced service management methods. The study group also advised government support for a service certification system, efforts to enhance the training of service personnel, and initiatives to expand the use of IT in the service sector. This includes software sharing, Internet based accounting, and backing for RFID technology.

Of interest to foreign investors, the study group also recommended Japanese government support for WTO negotiations that would advance the liberalization of trade in services. Additionally, it championed Japanese government initiatives that would encourage investment by foreign businesses in the Japanese service sector.

Efficiency of Service Sector Important for Both Domestic as well as Global Efficiency

As globalization has progressed and opportunities for modularizing the production process have increased, large Japanese firms have transferred an increasing percentage of the components of the manufacturing process abroad to reduce costs and gain the benefits of proximity to customers. This move outside Japan, though, is no longer confined to large firms as technological and other changes make it both more feasible and necessary for SMEs

to offshore some, or all of, their production processes. In the end, firms are likely to house in Japan only those operations that require advanced technology, highly skilled workers (engineers, managers, and the like), and select competencies primarily available in Japan.

While these operations provide many rewarding opportunities for Japanese workers and contribute to high Japanese living standards, the reality is that the service sector will become more and more important as a source of jobs and the resources needed to sustain rising living standards. Ultimately, however, the service sector will not reach its full potential until Japan moves forward on a number of the recommendations put forth by the aforementioned study group as well as others that are now under discussion.

Japanese policymakers recognize the need to do more to achieve this goal. Speaking about services, albeit with a focus on the Japanese stock market, Japanese financial services minister Yuji Yamamoto observed, "Japan cannot be totally dependent upon manufacturing alone."

Changes in Japan's Service Sector Driving New Business and Investment Opportunities in Japan

The desire to revitalize Japan's service sector is creating opportunities for U.S. and other foreign businesses and investors. First, foreign businesses may be able to supply services—e.g., data gathering, software and IT consulting, and training—and goods—RFID devices, software, and Internet based certification structures—that improve the productivity and efficiency of Japanese service providers.

Second, foreign businesses may locate attractive opportunities as the Japanese government moves to deregulate, privatize, and liberalize in an effort to enhance the level of competition in Japan's service sector as well as to bring in new ideas and methods. For example, if Japanese debates to liberalize the aviation sector pursuant to the Asian Gateway Initiative make headway, new opportunities will emerge for foreign firms to provide aviation as well

as airport services. Similarly, Japan's current quest to reinvigorate Tokyo as a global financial center will create opportunities for foreign banks, hedge funds, and private equity funds to offer a multitude of investment products. The lure of this is clear given that big foreign investment banks such as Morgan Stanley and Goldman Sachs achieved record revenues in Japan in 2006 as a result of their brokerage, securitization, and M&A operations in the country.

Many foreign retailers and restaurateurs have also had considerable success in the Japanese market. In the former category are firms such as L.L. Bean, Benetton, and the GAP. In the latter category are entities such as TGI Friday's, Outback Steakhouse, and Gramercy Tavern. Tellingly, even smaller firms are finding opportunities in the Japanese service sector, moving into diverse areas sometimes with the assistance of Japanese government organizations such as the Japan External Trade Organization (**JETRO**). To illustrate, Scala Inc., a Pennsylvania manufacturer of digital design software, recently opened a wholly owned subsidiary in Japan. In addition, Clear Channel Outdoor Inc., an outdoor advertising company from Arizona entered into a joint venture in with Mitsui & Co. Ltd. Finally, Giuliani Partners LLC, former New York Mayor Rudolph W. Giuliani created a safety and security management consulting firm titled Giuliani Security and Safety Asia Inc.

Third, foreign investors such as mutual funds, hedge funds, and private equity firms may identify opportunities to invest in Japanese service firms that offer attractive returns as they restructure and enhance their productivity.

Aside from potential gains from supplying Japanese firms with goods and services, operations in Japan also provide businesses and investors with an opportunity to diversify as well as to expand their international exposure to East Asia, with which Japan has become increasingly integrated.

It should be recognized that a foreign presence in Japan permits foreign firms to learn from operations in Japan and dealings with Japanese consumers as well as to absorb new

product ideas that can be transferred to other markets. In this vein, Jochen Zeitz, CEO and Chairman, PUMA AG Rudolf Dassler Sport, which opened an operation in Japan in 2003, quipped, "Since Japan and Tokyo in particular, is the epicenter of trends in the Asia/Pacific Region, our focus is on further strengthening our position in this key market."

To further examine Japan's service and other targeted sectors as well as innovation, case studies, and other issues that impact on its attractiveness as a market for business and financial investment, JETRO, the U.S. Department of State and METI, in cooperation with the U.S. Chamber of Commerce, are now planning to host a symposium on October 24, 2007 in Washington, D.C. This event will be organized as part of the annual United States – Japan Investment Initiative. For registration and other details, please visit: www.jetro.org/symp2007. Media requests should be directed to jetro@kwrintl.com.

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