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1. Introduction

More and more attention has been given to the distribution system in Japan as barriers to trade. After most of formal barriers to trade such as quotas were removed and tariff rates were lowered, informal barriers to trade became relatively more important. Various business practices observed in distribution system are of particular importance, since most of the goods imported must go through domestic distribution system. This issue has also attracted wide attention in Japan as a cause of high prices in Japan.

One can observe various interesting business practices in distribution system not only in Japan but also in all other countries. To mention a few examples, we can observe such practices as consignment, various types of rebate system, resale price maintenance, and close territory arrangement between manufacturers and wholesalers. These practices imply weak form of vertical integration under which manufacturers and wholesalers as well as retailers form certain types of ties. Under such vertical arrangement it is not easy not only for foreign firms but also for domestic new entrants to penetrate into the market unless they create new distribution channels.

Based on the above view, Japanese distribution system has been criticized as barriers to import. In Japan-U.S SII (Structural Impediments Initiatives) Talks the deregulation of Large Retail Store Law, by which entry of large retail stores has been regulated, became one of the central negotiation issues between the two countries. In more recent negotiation between the two countries on automobile trade, the dealer system in Japan became major issue. In film trade dispute Kodak criticized rebate system of Fuji film in Japan, although Fuji film counterattacked Kodak by pointing out that a similar practice is employed by Kodak in the United States.

Retailers, wholesalers and manufactures are affecting each other in various ways. In economics terminology we may say that there are various kinds of externalities among them. Consider, for example, how the behavior of retailers affects the profits of manufacturers. One retailer usually sells the products of various manufacturers. Thus, if the railer puts more effort on one particular manufacturer's products, other manufacturers will suffer from the discriminating behavior. Manufacturers therefore put great efforts to give retailers incentives to favor their products. Rebates are the measures used for that purpose.

Retailers' effort or behavior, which affects the sales of manufactures, can take various forms. Where the products are exhibited is very important; manufactures are competing for better places in shops. The prices set by retailers also affect the sales of the products. Although resale price maintenance, under which manufacturers control the retail prices, is illegal, manufactures often put some control on the retail prices. The level of after-service is also quite important for some type of products such as consumer's durables.

Considering various kinds of externalities, it is natural that vertical relation between manufacturers and retailers often become quite complicated. It is also important to note that the types of vertical relation one can observe often depend on the structure of distribution system such as size distribution of retailers and the nature of products distributed.

The purpose of this paper is to examine what kinds of business practices are observed in the Japanese distribution system, what is the economic mechanism behind these practices, how these practices emerged and have evolved, how they are changing, and what effects these practices have on imports. By these examinations I will discuss the function of distribution system in Japan and its relation with Japan's trade. Due to lack of knowledge about other countries, most of the discussion in this paper is restricted to the case of Japan. However, I believe that many of the practices discussed in this paper will be observed in other countries as well.

2. Vertical relations in the distribution system: some cases of traditional distribution channels

The characteristics of distribution channels are different among various commodities, so I first discuss some typical cases to illustrate the function of traditional distribution channels in Japan. In this section I raise four cases, the case of medicines, men's suits, cosmetics (as well as home electronics) and processed food to illustrates how various business practices have evolved.

Note that most of the discussion in this section is restricted to the case of traditional channels. Although this type of traditional channels still covers very large portion of today's distribution system in each category of products, new type chain stores are rapidly expanding their shares. I will also briefly discuss how the system is changing from the traditional system to the new one.

2-1. home medicines

The distribution system of home medicines (drugs which consumers can purchase at drugstores without doctor's prescription) illustrates a very extreme case of typical traditional distribution system in Japan.

One of the important characteristics of the distribution system of medicine in Japan is that the retail sector has been dominated by small papa mama shops until recently and that small shops still has a large share.[1] There are several reasons why the retail sector was dominated by papa mama shops. Among the various factor, the most important one is the regulation by the government. Due to the special nature of the product, the retail activity of medicine is heavily regulated. The government approval is necessary to run drug stores and there are several requirement for the approval. To mention a few important requirement, (1) A pharmaceutist must be in the shop, (2) when supermarket or convenience store sell medical products, the area selling medical products should be separated from other area, and (3) when there is already a drug store in one area, it is difficult to start another drug store in the near distance.

One of the intentions of the government to introduce various regulation measures is to discourage "excessive competition". "Excessive competition"[2] is a word often used by the Japanese government officials when introducing regulation measures. The Ministry of International Trade and Industry once introduced various regulation measures to discourage excessive competition in such industry as steel, petro chemical and textiles. Ministry of Finance introduced various regulation measures in banking sectors so that excessive competition will not lead to excessively risky banking behavior. Similarly, Ministry of Health and Welfare introduced regulation measures on retail activities of drug stores in order to make it sure that drugs with right quality will be supplied with appropriate information. I am not going to discuss whether this kind of regulation is justified or not. These regulation measures can be observed more or less in any countries. However, it is obvious that these regulations made it difficult for big retail companies to expand drug store chains or to expand their sales of medicines in supermarket shop outlets.

The second important characteristics of medicines is that consumers' decision is

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[1]Note that papa mama shops are now rapidly disappearing and that chain store drug stores are now becoming the major player in the retail sector.

[2]See Itoh et al [1992] for economic interpretation of the concept of excessive competition.

strongly affected by retail stores. According to one survey, about 65 % of Japanese consumers ask shop owner's suggestion (shop owner is often a pharmaceutist) for the choice of such medicine as cough medicines and digestive medicines. Even when a consumer does not ask the opinion of a shop owner, he often purchases the products which are exhibited in a good location rather than the ones exhibited in unobtrusive places. Note that it is the shop owner who decides the place of exhibition of each product. Thus, the behavior of retail stores have very strong effects on the sales of the products.

It is the characteristics not only of medicine distribution but also many other products that small scale retailers depend heavily on wholesalers. Due to lack of capability of various activities, small scale papa mama retail stores depend on various service of wholesalers such as store exhibition arrangement, transportation of products, the choice of products they sell in the shop as well as the decision of retail prices. If one exaggerates the situation, the owners of the retail store just sit in the shop and sell to the customers, and all other services are provided by wholesalers. Due to this dependence of retailers on wholesalers, wholesalers have strong influence on the retail activities.

Some of the manufacturers, which have established their dominant position in the early history of the market, have strong ties with wholesalers. These manufacturers influence the behavior of wholesalers by way of various measures. Rebate system is a typical measure, under which manufacturers provide wholesalers and retailers with bonus payment for promoting the sales of their products. Long term relationship established between a manufacturer and a wholesaler is also a key for manufacturers to control the behavior of wholesalers.

It is difficult to know how much influence major manufacturers have on wholesalers. However, the fact that some of the manufacturers which entered the market later made impressive success by introducing the strategy of distributing their products directly to retail stores without using wholesalers. It is pointed out by many people in the industry that the choice of direct distribution strategy by these new firms was due to their difficulty of using wholesalers which are influenced much by incumbent firms.[3]

My students examined retail margins of cough medicines by major companies based on interviews with several drug store owners.[4] The following are the retail margins which retail stores can obtain when they sell the products at manufacturer's suggested prices.

Benza A (Takeda): 40 %

Ruru (Sankyo): 38%

Paburon (Taisho): 64%

Sutona (Sato): 60%

Takeda and Sankyo are manufacturers selling their products through wholesalers, and Taisho and Sato are the ones selling their products directly to retail stores. Note the fact that retail margins are very high for medicines and that they are extremely high for the latter two.[5]

Taisho and Sato, well known as "choku-han meka" meaning direct sales manufacturers, set their retail margin high. These high margins give strong incentives for retail stores to sell their products. In order to succeed as direct sales manufacturer it is vital to sell a large amount per shop; otherwise, they cannot cover a large fixed cost for sending their products directly to each shop.[6] High retail margin implies low selling prices

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[3] Note that Coca Cola employed the same approach of shipping the products directly to retail storesı the route-sales approachı, when it entered the Japanese market.

[4] This is based on Itoh [1995].

[5] The margins are similarly high for other medicines. It is often said in this industry that price structure is ⁄kuso baiı, meaning that the retail price is about nine times as high as production cost.

[6] Note that Taisho has about 46,000 drug stores to which it sends its products directly.

to retail stores. Using this high margin strategy Taisho and Sato have been very successful in spite of the fact that they are later comers and that they did not have intimate relation with wholesalers as Takeda and Sankyo, established incumbents.

Takeda and Sankyo cannot set high consumer margins as Taisho and Sato, since they have to give certain margin to wholesalers. However, their influence on wholesalers and retailers dependence on wholesalers as well as their established brand, allow them to keep high market share in these products. Perhaps the high retail margin of Takeda and Sankyo, relative to other products in general, can be explained by competing margin with direct sales manufacturers as Taisho and Sato.

Note that the prices of some of the medicines (but not all) are allowed to be controlled by manufacturers. Thus, these products are exceptional case in Anti Monopoly Law in Japan, which generally does not allow manufacturers to control retail prices. Even for those medicines whose prices are not allowed to be controlled by manufacturers, the retail prices seems to have been controlled well by manufacturers without showing much evidence of the violation of the law to the regulating authority.

High retail margin, of course, gives strong incentives for some retail stores to discount retail prices so that they can expand their sales. However, there are several reason to discourage retail stores from discounting. First, there is mutual watch system among retail stores, and if extreme discounting by some retailer is observed, the fact will be reported to the manufacturers and wholesalers. Second, due to the structure of retail stores in this product, namely small scale retail stores spreading all over the nation with some distance between two shops, made price elasticity of demand for each shop quite low. Thus, the retail stores do not have much incentive to discount. Third, large scale retail chain stores, which have stronger incentives to discount, have much difficulty to expand due to various regulation measures I have already mentioned.

The case of medicine distribution have many of the features of traditional distribution channels in some extreme way. Let me summarize some of the most distinguished features:

(1) Retail sectors were dominated by small papa mama stores, and government regulation measures supported the dominance of small scale retail stores.

(2) Control of distribution margin was an important marketing method for manufacturers. By setting distribution margin high, manufacturers are competing for giving more incentive for retailers to sell their products.

(3) Retailers depended heavily on wholesalers and manufacturers, and thus they were quite obedient to the upstream.

The first point is actually the characteristics of the distribution system of Japan in general. We can observe the control by manufacturers and dependence of retail stores on manufacturers and wholesalers in variety of forms. As illustrated in the case of home electric appliances and cosmetics (Section 2-3 below), rebate system is often used by manufacturers to control the behavior of retail stores and wholesalers. For the case of apparel products (Section 2-2), consignment practice is often used, under which manufacturers have space to sell in retail stores. For the case of processed food such as beer and dairy products (Section 2-4) manufacturers have tried to integrate wholesalers as their sole agents.

Note that these practices have eroded gradually in recent years. Rapid expansion of drug retail chain stores made discounting more common features and it have become more difficult for manufacturers to keep high retail margin. Papa and mama stores now have difficulty of survival: deregulation as well as motorization made competition among retail stores more severe. Manufacturers thus have been changing their sales strategy. I will discuss the nature of these changes more in detail in Section 3.

2-2. Men's suits[7]

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[7] This part is based on Findlay and Itoh [1994].

In men's suits distribution we can observe different kind of vertical relation between retail stores and manufacturers. Although I discuss the case of men's suits here, most of the analysis can be applied to other apparel products such as lady's cloths, casual wears and underwear.

There are several large apparel manufacturing firms which also have function of wholesalers. I call these firms apparel firms. Department stores are major places for large apparel firms to sell their products. Consignment arrangement is highly used between large apparel firms and department stores in men's suits distribution. By consignment arrangement I mean such an arrangement as the one under which apparel firms send their sales clerks, they set the retail prices and all unsold products are returned to apparel firms. Thus, department stores do not take risk of dead stock nor they make any decision on the final prices. They just provide the places for selling. In addition to consignment we can also observe weaker form of consignment-like arrangement such as conditional return of unsold products.

Under consignment arrangement apparel firms are heavily involved in retail activities, and department stores as retailers depend heavily on apparel firms. Figure 1, which illustrates the value added structure of a typical men's suits sold in a department store and in roadside stores, illustrates how important the activity of apparel firms in the distribution of men's suits sold at department stores (but not the ones sold in roadside stores). Note here that the apparel firm takes a high margin (33%). This margin (we may call it value added by the apparel firm) covers various distribution costs as well as design costs. Note that production cost is not included in this margin. Although some part of this margin is the apparel firm's profit, most are such costs as wage costs of shop clerks, costs for covering unsold products as well as other distribution costs.

One of the important characteristics of men's suits is that there are a wide variety of products with different materials, colors, designs and sizes and that the fashion trend changes frequently. Thus, there is a large degree of uncertainly in demand and someone must cover this risk. The department stores are not good at covering this risk due to their structure. Most of the department stores are not chain operated in Japan. In other words each department store outlet has its own procurement function. There are usually 500 thousands to two million products sold in one department stores; all kinds of products from apparel products, furniture, jewelry and sporting goods to international foods and traditional Japanese kimono. It is almost impossible for a department store to hire its own shop clerks and buying staffs to cover all these goods and to take all the risks. Thus, department stores take an alternative approach, that is, consignment. By consignment arrangement, department stores can depend on various functions of wholesalers and manufacturers. The case of men's suits discussed here is a typical example of this practice of department stores.

European brand products take a large share in department stores. Some department stores are very aggressive to import expensive European brand products including Italian and French suits. Apparel firms also get licenses from foreign firms and manufacture the products in Japan. European brand products were expensive products and the lot for each item is quite small. Thus, department stores are ready to take risk without depending on consignment arrangement. However, inexpensive Asian products have much more difficulty of penetrating into department store market; department stores do not have capacity to take risk. Apparel firms, which have a large capacity of production in Japan, is very reluctant to import foreign products.

The situation is very different for other distribution channel of men's suits. So called "Kogai-ten" (roadside chain stores) have grown very rapidly. Their share in men's suits was almost nothing about 15 years ago, but they sold about 50 % of men's suits (in terms of the number of suits not the value) a few years ago.[8] The way men's suits are sold

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[8]However, they are now challenged by General Merchandizing Stores as well as other new types of chain stores. General Merchandizing Stores and new types of chain stores also take an approach similar to the one taken by roadside stores. Thus, the type of discussion made about roadside stores below can also be applied to these chain stores.

in roadside stores is quite different from the way men's suits are sold in department store. The value added structure shown in Figure 1 illustrates this difference. One roadside store chain usually has more than 100 shop outlets, someone having more than 300 shop outlets. Since these shops are chain-operated, everything is controlled by the headquarter. Due to the large number of standardized shop outlets and to their specialization of selected men's suits (usually their own brand), they can enjoy scale economies; that is, they sell a large number of same types of suits. Scale economies allow them to take risk; thus, roadside stores purchase men's suits from apparel firms and take the risk. Roadside stores do not rely on consignment arrangement. The low margin of apparel firms for the men's suits sold in roadside stores indicates the low level of commitment of apparel firms in the distribution.

Motorization and yen appreciation promoted growth of roadside stores. Roadside stores are usually located in suburban areas where land cost is low. Due to the large volume of sales for each item product and their own risk taking, roadside stores are very aggressive to utilize inexpensive labor forces in such countries as China for sewing. In fact, growth of roadside stores almost coincided with growth of imported suits from China.

Although roadside stores' growth has stopped, a similar approach are now taken by other retailers such as large scale General Merchandise chain stores and new type chain stores. Even the department stores are now more aggressive to take risk to increase imported goods. Apparel firms are gradually replacing products from their domestic factories by the products imported from Asian countries.

2-3. Cosmetics (and home electric appliances)

Cosmetics market has attracted considerable attention due to its very special features. The size of the market is more than 2 trillion yen sales per year (2 trillion yen is about 20 billion dollar at the current exchange rate of 1 dollar = 100 yen). There are about 900 manufacturers including foreign firms supplying cosmetics in Japan. Technically, barriers to entry to this market seem to be very low. However, top three large manufacturers have about 43 % share of the market (1993). One of the important characteristics in this market is that large manufacturers utilize rebate system strategically and construct Keiretsu network of retailers (the network of retailers which favor one manufacturer's products).

In order to protect their keiretsu networks, large manufacturing firms put great efforts to control the retail prices of their products. Just like the case of medicines, retail margins are quite high for cosmetics. So, there are always some retail stores trying to discount their retail prices for attracting more customers. The actions taken by large manufacturing firms to discourage this kind of discounting behavior caused troubles and there have been several cases where the Fair Trade Commission intervened. Large manufacturing firms justify the importance of keiretsu system as necessary for maintaining high quality service with appropriate information and thus for maintaining good brand image.[9]

Let me explain briefly the content of keiretsu relation of large cosmetics manufacturing firms. The retail stores which form chain-store contracts with a large manufacturing firm deal with all the products of the manufacturer and receive various services from the manufacturers such as design of stores, store arrangement and free supply of samples. The manufacturers often monopolize the use of some corner of the shop for the exhibition of their products; in that sense, just like the case of consignment arrangement in men's suits, large manufacturers utilize some space in retail stores to sell their products exclusively. The manufacturers send beauty consultants to the retail stores, who not only give suggestion to customers about the use of cosmetics but are also involved in all kinds of activities related with the sales of the manufacturer's products.

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[9]Note that the situation is very similar to the well known Schwin case in the United States, where Schwin□s behavior to restrict its distribution channel for maintaining quality of retail service was challenged by anti-monopoly law. See Williamson [1985] for economic analysis of this case.

Rebate is another important measures for sales policy of large manufacturers. Rebate is a kind of bonus payment manufacturers offer to retailers depending on the amount the retailers sell. Table 1 illustrates an example of rebate system. The numbers in this table show how much percent of the amount paid by retailers are returned as rebate. As the table shows, up to 15 % of the original payment by retailers to manufacturers can be returned as rebate when retailers purchase a large amount from the manufacturers. This is nothing but non-linear price system, or volume discount system. Under this price system retail stores have strong incentive to sell one manufacturer's product.

The keiretsu relation observed in cosmetics market can go back to the 1930s. In this period the retail market was dominated by a large number of small scale retailers with a large number of entry and exit. It was then difficult for manufacturers to establish good brand image, since it was almost impossible to control the way the retailers sell their products. Discounting was just everyday practice and retail service such as explanation of products and beauty consulting were in very low quality level. Some manufacturers such as Shiseido, which is now the number one manufacturer, thus built up its own chain store network: that is, Shiseido formed exclusive chain store contracts with limited number of retail stores and sold its products exclusively in these chain stores.

The high share of small number of firms (45 % for the top three firms) in spite of the large number of firms supplying the products in cosmetics markets may be explained by this kind of keiretsu relation. It is not easy for small firms or for new entrants to find enough number of shop outlets to sell their products. In fact, just like the case of medicines, some firms choose direct marketing approach and visit the customers' home to sell their products. They bypass retail stores in this way.

The traditional distribution channel for home electric appliances has a very similar structure as cosmetics market. Large manufacturing firms such as Matsushita made chain store contracts with retail stores.[10] Rebates have been actively used for maintaining keiretsu network of retailers. Large manufacturers such as Matsushita depend heavily on small scale retail stores for the sales of their products.

In both cosmetics and home electric appliances manufacturers have nurtured the network of chain stores, which consist of small scale papa mama stores; not only retail prices but also the level of retail service are controlled by manufacturers, and high retail margin as well as rebate system have been utilized as measurers for promoting vertical relations between manufacturers and retail stores.

This traditional system have been challenged by large scale retailers. For example, Daiei, the largest retailer in terms of the amount of sales, did not have had formal transaction relation with Matsushita for more than 30 years until recently due to aggressive discounting sales of Matsushita products by Daiei more than 30 years ago (Matsushita rejected to sell its products to Daiei). For cosmetics market newly emerging discounters challenged resale price maintenance policy of large manufacturers. Some of the cases were actually brought to the Court. Some national GMSs started special discount sales against the will of large manufacturers. The expanding share of large scale retailers has changed the market environment and the large manufacturers are now moving gradually toward emphasizing the market of large scale retailers. However, the shift is very gradual, since large manufacturers still depend very heavily on the network of small scale papa mama stores.

The implication of the structure of distribution on imports is obvious. Traditional channel of networks of small scale retail stores has been controlled by large domestic manufacturers and it is quite difficult for foreign manufacturers to penetrate into this channel. Thus, most of the entry of foreign products was through other channel or by the

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[10] For example, the retail store in which the share of Matsushita is more than 79 % ia called ﾒNational Shopﾓ (ﾒNationalﾓ is a brand name of Matsushita). There are more than 20,000 ﾒNational Shopsﾓ in Japan.

creation of new channel. Some European cosmetics manufacturers were quite successful by creating their own channel of retail stores in large department stores. Their success was supported by their international brand reputation. For the case of home electric appliances the entry of foreign goods (except the products manufactured in foreign factories of Japanese firms) were realized through the channel of large retail stores. Such retail stores as national GMS chain stores or discount chain stores now become quite active to introduce inexpensive Asian products; they sell these products as store brand products.

2-4. Processed food

Food distribution has the largest share in the Japanese distribution market. In terms of the number of stores, about 21 % (100,000 shops) of wholesalers and about 39 % (620,000 shops) of retailers deal with food. In terms of the amount of transactions about 19 % of wholesalers and about 30% of retailers deal with food. In terms of employment about 20 % of the workers in wholesalers and about 37 % of the workers in retailers are employed in food related business. Thus, roughly speaking about one third of Japanese distribution market is that of food distribution.

Table 2 shows the prices of various food prices in major cities. In almost all goods the prices in Tokyo are the highest. Of course, there are various factors behind this international price difference and high prices are not the phenomenon observed only in food prices. Among the factors behind the high prices many people point out the importance of various regulations. Japan still maintains severe import regulations on food materials. For the products like beer and other liquors, consumption taxes are quite high. Furthermore, entry to retailing and wholesaling business of beer and liquors are restricted by license system, and it is often pointed out that this license is very restrictive. There are still a large number of supermarkets and convenient stores which cannot obtain the license.

In the distribution of processed food, just like other cases I discussed above, one can observe intimate vertical relation between manufacturers and wholesalers. The structure of distribution in processed food in Japan is often called "tatewari kozo" meaning "vertically separated system". Depending on the types of goods and manufacturers the products go through different wholesalers. According to a study by my student 23 trucks came to one small scale supermarket in a day: four trucks of fresh food, four trucks of daily food, four trucks of bread, one truck of frozen food, one truck of ice, one truck of dry food, four truck of sundries, and several others (This example is illustrated in Figure 2). All these trucks came from different wholesalers or manufacturers, and some actually traveled several wholesalers before coming to this supermarket.

It is usually the case that one supermarket has transaction with about 50 wholesalers and sometimes with more than 100 wholesalers. Among these wholesalers are included not only national level general food wholesalers but also local wholesalers for special products such as miso and dry snacks. In the past each retail store tried to decrease the number of wholesalers they deal with, and actually the number has been decreased. 23 trucks in the above example is the result of this structural change, but the number is still large. There are still many specialized wholesalers such as wholesalers for beer and liquors, for dry snacks, for miso, for frozen food, for meat, for sea food and for dairy products. The fact that there are a large number of specialized wholesalers or local wholesalers implies that it is difficult for national wholesalers to cover all products and all regions.

Figure 3 compares vertically separated distribution channel and integrated distribution channel. The United States already has quite integrated systems: manufacturers deliver their products either to distribution centers of large supermarket chains or to the distribution centers of large wholesalers. There are also cases where large retailers or wholesalers pick up products from manufacturers. Then, in the distribution centers all products are reallocated to the shipment to each shop outlet. Thus, theoretically there is one truck from the center to each shop.

For the case of vertically separated system the distribution channel is different depending on the goods. Thus, there are a large number of trucks coming to each shop. Behind this vertically separated distribution channel is the close relation between manufacturers and wholesalers. In many products manufacturers choose a certain number of wholesalers as "tokuyakuten", meaning "sole agent". Thus, when a retail store purchases a product from a manufacturer employing sole agent system, the retail store must buy the products from the wholesaler which the manufacturer instructs (closed territory system). When a supermarket sells salad dressing of three manufacturers each instructing different wholesalers as its sole agent, the supermarket must buy from the three wholesalers instructed by the manufacturers. One can observe this type of sole agent system in the products like beers, dairy products and dry foods. It is often the case that one wholesaler becomes an agent of more than two manufacturers, so the separation is not perfect. However, as Figure 2 illustrates, the number of wholesalers a retailer must deal with is quite large due to this relation between manufacturers and wholesalers.

Historical factor is quite important to understand the reason why this kind of vertical keiretsu exists between manufacturers and wholesalers. The following facts are often pointed out:

(1) wholesalers have much longer history than manufacturers; most of the national manufacturers have grown in the postwar period, but there are many influential local wholesalers which have more than 100 years history. Thus, in the process of growth, manufacturers had to depend on the function of local wholesalers: this dependence created keiretsu relation between manufacturers and wholesalers.

(2) One manufacturer produces many varieties of goods; so, without the help of wholesalers, it is impossible to satisfy the request of retailers. It is often said that only 20% of new products will remain in the market and 80% disappear after one cycle or one season.

(3) There are few wholesalers which covered all regions. Most of the wholesalers were specialized in some region. The fact that the retail sector is dominated by papa mama store

made it necessary for a large number of local wholesalers to survive.

It is only recently that large chain stores have expanded their share. For large scale retail stores it is better to deal with smaller number of wholesalers or to make manufacturers to deliver their goods directly to distribution centers. Concentration of wholesale system to a few national level large wholesalers are gradually proceeding. However, the process is still very slow, and quite a large portion of the distribution of processed food is run as I explained above.

However, the developments in the last few years should be given some attention. Although the change can be observed widely in various types of processed food, I will discuss only the case of beer market here. For a long time Japanese beer market was controlled by four large manufacturers. These four oligopolistic manufacturers controlled not only the distribution channels but also prices, both retail prices and wholesale prices. It was not easy for new coming firms to sell beer in this market. Wholesalers will not deal with new entrant's beer.[11] It is thus not difficult to imagine that penetration of foreign goods was quite difficult. Coca cola for example created its own distribution system when it entered Japanese market. Other large manufacturers such as General Foods employed the strategy of joint venture with large Japanese manufacturers and use the channel of the Japanese manufacturers.

However, yen appreciation made the relative price of beer in Japan extremely high as compared with other countries (see Table 2). Facing this condition large retail stores started importing foreign beer and sold them in their shops. A large scale of sales by these retailers allowed them to enjoy economies of scale in imports. The share of imported beer increased greatly and competition with imported beer forced domestic beer manufacturer to change their rigid distribution strategy.

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[11]In fact, it is a famous story in this market that number 4 company in beer market, Suntory, had a lot of difficulty of entry into this market. Suntory could not find wholesalers to deliver its beer to retailers, since most wholesalers had exclusive contracts with some beer manufacturer.

3. What caused the change in distribution market and import behavior?

Last five years have witnessed drastic change in the distribution system and import behavior. Yen appreciated from the level of $1=250 yen in 1985 to the level of $1 = less than 100 yen in 1995. Reflecting this yen appreciation, per capita GDP of Japan in terms of U.S. dollar increased from the level of about 11,000 dollar in 1985 to the level of about 35,000 dollar in 1994. This expansion of the size of Japanese market triggered increasing flow of goods into the Japanese market. Although the share of manufactured goods in total import was only 30 % in 1985, it exceeded 55 % in 1994 (See Figure 4).

The four case studies in the previous section suggest that the drastic increase in imports coincided with structural change in the distribution system. In fact, increase in imports of such products as Asian made apparel products, foreign processed food and drinks and home electric appliances have been supported by aggressive import behavior of large retail stores. The emergence of various large scale chain stores and their growth have destructed the traditional vertical ties between manufacturers and retailers (and wholesalers). Needless to say, this phenomenon is observed in any industrial nations. The question then arises as to why Japan had not experienced this kind of structural change until recently.

As our four case studies illustrate, keiretsu relation and various business practices therein have close relation with the fact that retail sector was dominated by small scale papa mama stores. Small scale retail stores need supports of wholesalers and manufacturers more than large scale retailers do. It is much easier for manufacturers to control small retail stores than to control large scale retailers. This kind of control is, on the one hand an effective measure to exclude rival manufacturers, but it is on the other hand a necessary measure to keep the level of retail service at appropriate level.

The reasons for the dominance of small scale retailers include the following ones:

(1) motorization factor:

Motorization was only a recent phenomena in Japan. In the United States there were already one car for 5.3 people in 1930, while in Japan there were one car for 7.5 people in 1973 (in 1973 West Germany had one car for 3.6 people, U.K. one car for 4.1 people and France one car for 3.5 people). This delayed motorization made it difficult for large scale retail chain stores to expand rapidly.

When consumers go shopping on foot or by public transportation, the size of retail stores are limited and the location of stores is also limited. Shops are usually located near the residential areas or near railway stations. Since there are not many customers who have access to these shops, the sizes of the shops are usually quite small. These location created the traditional shopping zone, where the major retail stores are traditional style retail stores, either small scale papa mama stores or department stores. High population density and high land cost may also help the survival of many small retail stores.

Rapid increase in automobiles, of course, promoted the expansion of suburban type large scale retail chain stores. However, the speed of change is not high due to several reasons. Infrastructure such as road is still poor for suburban shopping: serious traffic jam is caused by increasing suburban shopping. High land cost and distortion in the market of land use is another barriers to structural change.

Table 3 is interesting as an indicator suggesting the high space costs of retail stores in Japan. The number in this table is average amount of sales per 3.3 square meter (3.3 square meter is equal to "tsubo", Japanese unit of the size of land). This table compares space efficiency of sales between Japan and the United States in various types of retails stores such as department stores, discount stores, GMS and supermarkets. In each category the amount of sales per 3.3 square meters in Japan is about 4 to 7 times higher than that in the United States. In other words Japanese retail stores cannot survive unless they clear these high space efficiency.[12] This reflect various factors causing high land costs. Under this land cost constraint rapid expansion of suburban shopping is difficult, and this is behind the slow pace of structural change in the retail sector.

(2) Regulations

Another factor behind the slow speed of structural change is various regulations. Most well know regulation measure is Large Scale Retail Law. Under this law opening of large scale retail outlet has been severely regulated. Agreement of local small scale shop owners must be taken for opening new large scale retail shop outlet. However, since new large scale retail stores compete with local small shops after entry, it is difficult to get agreement. Under the law the government coordinates the negotiation process and finds compromised solution. However, the process of negotiation actually retards the timing of opening of new shop outlets.

There are some other regulation measures which become barriers to structural change. The regulations in liquor distribution and medicine distribution are notable examples. As I explained in the case studies in the previous section, these regulations make it difficult for large scale chain stores to expand their sales of these goods, and allow traditional system to survive.

As I explained in the four examples various business practices and vertical ties among manufacturers, wholesalers and retailers are closely related with the structure of retail sector. As long as the retail sector is dominated by small scale papa mama stores, some kind of vertical ties (keiretsu relation) is necessary for the well functioning of the distribution system. There are various kinds of externalities in the vertical chain of distribution system, and simple buy and sell transactions will cause distorted behavior.

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[12] Another interpretation of these numbers is that Japanese retail stores achieved very high profit due to this space efficiency. Considering the fact that the profit rates for Japanese retail stores are not high, I cannot accept this hypothesis.

Vertical relations as the ones I explained in my four examples are necessary for the well functioning of the system. However, it is true that these vertical arrangement at the same time become barriers to entry, both for domestic new entrants and for foreign goods. Here exist trade-off between well functioning of distribution system and better access from abroad.

For the economy like Japan better access from abroad have become more and more important in recent years. This change is behind the increasing attention on distribution system as barriers to imports. Thus, some people point out that it is necessary to regulate the behavior of manufacturers and wholesalers in order to weaken vertical ties in the distribution system. This kind of policy intervention may be effective for some type of business practices such as resale price maintenance. In fact, the Fair Trade Commission of Japan has strengthened its regulation on resale price maintenance in these years. For some cases this kind of more strict use of anti-monopoly regulation is welfare enhancing both for domestic citizens and for foreigners. However, as I explained in the case studies, many of the business practices observed in the distribution market and the resulting vertical ties are necessary for the well functioning of distribution market. So, unnecessary regulation may actually generate distortions.

Another channel for having better access is by structural change in the distribution system rather than by regulation of business behavior. The increasing opportunity to have access to inexpensive imported goods will promote the expansion of large scale chain stores. The vertical relation between large retail stores and manufacturers is more like a simple buy and sell relation, and vertical ties in the distribution system will be weakened by the expansion of large scale retail chain stores. These retail stores are also very aggressive to utilize import goods. Effective way for supporting the expansion of these large scale retail stores is to remove unnecessary regulations such as Large Scale Retail Stores Law. Distortion in the land use market due to various regulation measures and tax system is also an important barriers to the structural change.

4. Concluding remarks

The subtitle of this paper "protectionism or normal business practice?" was suggested to me by the conference committee. This question is very suggestive. There are two questions here, that is the part "protectionism?" and the part "normal business practice?". Thus, there are four pairs of answers to this question. The four pairs of answers are: (1) not protectionism and normal business practice, (2) not protectionism nore normal business practice, (3) protectionism and not normal business practice, and (4) protectionism but normal business practice.

The policy responses should, of course, be quite different depending on which of the four is the answer. For the first case, that is, for the case of not protectionism and normal business practice, there is no reason for policy intervention. For the second and the third case, that is for the case of not normal business practice, the practice should be restricted by some policy intervention whether it is protectionism or not. The type of policy intervention used here should be either anti-monopoly regulation or other related domestic policy (such as structural reform promotion policy) but certainly not trade policy. Although this is an important issue, it is not much interest for this conference. Thus, the fourth case, that is, the case of "protectionism but normal business practice", is the only relevant case for this conference.

When considering each concrete case, we first must ask ourselves the two questions; "whether is it protectionism?" and "whether is it normal business practice?". The classification I made above then suggests what policy response is necessary. As the cases I discussed in this paper suggest, many of the cases can be considered as abnormal business practice. So, some policy intervention (either anti-monopoly intervention or structural reform promotion policy) is necessary. There is not much reason to use trade policy.

The most controversial case is the case of "protectionism but normal business practice". We cannot deny that this case can arise. However, from the cases we considered in this paper, it is evident that many of the cases regarding distribution system is one of the other three cases. When it is barriers to entry, it is not only for foreign firms but also for domestic firms. Thus, the appropriate policy is not trade policy but anti-monopoly policy. In spite of this fact, trade disputes arise in many cases regarding distribution system in recent years. As for Japan such cases include those of semiconductors, automobiles and color films. What is necessary for these cases is not voluntary import expansion, which the United States requests, but anti-monopoly regulation when necessary. Perhaps, more efforts for international harmonization of anti-monopoly regulation may be necessary. The next round of WTO should discuss this issue, namely competition policy in international context.

Our case study suggests that many of business practices observed in the Japanese distribution market is dependent heavily on the structure of the market, such as size distribution and location of retailers. When there are some distortions in the market, it is much more efficient to promote the change in the structure of the market rather than to regulate the behavior of the firms. Fortunately, the market mechanism for structural reform is so far strong enough to change the underlying distribution sysmte.

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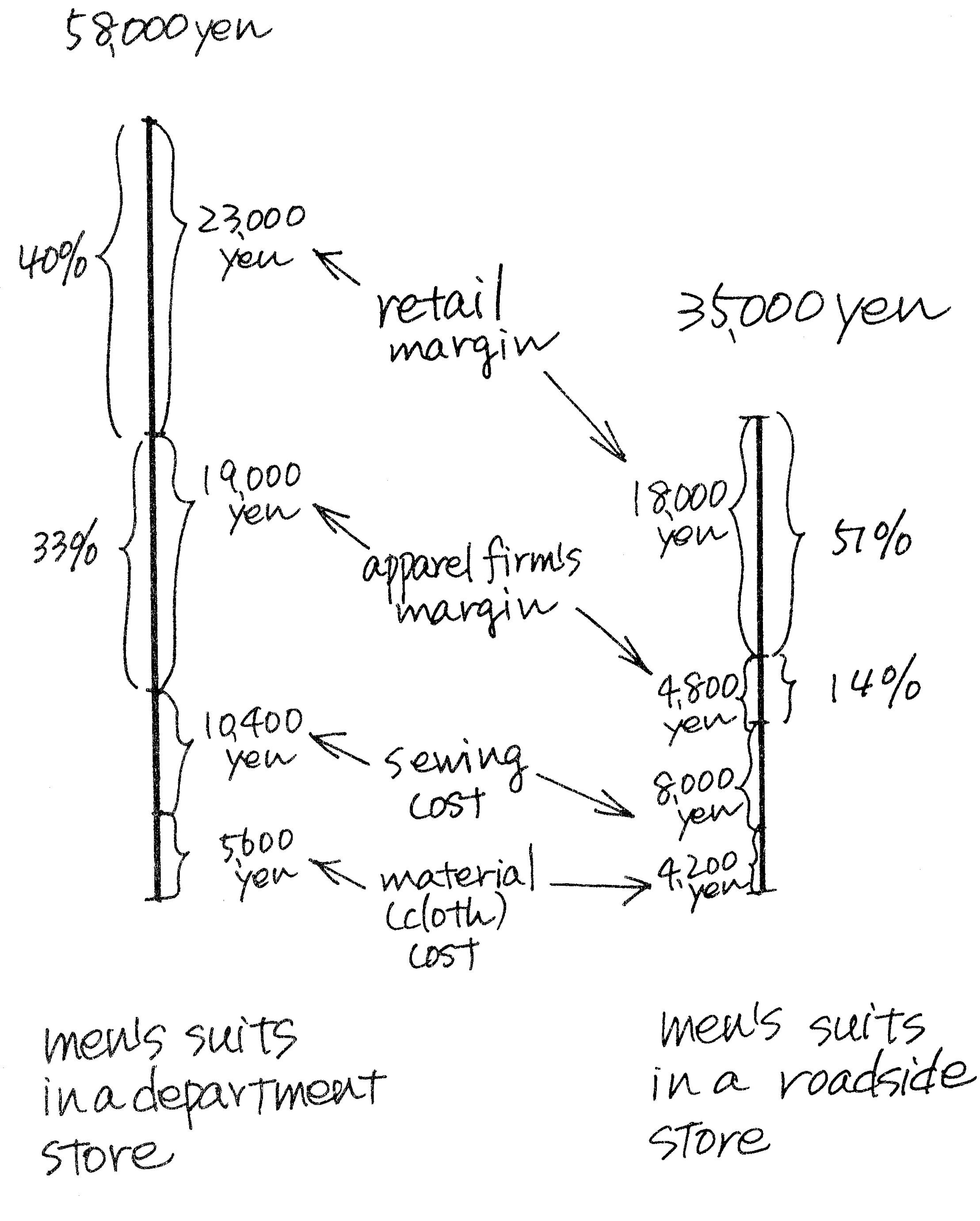

58,000 yen
40%
23,000 yen
retail margin
35,000 yen
33%
19,000 yen
18,000 yen
51%
apparel firm's margin
4,800 yen
14%
10,400 yen
sewing cost
8,000 yen
5,600 yen
material (cloth) cost
4,200 yen
men's suits in a department store
men's suits in a roadside store

Figure 1

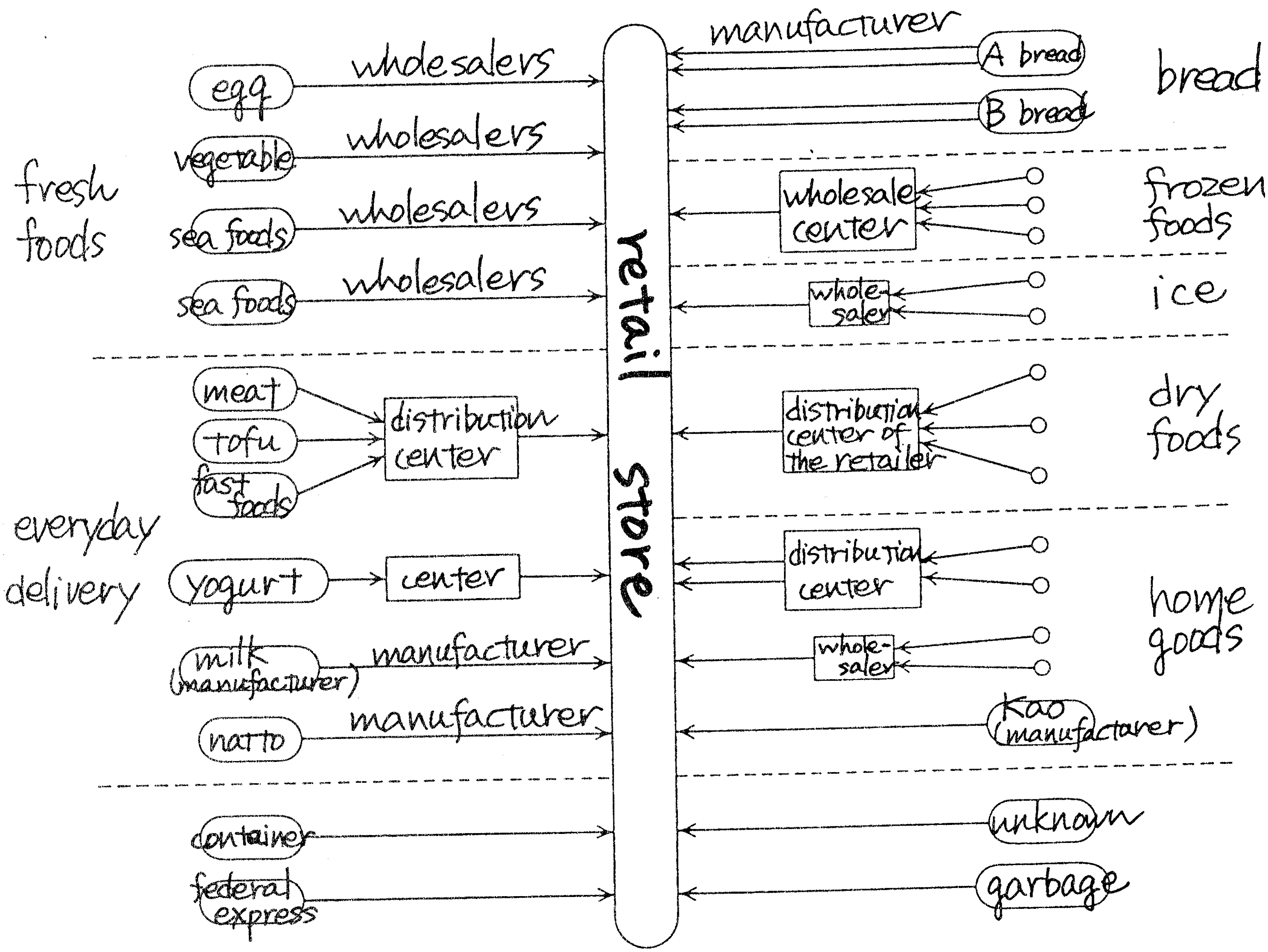
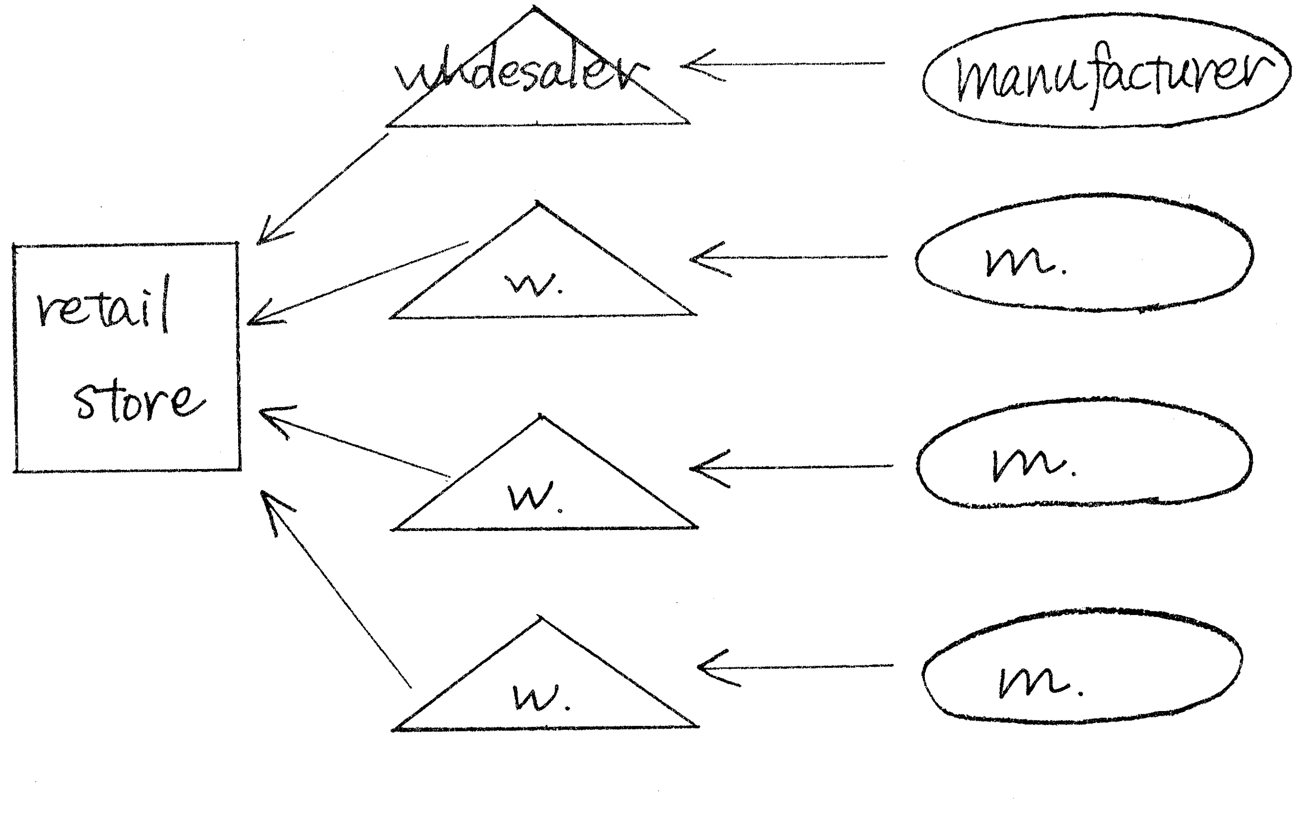
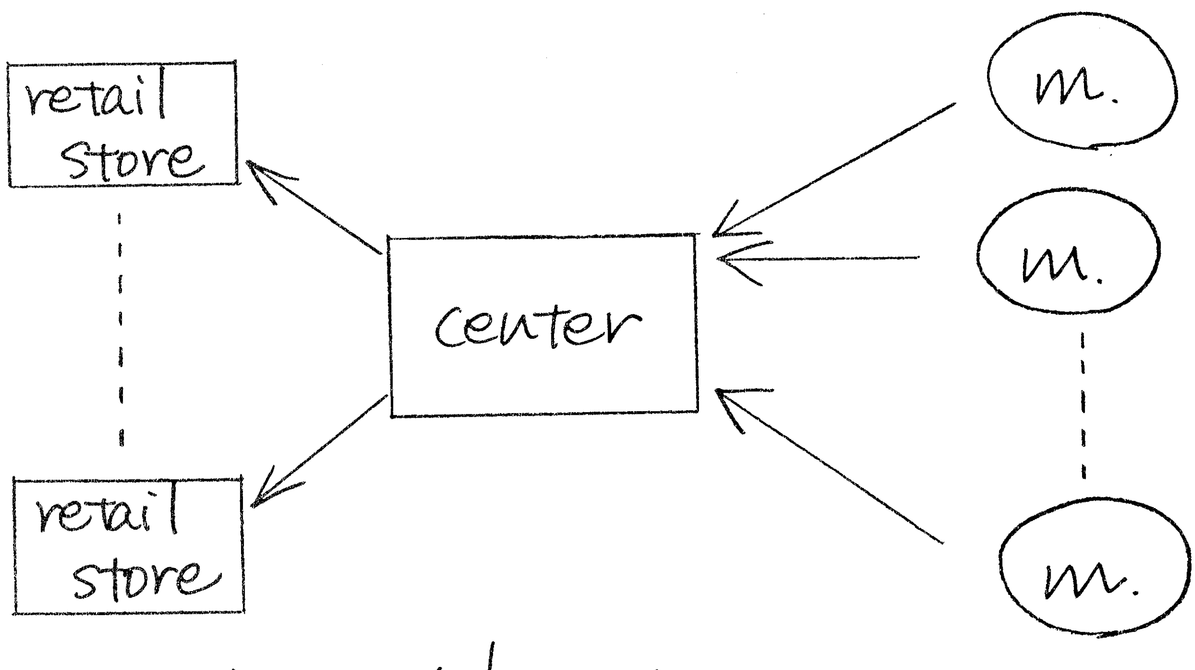


Figure 2 : Delivery of foods to a local supermarket on a day

Source : Itoh [1995]



vertically separated system



integrated system

Figure 3 : Two Types of distribution channels

purchase amount (monthly unit 10 thousand yen)	rebate rate (%)
> 500	15
> 240	15
> 120	15
> 90	14
> 60	13
> 40	12
> 30	10
> 20	10
> 15	10

Table 1 : An example of rebate rate

Source : Itoh [1995]

(Tokyo hundred)

	New York	London	Paris	Hamburg	Toronto
Total	71	74	70	75	74
cereals	60	85	76	90	59
sea foods	104	81	62	89	71
meats	54	68	59	63	70
dairy products	70	69	77	66	91
vegetables	65	52	64	59	63
fruits	71	76	78	66	61
oil	111	100	106	127	139
confectionery	73	64	60	61	96
soft drinks	68	72	51	63	74
hamberger	96	105	96	88	89

Table 2 : Prices of food in various cities

Source : Ministry of Agriculture and Forestry

Annual sales per 3.3 m^2
(unit 10,000 yen)

	Japan	U.S.A.
Department store	860	76
G.M.S.	318	76
Discount store	697	97
Food supermarket	427	143
Specialized store	274	63

Table 3

Source: Itoh [1995]