Japan
Foreign
Trade
Council,
Inc.

Shosha's Challenges in a Changing China

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Foreword

The Japanese word "*Shosha*" consists of the two Chinese characters "sho" and "sha", and the former ("sho") is derived from the Yin Dynasty which prospered in China for some 600 years from the 17th to 11th century B.C.

The country of "Yin" is said to have originally been called "Shang" (i.e. "sho" in Japanese meaning "trade" or "commerce") with "Yin" named afterwards. While boasting of its culture at such a high level as exampled by the creation of bronze vessels, people in the Shang Dynasty became aware of the fact that they could earn profit by moving goods from one place to another and began to set out for peddling to foreign countries. People of such foreign countries must have called the peddlers from Shang "sho-nin" or "person of Shang", from which words such as "sho-bai" (trade) and "sho-ten" (store) branched out and gave birth to the word "*Shosha*" in a later age.

(Note) Today's *Shosha* is no longer a mere trading company. Its activities are quite diversified into various fields such as investment, finance, logistics, and project coordination. No English word properly explains the image of such a *Shosha*.

Since the People's Republic of China was founded in 1949, the Japanese *Shosha* have been making efforts, as an engine for the Japanese economy, to promote trade/investment with China, the home of "sho" activities. Since politics and the economy are two sides of the same coin in China, a lot of risks are involved in Sino-Japanese trade. Therefore, it may safely be said that the trade relationship would have been impossible to grow to the extent that we can see today without *Shosha* acting as a pilot to maneuver the matters with flexibility.

In 1992, a famous lecture was given by Deng Xiaoping during his tour to the southern provinces of China. With this momentum, he resolutely promoted the reform and open policy. Then, thanks to Jiang Zemin's leadership to positively accept foreign enterprises while introducing foreign funds, China is now in the midst of rapid economic progress. Realizing its long-awaited participation in the WTO in December, 2001, China is increasingly expanding its presence as a production base in the world economy although various problems are yet to be solved.

Shosha have hitherto been taking the lead in Sino-Japanese trade. Based on experience thus acquired, they are now taking further steps to enhance economic exchanges between the two countries by assuming a new role in new business sectors and markets. The roles of the *Shosha* are expected to grow in the light of deregulation and open policy as a result of China's membership in the WTO.

China has a proverb to the effect that "when drinking water, you should not forget those who dug the well". As the proverb goes, *Shosha* will continue to dig wells, contributing to the economic exchange between Japan and China, so as not to be forgotten.

Japan Foreign Trade Council Inc. organized a special study group for "*Shosha*'s Challenges in a Changing China" with 10 members representing each respective *Shosha*. They made the one-year study under the guidance of Dr. Chi Hung Kwan, a senior fellow in the Research Institute of Economy, Trade and Industry, an incorporated administrative agency. He kindly joined the group as the chairman of the study meeting. This book is compiled based on the group's studies and discussions.

We hope that people will get a real image of business in China through the *Shosha*'s observations noted in this book. We will be more than happy if this book will provide a perspective for the China business in the future.

March, 2003

Kenji Miyahara
Chairman, Japan Foreign Trade Council, Inc.

***Shosha*'s Challenges in a Changing China**

Published by Japan Foreign Trade Council, Inc.

ISBN4-931574-04-1 C0033 ¥500E
Domestic price: ¥500 (consumption tax & postage excluded)

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As of Feb. 2003

Table of contents

Chapter 1. Changing China and Changing *Shosha*'s China Business

By joining the WTO China's moves towards internationalization, a market economy and rule of law have accelerated, causing remarkable changes in the business conditions of China. The 'China threat' theory is on the rise in Japan in fear of high economic growth in China. However, wouldn't it be rather a good opportunity for Japan to have China growing strongly and open its market more widely? Chinese enterprises' strength and weakness, coupled with their needs toward internationalization, will surely bring business opportunities to Japan, especially to *Shosha*.

1. Changes in China after its WTO Entry

1) China's integration into the world economy

With the WTO membership, China will enter an all-out opening stage from a partial opening. The conventional opening policy is applied only to specified industries with a certain limitation in the extent of openness, and is executed in some experimental areas under administrative guidance. There will be complete opening for all kinds of industries and everything will become predictable as a legal framework is put in place. It is not a one-sided opening but opening reciprocated by other WTO member countries. As a result of the reduction in customs duties and the removal of discriminatory measures, it will become easy for foreign companies to make inroads into China and access its domestic market. At the same time, China will benefit from an increase in foreign trade with, and direct investment from foreign countries. Under these circumstances, the Chinese economy will increasingly ride on the waves of globalization, thus fusing into the world economy.

Firstly, China will be incorporated into the world production system assuming an important role in the step-by-step transfers of industries across borders. World industries are now in the process of restructuring that involves the reallocation of resources across borders under intensifying international competitions. As the developing country, China, is becoming the factory of the world in the 21st century by making use of its comparative advantage in abundant labor supply. Chinese private enterprises will probably become main industrial forces replacing foreign-based companies. Then, China will likely increase its own direct investment to foreign countries rather than merely introducing direct investment from abroad.

Secondly, China will become part of the global technological innovation system. Although it is very important for a country to carry out research and development as well as scientific and technological innovation, it is unrealistic and uneconomical for a country at an initial stage of development to achieve them by its own efforts for the purpose of upgrading its industries. For example, China is in need of technical assistance from foreign countries in such fields as automobile body design and chip manufacturing where China is short of research and development ability. The share of technology and high-tech products in world trade is going up. International cooperation and exchange in the fields of science and technology will be further promoted. Therefore, China is favored with a good chance to introduce, absorb, and digest high level technologies relating to high-tech products, as they are brought into China together with imported new products. Further, leading foreign companies and multi-national corporations have begun to open research and development institutes in China, which are intended to form an important base of their global network. Internationally reputed multi-national high-tech corporations have already branched out into China one after another. These include IBM, Dell Computer, Microsoft, Hewlett Packard, GE, and Matsushita Electric.

Finally, China will be further fused into the international financial system. After entering the WTO, China's financial sector will be more widely open to foreign countries, resulting in closer ties with the rest of the world. Chinese enterprises will have access to new fund-raising methods such as listing their stocks on foreign stock exchanges. At the same time, a large amount of foreign venture capitals are ready to rush into China. Thus, Chinese enterprises will diversify their fund-raising routes, while withdrawal mechanisms for foreign venture capitals will be built up.

2) From rule of man to rule of law

The WTO consists of a set of regulations and agreements that has a strong binding power on its member countries. The negotiation with China concerning disputes in three agricultural items in 2002 was extremely hard for Japan as China had not become a WTO member at that time. Settlement of this kind of trade friction will be left to the WTO from now on. China has not only committed to observe the international trade rules set forth by the WTO, but also to revise its domestic laws to conform to the international standard. With its WTO membership, China is expected to improve protective measures for intellectual property rights and the transparency of its policy towards foreign investors. China has often been criticized that it is a "rule of man society" rather than a "rule of law society". Its affiliation with the WTO is a large step for China towards realizing its aims to build up a "rule of law society".

Until the reform and open policy was adopted, most economic activities in China were directly controlled by the State under a planned economy system. Although this situation began to change after the reform and open started, both the central government and local governments still controlled the economy by relying on administrative measures without resorting to laws. Policies are applied arbitrarily and revised frequently. In addition, governments at various levels make too much intervention in enterprises and markets. At the present time, a considerable number of enterprises are still under direct control by the governments and some of such companies are even monopolizing specific fields. However, under the WTO's principles of nondiscrimination and fair competition, governments are now required to thoroughly give up the inappropriate interventions in the markets and their tolerance to the monopolizing enterprises in such industries.

Under the traditional planned economy system, the governments directly controlled the economic activities of economic entities by making use of administrative measures and/or taking advantage of ownership in the case of state-owned enterprises. These controls were fairly reasonable in those days as they were conducted under the planned economy. However, after joining the WTO, in order to achieve economic goals such as economic development, the governments are required to take indirect intervention to economic entities, mainly paying attention to market mechanisms instead of simple administrative measures and direct intervention. Since China is now in a transitional period from a planned economy to a market economy, many unreasonable administrative examination systems still remain, by which the market is prevented from performing its role and the Chinese economy is hindered from joining in the world economy. Confronting the challenge arising out of the affiliate with the WTO, China is now required to reform the administrative examination system to cope with the globalization of its economy.

Thus, talking about the effects of China's participation in the WTO, China will be more seriously affected by changes in its economic system and legal system rather than its reduction of customs duties and the flow of foreign goods into its domestic market. Accordingly, China is required to perform substantial reform and adjustment of its economic and legal systems. Large adjustment pressure brought by the WTO entry will become a strong driving force for the reform. If this challenge is successfully managed, several serious problems facing us in the reform process will be smoothly overcome. Then, the formation of a market system and the establishment of a legislative system suitable to the economic system will be accelerated. And the conventional way of thinking based on the planned economy and the bad habit of thinking light of legislation will be changed, which will bring about major effects on economic and social development.

3) Challenges for further reform

Since the reform and open policy started, China has achieved high economic growth at the level of 9 percent per year and people's standard of living has been remarkably improved in coastal areas in particular. However, while keeping pace with progress towards a market economy and globalization, competition has become keener and bad debt problems have worsened, revealing inefficient management of state-owned banks and state-owned enterprises. On the other hand, private enterprises are still discriminated in many aspects including loans, and therefore their growth is restricted. In addition, mass unemployment and farmers' depauperation caused by polarization between haves and have-nots are becoming causes of an unstable society, weak private demand, and worsening deflation. Further, as a result of the rapid progress in industrialization, environmental problems such as air pollution are worsening. For the purpose of keeping sustainable growth, General Secretary Hu Jintao and other new leaders are compelled to carry out their policies taking into account "justice" and "stability" rather than only "efficiency" and "growth".

Although the current Chinese economy is being classified as "early stage of socialism" by Chinese authorities, it is better classified as "early-stage capitalism" with the polarization of haves and have-nots rapidly in progress. The Chinese economy is sure to be heading for a higher level of capitalism rather than that of socialism. However, unlike early-stage capitalism, high-level capitalism is based on rule of laws instead of rule of man and democracy in lieu of dictatorship, and requires the protection of private property and the presence of a social security system to help the weak. China will confront many difficulties from now on.

It goes without saying that the most difficult challenge is political reform, the necessity of which is also recognized by the Communist party leaders. Concretely speaking, as a result of increased capitalists due to the development of the market economy, it has become difficult for the Communist party to maintain its political power without support from the newly emerging forces. Under the circumstances, in his speech made in July, 2001 commemorating the 80th anniversary of the party's establishment, General Secretary Jiang Zemin at last formally admitted the capitalists to join the party. This decision was justified by his "theory of three representatives" announced in his important lecture during his inspection tour of Guangdong Province in February, 2000. This theory declares that the Communist party represents advanced productivity, advanced culture, and the widest range of the people's interests. Considering that the Communist party is supposed to represent the proletariat following the traditional Marxian doctrine, the "theory of three representatives" emphasizing the party for all people is far from the principle. The Chinese Communist party would be no longer a real Communist party if it turned out to be a party for all people. The "Theory of Three Representatives" is by no means reflection of a patched-up reform. It has a potential to change the foundation of the present Communist party.

2. To Overcome the 'China Threat' Theory

The 'China threat' theory is on the rise in Japan whose economy is suffering from a long-lasting depression in contrast with the Chinese economy which is under rapid growth. However, a cool-headed analysis shows that a large difference still exists between the two countries in the development stage of their economies. Because of the difference, the two countries can be said to be placed in mutually supplemental relations. From this view, China's rapid advance is regarded as a plus-sum game to Japan. Therefore, Japan should not be afraid of implementing structural reform, but should carry forward an "industrial upgrading without hollowing-out" strategy by moving declining industries to China while creating new industries at home.

1) Business opportunities from China's rise

Many companies in Japan consider it a threat to them that China is expanding its production capacity, while regretting that China has no attractive domestic market. However, according to the basic macroeconomic identity of aggregate output, income and expenditure, expansion of production naturally brings about an increase in income and spending by an amount equivalent to the increased production. This is not peculiar to China but happens in all other countries. Moreover, it may be easy for Japanese companies to branch out to the Chinese market, as Japan and China complement each other. Pessimistic views may be amplified by such information bias that companies making profits are silent but those who are losing money raise their voices loudly. Even if admitting this view, if the domestic market in China has not expanded as fast as its production, the reasons may be as follows:

Firstly, reflecting a comparatively higher market share and the profitability of foreign-funded companies in China's output, the GNP (gross national product) is exceedingly lower than the GDP (gross domestic product). For example, most dividends paid to foreign-affiliated companies are transferred abroad without becoming income for the Chinese people, and economic growth does not result in an expansion of domestic demand. Under such a situation, China is attractive to foreign enterprises including Japan-based companies only as a production base for exports. If only Japanese companies are unable to manage business development in China, despite the fact that Western companies are smoothly operating it, the Japanese companies' conventional managerial strategies should be reviewed.

Secondly, because of a high saving ratio as a whole (household, enterprise, and government), expenditure is much lower than income in China. Money derived from the difference heads for properties in foreign countries mainly through an increased foreign reserve without enhancing domestic demand for goods and services. In this regard, Japan would like to be a saucer for the funds recommending that the Chinese monetary authorities purchase Japanese government bonds. Regrettably, most of the Chinese money flows out to the U.S. bond market, while Japanese bonds seldom become a target for their investment.

Finally, in an inverse proportion to the expansion of exports, terms of trade (relative price between exported goods and imported goods) have worsened in China. The more the export quantity increases, the lower the export prices drop, and the quantity of exchangeable imported goods all the more decreases. Thus, China falls into a situation similar to "immiserizing growth". Consequently, the Chinese yuan increasingly weakens and national income in dollar terms does not increase as fast as production. Under such a situation, Japan can import low-cost products and semi-finished products from China, enabling Japanese consumers to purchase good products at low prices and Japanese enterprises to reduce their production costs. Regrettably, clamorous voices have been calling for import restriction to protect certain domestic industries as a result of the sharp increase in imports from China.

Thus, even if the expansion of the Chinese market is not proportionate to its production growth, there must be some ways for Japanese enterprises to utilize the economic growth in China. So far, OEM schemes, by which products manufactured in China are reimported into Japan, are operated fairly satisfactorily. According to data issued by the Ministry of Finance, however, although Japan's direct investment in China sharply increased in fiscal year 2001, up 64 percent over the previous year, it still remains at such a low level as 180 billon yen (4.6 percent of all the foreign direct investment). It can be said that mutually complementary relations between the two countries are not yet fully utilized by Japan.

As one of the reasons behind this, Japanese companies' delay in localizating management has been pointed out, apart from problems on China's side. Especially, the Japanese companies' wage structure, based on a lifetime employment and seniority system, is making it difficult for them to secure the most talented workers who prefer merit-based treatment. Under the circumstances, it is difficult to transfer authorities from managers dispatched from headquarters in Japan to local managers who are familiar with business conditions in China. To Japanese companies aiming to expand their business in China, management localization is an urgent task to be tackled.

In order to solve this problem, students studying in Japan (NECs or Nippon Educated Chinese as it is called) with knowledge about Japanese and Chinese situations should be much more utilized. So far Japanese companies have been being reluctant to transfer their technology to China in fear of a "boomerang effect". While recently Japanese companies have started to set up research and development departments in China, they are considerably behind, their Western counterparts such as Microsoft and Intel.

In contrast with the Japanese companies' cautious attitude, Western companies positively regard the rise of Chinese economy as a business chance, and successful companies are coming out one after another. In fact, when referring to the sales ranking list of foreign-based companies in China, most of its higher ranks are monopolized by Western companies. German Volkswagen is by far the leader in automobiles, and Motorola (U.S.A.) and Nokia (Finland) are remarkably active in cellular phones, while Japanese companies look very poorly. Chinese enterprises have also gathered strength vigorously in the electronics field, where Japanese manufacturers' market share is declining. Japanese companies should be more concerned about the possibility that they will be left outside the growing market in China rather than a hollowing-out of domestic industries due to increased investment in China

2) Aiming at industrial upgrading without hollowing-out

In order for Japan to study how to cope with the rise of China, it may be helpful to distinguish conceptually between a "good 'China threat' theory" and a "bad 'China threat' theory".

In the "good 'China threat' theory", the rise of China acts as a stimulus to structural reform in Japan. Industries which have lost comparative advantage in Japan should be moved to China, with their factors of production relocated to growing industries at home. The aim is to raise Japan's production structure up to a more advanced level and leave China the industries which technologies are too obsolete to continue their production in Japan. In this way, the Japanese economy may recoup its superior position again.

On the contrary, in the "bad 'China threat' theory" industries hurt by competition with China seek protection by exerting political influence. In this case, the 'rise of China' theory provides the governmental authorities and corporate managements with a very convenient cover to hide their mistakes. However, by averting people's eyes from the true nature of the problem, Japan will have to pay a large compensation in the form of a further delay in the structural reform.

To revitalize its economy, Japan should seek to build a division of labor with China making use of China's vital power rather than protecting declining industries by restricting imports from China. Many Japanese companies have already succeeded in direct investment, outward processing, and OEM schemes, making use of both China's abundant labor force and Japan's advanced technologies. The number of such companies is increasing. It is not right to think that domestic production in Japan will decrease in proportion to an increase in Japan-based companies' production in China. In fact, sales of overseas subsidiarities of Japanese corporations include parts and components procured from Japan, dividends paid to parent companies, royalties for technologies, etc. Nevertheless, a question may still remain as to whether employment opportunities will decrease in Japan or not. However, so long as a macroeconomic policy is properly carried out and current rules hindering resources from movement are deregulated, full employment should be achieved. For instance, in the 1990's, America achieved almost full employment while increasing foreign investment, and enjoyed a decade-long prosperity.

As shown in the American experience in the 1990's, Japan is required to develop new growth areas in place of industries moved abroad. The target areas should not be limited to manufacturing industries, but attention should also be paid to the potentiality of service sectors abundant employment opportunities. Tendencies for an economy to shift to service-oriented businesses and post-industrial age are a phenomenon due to economic maturation in advanced countries, and therefore it should be distinguished from the hollowing-out. Keeping pace with the global tendency toward an information-oriented, software-oriented, and network-oriented economy, Japan should aim to develop new industries without sticking only to traditional ones. Business leaders in Japan have seen the country's transformation from a developing country into an economic superpower through industrialization over the last 50 years. They are now unable to change their way of thinking because of their excessive attachment to manufacturing industries based on this success. It may be a problem that they do not easily pay attention to any industries except manufacturing with the firm belief that only manufacturing deserves an industry. Their past experiences of success have ironically become an obstacle that prevents the economy from further development.

In the process of its industrialization since the Meiji Restoration, Japan has consistently led Asian countries. Therefore, Japan must have received a strong shock from the China's rise as "the factory of the world". However, it should be recognized that catching up by Asian countries such as China means a reduction in the gap between the North and South in the Asian region, which should contribute to stability in the region. Obviously the reduction in the gap should ideally be realized by good economic growth of latecomers including China rather than by the decrease in the growth rate of advanced countries such as Japan. As a matter of fact, the *per capita* GDP of NIEs has already reached its level of

OECD countries, and the age that Japan is the only advanced country in Asia is over. However, if the structural reform is properly carried out, Japan will be able to further raise its people's standard of living, though the relative position of its economy may decline. Needless to say, as suggested by the recent financial crisis in Asia, the prosperity and stability of neighboring countries is more helpful to Japan's national interests than their poverty and disorder.

3. An Opportunities and Challenges for *Shosha*

1) *Shosha* keeping pace with China's reform and opening

Recently, economic exchanges between Japan and China have become brisk through trade and direct investment, for which *Shosha* are performing an important role. Prior to the normalization of diplomatic relations between Japan and China in 1972, *Shosha* were already engaged with business in China through their dummy firms. Right after the normalization, the Chinese government wanted to promote economic development by utilizing yen loans. In this regard, *Shosha* assumed a function as a bridge between Japan and China. One of such projects was the present Baoshan Iron & Steel Corp., Ltd. in Shanghai, for which the protocol was signed in May, 1978. Around the latter half of the 1970s, *Shosha* gradually began to open representative offices in several cities of China and rendered such services as liaison, market research, consulting and the like.

After Deng Xiaoping's lecture during his tour to South China in 1992, *Shosha* shifted their weight in China business to investment. Almost all of the leading *Shosha* branched out in China, and one after another they established companies in free-trade zones to conduct production such as processing raw materials to make use of low-cost manpower. As a result, Sino-Japanese trade expanded considerably. At the outset, *Shosha* were handling products mainly for export to foreign countries including Japan. To exploit the large potentiality of the Chinese market, trading companies in tax-free zones started to sell products to the domestic market in China. After 1992, large-scale investment projects began to emerge and the number of investments increased remarkably. Investment targets widened from textile and food processing to include machinery, steel sheet fabrication, communication, energy, chemicals, distribution, services and the like.

Upon the issuance of related regulations by the Chinese government in 1995, foreign-based companies including Japanese *Shosha* started to establish, one after another, holding companies (umbrella-type corporations) to place affiliated enterprises under their control. Then, they further expanded their investments in China. In August 2002, the Shanghai city government recognized the above-mentioned holding companies as headquarters for all enterprises of each group in China. Mitsubishi Corp. and some other firms were authorized. Since then, *Shosha* have advanced to a new development stage in China. Moreover, China's entry into the WTO has provided *Shosha* with new business opportunities and prompted them to adjust their development strategies.

In the past 30 years, *Shosha* functions in China have delicately changed. At the outset, *Shosha* were surely a leader in China business, playing a key role in the division of labor with other industries. When small and medium enterprises made inroads into foreign countries, besides the government aid, a *Shosha*'s assistance was indispensable to them. Their general plans on trade were made by relying on information collected by a *Shosha* at their request. In terms of superiority as a group and the impact of scale, no other organizations can compete with the *Shosha*.

But, as the division of production progresses internationally and information technology develops globally, many manufacturers have come to acquire the ability to carry out their business abroad by themselves. They got rid of their reliance on *Shosha* and started to walk their own way, forming their own group for business in China. To countervail the gradual deterioration of the *Shosha*'s role in the economy, its functions such as logistics and financial investment have consistently been strengthened.

However, *Shosha* in China have not yet made full use of their intrinsic superiority. In early days, a *Shosha*'s representative offices were restricted to perform only a liaison function. Neither domestic sales nor investment were possible. Foreign companies access to the Chinese market was also restricted. Various duties and non-tariff barriers were obstacles to their import and export. Trading activities in which *Shosha* have the strongest advantages have been heavily restricted by laws. As a result, even with over 20 years under development in progress, *Shosha* have been unable to build close relationships with Chinese enterprises. In particular, they have been unable to establish long-term cooperative relationships with private enterprises which have shown vigorous growth during the period. Accordingly, their main customers are limited to subsidiaries of Japanese companies in China, and *Shosha* have been extremely hindered from demonstrating their superiority in China.

Following WTO accession in December of 2001, China has further opened distribution and trade fields. To cope with this new situation, *Shosha* are switching their stance from import/export businesses to domestic transactions in China, to take advantage of progress in deregulation. In addition, as newly emerged private enterprises have grown at an amazingly fast speed, *Shosha* are strengthening their efforts to expand transactions with them and invest in them. Moreover, in view of China's further growth in the future, *Shosha* are considering to make inroads into China not just from their headquarters in Japan but also from their various bases in Asia, America, and Europe. At the same time, they are setting up organizations in their head offices in Japan to exchange Chinese market information among all staff concerned so as to improve the quality and efficiency of their services, while upgrading their strategy.

Shosha have hitherto been unable to fully perform their functions due to restrictions by regulations, but, with the WTO entry as momentum, there have already been signs that their functions will be activated from now on. China's open-door policy will surely provide them with a new large expectation and opportunity. *Shosha* have long been assuming such functions as coordination, marketing, lease and finance to help Japanese enterprises make inroads to foreign countries. However, at the stake of survival, they are now concentrating on more focused businesses, getting rid of "across-the-board" business style, and are trying to build more efficient organizations. *Shosha* are looking for business models in which they can make full use of their resources. *Shosha* should take advantage of the chances arising from the reform and open-door policy as well as China's participation in the WTO. Considering their present advantage and superiority, the new business models should include the Chinese market and Chinese enterprises as new business partners.

2) Overcoming the '*Shosha* unnecessary' theory

After the end of the World War II, *Shosha* started their business as a guide for Japan to restructure the country on the basis of foreign trade. Since that time, they have expanded their business scale and scope. However, this process has not necessarily been a smooth one. The "'*Shosha* sunset industry' theory" and "'*Shosha* in winter time' theory" appeared in past questioning about the role played by *Shosha*. The "'*Shosha* sunset industry' theory" was brought forward in 1961 and advocated that : (1) as industries advance to a higher level, manufacturers begin to handle foreign trade by themselves, (2) in an inverse proportion to the development of information and communication technology, a *Shosha*'s function as an information provider decreases, (3) as technology becomes more sophisticated, *Shosha* begin to have difficulty in handling products with such technology incorporated. The "'*Shosha* winter time' theory" appeared in the latter half of the 1980s and emphasized *Shosha*'s heavy dependence on smokestack industries, their lateness in branching out into software-oriented industries, and their declining profitability. In the 1960's, manufacturers were expanding their sales channels in Japan. To cope with the situation, *Shosha* shifted more of their weight to foreign trade while diversifying their businesses.

Today, many manufacturers have built up their own sales channels both in Japan and abroad by their own efforts, and have branched out into foreign countries without relying on a *Shosha*'s intermediary function. So-called "distintermediation" is in progress. Moreover, *Shosha* are in short of specialists who are required to branch out into new fields. It is apprehended that the importance of their information providing function will further decrease noticeably in proportion to the development of information technology.

The *Shosha*'s crises have so far given them a springboard to expand their business scale and functions, but business conditions have not yet turned better for them. Kanematsu Corp. reduced its business scale and curtailed its employees to become a specialized *Shosha* in 1999. Tomen Corp. asked Toyota group for additional aid and announced to restructure itself under the wing of the Toyota group in November, 2002. Nissho Iwai Corp. and Nichimen Corp. announced their merging in December, 2002. At any rate, finding new business chances is the key to overcome the "'*Shosha* Unnecessary' theory".

In order to activate *Shosha*'s business activities, it is effective for them to build up close relationships with customers who have vitality. Also it is important to secure rapidly growing markets. If they can make use of their own core competence in doing so, they will be able to obtain new business chances. *Shosha* will be sure to get business chances by targeting the Chinese market and Chinese enterprises. Chinese enterprises have vital energy and Japanese *Shosha* have know-how. Both parties should make full use of their respective strengths, and also mutually make up for the other party's weaknesses.

Shosha can help its Chinese partner solve its problems. For instance, to solve environmental problems caused by industrialization in China, a Chinese enterprise can introduce environmental technology through *Shosha*. Other industrial technology introduced from Japan through *Shosha* will also help Chinese enterprises improve their productivity. In addition, *Shosha* can show their real functional ability in providing China with an efficient logistics system. Also, *Shosha* are expected to help Japanese small and medium enterprises branch out into China by finding good Chinese partners for them and providing them with appropriate information. Moreover, when a Chinese enterprise branches out to a foreign country, *Shosha* can serve as its partners and utilize their know-how acquired in the past.

In the meantime, *Shosha* will be able to obtain new business chances by making the most of China's strength. Domestic demand is now increasing in China under the high economic growth in progress. Industries such as housing and automobile are forming vast markets. *Shosha* will be able to enter such growing markets by functioning as a technology provider and consultant. China still maintains a comparative advantage in labor-intensive industries and processing trade. *Shosha* will be able to earn fairly large profits by utilizing their coordinating function and taking advantage of China's merits as a production base.

Under these circumstances, both *Shosha* and Chinese enterprises will largely benefit from China's strength as a production base and large consumer market, if they can fully utilize these merits. Accordingly, in establishing management strategies, it is important for *Shosha* to take into account both the complementary relationships between Japan and China and the full utilization of China's vitality and potentiality. At any rate, to overcome the "'*Shosha* Unnecessary' theory", it is an effective way for *Shosha* to challenge new business opportunities.

Chapter 2. *Shosha*'s Functions and the China Business Model of the 21st Century

1. *Shosha*'s Function

Shosha have developed their businesses by making full use of their trade function and other various functions. They are now making efforts to make these functions more advanced, more sophisticated and more value-added to keep pace with today's significant changes in business conditions seen through economic globalization and the IT revolution.

In its web site, the Japan Foreign Trade Council, Inc. explains a *Shosha*'s eight functions as follows:

(1) Trade Function: This is the core function of buying and selling "goods" and "services" in Japan, to and from Japan and outside Japan by making use of worldwide disparities in supply/demand and information. Various services pertaining to these transactions are offered, namely, logistics (transportation, customs clearance, processing and storage), financing (fund raising, fund management, international payment, and foreign exchange), insurance (marine, import/export and fire), legal affairs, credit control and the like.

(2) Information and Research Function: A wide range of information is collected through a worldwide network and is analyzed for use in corporate strategy and operating plans as well as for daily business activities.

(3) Market Development Function: By making supply and demand to match each other in the world market, *Shosha* introduce new technology, find customers for it, and sell new products developed by the customers using the technology, thus creating new markets.

(4) Business Management Function: *Shosha* make investments in various

businesses inside and outside Japan, and make them grow and improve their performance through raw material procurements, product sales, logistics arrangements, fund raising, and human resource development. Their aim is not merely to increase profits from trade but also to boost consolidated returns, dividends and capital gains. They also pursue strengthening their group level management.

(5) Risk Management Function: By utilizing managerial resources accumulated over the years, many business risks are contained to a minimum. Especially in the case of large-scale projects and venture businesses in new growth fields, risks are minimized by selecting appropriate partners, forming consortiums, sharing responsibilities properly, securing collaterals, and utilizing insurance facilities.

(6) Logistics Function: *Shosha* offer the best logistics by land, sea or air. They are involved themselves in the logistics business to prepare efficient logistics information systems and to operate logistics facilities such as warehouses and distribution centers.

(7) Financial Function: Unique financial facilities different from those of banks are offered. These include a credit substitution for customers, a guarantee of debts, project finance, foreign exchange dealing, and leasing services. Recently, functions related to venture capitals and business acquisitions/mergers are also offered.

(8) Organizing Function: By combining their functions systematically, *Shosha* lead large projects through such comprehensive activities as information collection, plan preparation, partner selection, consortium formation, fund raising, construction contract, and market development.

Making full use of these functions, *Shosha* have developed their businesses both inside Japan and in many other countries. However, it was not so in China until its entry in the WTO as there were various restrictions. With the WTO membership, the restrictions on foreign capitals will be lifted to remove the obstacle which has been hindering

Shosha from exerting their functions. With a new stage for their activities, *Shosha* will enter into high value-added industries such as distribution, logistics, finance and information. They will contribute to develop these markets, raising them to higher level.

If fact, *Shosha* are recently targeting at service-oriented industries and other new frontiers in China business. In this chapter, some examples of the *Shosha*'s challenges in a changing China are introduced.

2. Business Model for *Shosha*'s Business in China in the 21st Century

Birth of China's First Wholesaler under Joint Venture

Backward wholesale business in China

In the middle of the 1990s when the market economy was rapidly growing in China, it was an urgent task for *Shosha* to make a full-scale entry into its distribution industry. At that time, the distribution industry in China had only scheduled distribution systems conforming to a shortage of goods under the planed economy. The industry was extremely short of abilities. It was able neither to adjust supply and demand nor to respond to a division of production, despite these abilities being indispensable to a market economy. This situation was one of obstacles for foreign-based companies trying to develop a domestic market in China. Therefore, efficient distribution systems were needed in China.

In those days, in opening the market to foreign countries, the Chinese government gave a priority to export-oriented industries at the beginning, resulting in delay in opening the domestic distribution industry. Although the retail market began to open in 1992, the wholesale business was still under strict control. It was difficult for Japanese companies to branch out to China and build efficient sales channels in the domestic market. Under the circumstances, *Shosha* A predicted that China would be allowed to participate in the WTO and, if so, the Chinese government would finally open the distribution industry to foreign countries. Since 1996, they made preparatory work for the possible opening, and selected Chinese Company Z as a partner, who belonged to a leading distribution group in Shanghai.

The situation quite noticeably changed in June, 1999, when the Chinese government made public the “Experimental Measures for Commercial Enterprises with Foreign Investment”. Now, foreign capitals were permitted to enter the wholesale business under partial shareholding (foreign capital as minority). At last having obtained the opportunity to enter the market, *Shosha* A and Company Z immediately conducted a thorough survey on manufacturers and retailers of both Japan and China to find a concept of wholesale business which would be viable in China. The survey revealed a situation that foreign-based manufacturers were unable to locate customers in China, while Chinese retailers were unable to procure enough goods to sell. Their further survey identified problems behind the situation, that is, the deficiency of a logistics network and the anxiety for debt collection. Under continued economic growth, Shanghai had potentially an enormous volume of consumption which was more than enough to absorb a large quantity of supply. But, the potentiality could not be actualized due to the mismatch as mentioned above. *Shosha* A and Company Z reached a conclusion that a great opportunity was hidden in the mismatch, and if the debt collection problem could be solved, their branching out into the wholesale business would be successful. They made an application for the feasibility study to the central government in July, 2000. After obtaining its approval, the joint venture agreement was concluded to establish a firm for wholesale business. The business license was issued in August, 2001 and the firm started its operation in September of the year.

The first modern general wholesaler in Shanghai

The jointly owned wholesaler, Firm Y, mainly handles toiletries, sundries and textile goods. As a general wholesaler, it has many functions such as wholesale of domestic goods inside China, import and export, warehousing, delivery and retail (a part of goods handled by the firm). Features of these functions are explained respectively as follows:

First, with regard to its wholesale business in China, Firm Y purchases goods from foreign-capital manufacturers in China, *Shosha* A, its affiliated Japanese company, and Chinese enterprises, and supplies the goods to large-scale retailers under the umbrella of the joint venture partner and other retailers in China. From now on, Firm Y offers their domestic sales channels to foreign-affiliated manufacturers in China, while providing foreign-affiliated retailers in China with the new supply source which has distribution function. Thus, with the two functions, the firm should contribute to vitalize the distribution industry in Shanghai. In regard to domestic sales of clothing items, Firm Y noticed that cash transactions are prevalent in China, and made a tie-up with a Japanese cash-and-carry wholesaler. It can accept orders for a wide variety of goods each in small quantity. No local wholesalers have this kind of function.

With regard to import and export, the type of goods which foreign-affiliated manufacturers were allowed to handle had long been limited, unless the goods were their own products. However, Firm Y was permitted to handle a wide range of goods and raw materials. As a result, as far as exports are concerned, Firm Y became able to perform all work, from finding customers for export goods to actually shipping them. Meanwhile, assorting, tagging and inspecting goods to be imported to China have so far been carried out in exporting countries of the goods. But, from now on, many manufacturers will shift this work to China, as they can reduce their cost by utilizing the Firm Y's logistics function. As to import business, Firm Y is preparing to offer new function by providing Japanese suppliers and other suppliers in the world with the sales channels of Company Z, the joint venture partner.

Foreign-affiliated companies in China and their related Chinese firms are highly appreciative of the new functions as mentioned above. Firm Y's business performance has been satisfactory from its first fiscal year, which ended in the black on a monthly basis. To further strengthen its competitiveness as a wholesaler, Firm Y is scheduled to complete a distribution center in 2003. Its site area is 20,000 square meters and its floor space is 10,000 square meters. It will be equipped with a state-of-the-art ERP (Enterprise Resource Planning) system to centralize the control of diversified processes from putting goods into storage to taking them out of storage. It will realize an efficient logistics and a complete just-in-time system. By introducing the modern managerial method, Firm Y will be clearly distinguished from conventional Chinese wholesalers who rely on only human labor, and will probably become a model for new type of wholesaler who can provide efficient distributing services.

A Partner is the key to success

Firm Y's entry into the distribution industry has so far been successful. The main reason is attributable to the partner in this joint venture, who is considered the best in this particular case. Because of the difficulties involved in debt collection in China as mentioned earlier, many Japanese companies have reluctantly withdrawn from the Chinese market after getting in trouble. Firm Y has taken over staff with enough experience in toiletries wholesale in addition to good customers from Company Z, the J/V partner. The debt collection system was also introduced from the company. Therefore, almost no problem has so far occurred in this regard. In order to be successful in China business, it is important for companies to have a thorough knowledge of Chinese trade customs and to secure good customers from the beginning. However, it is not easy for Japanese companies to overcome these problems if they make the inroad alone. It will be indispensable for them to tie up with an excellent Chinese enterprise so as to utilize their know-how and credibility in the region. Recent good examples are a partnership between Sanyo Electric and the Haier Group, and an agreement for cooperation between Matsushita Electric and the TCL Group in connection with home electrical appliances.

Although Firm Y has started its operation smoothly, it is not guaranteed to be successful in the future as well. Firstly, the current restrictions on entry into the wholesale business by foreign capitals are scheduled to be lifted within three years after China's participation in the WTO. Firm Y can enjoy the pioneer's profit only until such time. It is quite possible that many new entries will be made to the distribution industry in 2004 and competition will be further accelerated. Secondly, the consumer market will grow very rapidly in Shanghai, where the distribution industry is expected to change drastically in the future. Wholesalers in Shanghai are not guaranteed to continue to exist maintaining such importance as is kept by Japanese counterparts. There is a possibility that most of the market will be occupied by direct transactions between leading manufacturers and large-scale retailers as now seen in America. Therefore, to prepare for possible furious competitions in the future, Firm Y is required to thoroughly strengthen its competitiveness during the period when it can earn its pioneer's profit. As one of such means, they are newly building a distribution center equipped with an ERP system. Leading Japanese wholesalers have the marketing ability to give advice to their customers about best-selling goods. It will be necessary for Firm Y to acquire the ability to assume a leading role in the industry. Even if the restrictions on foreign capitals are lifted, Chinese trade customs will never change in a day. The relationship with company Z will be necessary to be further strengthened. To achieve sustainable success, it is necessary for them to identify what will change and what will not change by the economic growth after China's entry in the WTO, while taking necessary steps without delay.

Aggressive Logistics to Develop the Chinese Market

Establishment of a logistics network

Japanese and Western companies are continuing to rush out to China. Both imports to China and exports from China are increasing. The distribution system in China is still backward and yet to be modernized.

To develop sales in the domestic market, which is rapidly growing, not only Japanese enterprises but also Western enterprises have long been looking forward to general logistics services of good quality.

Reliability in logistics services in China is still fairly low. For instance, it is a daily occurrence for a truck loaded with products to become missing, or arrive late. Though quite normal in the past, it is still not unusual for customers to go to their suppliers' factory by truck to buy and pick up products in exchange for cash.

In order to positively comply with the needs, *Shosha* B started in 1994 to make a study to establish a logistics network to perform reliable and speedy distribution services. After making the feasibility study for two years, they selected a partner and obtained necessary licenses. In 1996, jointly with a Japanese distribution company and an overseas Chinese company, they established a distribution hub and a transportation company in Shanghai. These were the first case established by foreign capital as majority shareholders.

The distribution hub (with floor space of about 35,000 square meters) and the transportation company are operated as if they were within in the same entity. With the two facilities at the core, a very closely knit transportation network is built up by linking local networks with coastal and inland bases on trunk routes.

The present network consists of 32 bases in 23 cities. In the business circle of *Shosha*, this is the only distribution network covering all of China. Its 22 bases in 18 cities handle the domestic transportation of general cargo, while 7 bases in 7 cities are engaged in international forwarding services. In addition, there is a cold storage warehouse in Qingdao and a tank terminal for liquid cargo both in Zhangjiagang and in Ningpo. The total warehouse floor space of all these facilities amounts to about 60,000 square meters, and these facilities have about 600 trucks in total.

To comply with customer requirements, *Shosha* B has established several of their entities in many locations throughout China to offer international forwarding, domestic transportation, storage, cold storage warehousing and delivery under the licenses obtained from the central government. They are making efforts to provide general distribution services for SCM (Supply Chain Management) in China and abroad by combining their trading and logistics functions. To satisfy their customer needs and to cope with situations in the future, they focus on "preparation for increasing cargo volume, reduction of distribution costs, shortening travel time, safety control, and improvement of reliability by an advanced information system".

Logistics strategy in China

Shosha B has made the inroads into China starting from a domestic logistics business. On this point, the company is distinguished from other *Shosha*, who have entered the market through international logistics services. Until recently, China had almost no means to locate cargo in transit. To solve this problem, this company has promptly introduced GPS (Global Positioning System): a mobile terminal equipped in a truck informs the control center of a cargo's location through the satellite. Installation of this system to Shanghai-based trucks is under way.

Based on this logistics network in China, *Shosha* B provides a wide range of their customers with efficient, safe, reliable (by information system) and low-cost services.

Their problem is in how to secure human resources. It is indispensable for all their logistics bases and their subcontractors to secure capable staff with know-how of all operations, from loading and unloading of cargo to management of the bases. In addition, an ability to communicate with Japanese customers is required. But, since logistics systems have emerged only recently, the number of such capable people is naturally limited in China. The supply of human resources is unable to catch up to the rapid growth of the logistics business, resulting in fierce battles of scouting. Requirements from Japan-based customers are very severe, and the same level of services as that in Japan is required by them. Therefore, it is necessary for staff in charge to have an ability of Japanese language to understand the customer requirements and respond to them. In addition, complaints about delayed deliveries and damage to cargo are daily affairs in this industry. While minimizing the occurrence of such incidents, it is important for the company to promptly and properly deal with any complaint once it has occurred. But, an ability to cope with such a situation cannot be acquired in a day. Moreover, the concept has not yet established in China that logistics are a service industry. *Shosha* B is eagerly tackling the problem to develop human resources by dispatching specialists from Japan.

In the meantime, further cost reduction is also one of the challenges for them. A key to success in the logistics business is to save labor costs, as it is a labor-intensive business and its profit margin is small. Besides the fast upbringing of Chinese key officers, the low-cost operation of warehousing is also important. However, the large volume of cargo which is worth the investment of a large-scale system is only available in coastal areas. Manpower is often more economical than using systems in inland areas. Cost-cutting is impossible unless a certain volume of cargo is secured. Since many contracts on cargo transportation are negotiated between head offices in Japan, the logistics business in China can be said to be conducted through a three-legged race by *Shosha*'s local entities in China and their head offices in Japan.

In addition to major manufactures, small and medium enterprises including Japanese component manufacturers are expected to branch out into China in the future. In its logistics strategy for China, *Shosha* B is planning to expand their service menus to precisely satisfy their customer needs, which are becoming higher and more complex. For example, the launching of scheduled transportation services between large cities, the expansion of consolidated small cargo services, and the improvement of a cargo tracing system by using GPS are included in the plan. Also, home delivery services in large cities and SCM services covering all of China are under study.

Shosha B is developing aggressive logistics in China because they aim to enter the trade of goods in the future after starting from performing logistics services.

Cost Reduction of Components by Local Procurement — Establishment of a Trading Company for Electronics Components

Current situation of IT industry in China

China has become the factory of the world. Its next challenge is to become a more value-added self-sufficient type manufacturing base after getting rid of its present situation of mere assembly and fabrication. What China expects from foreign companies will shift from assistance in fund raising to advanced production technology and software for marketing and distribution. Local governments in particular are desirous of developing high value-added export-oriented industries and are earnestly inviting foreign enterprises which have advanced technology. To such enterprises, they offer tax exemption and other incentives in addition to certain benefits (e.g. simplification of application procedures) after the enterprises settle down there. Excessive incentives beyond those of the central government are offered by the local governments, making competition escalate among them. This situation rather causes not only confusion to foreign enterprises but an anxiety for the continuation of such policies among them as well.

Local governments are enthusiastic about the introduction of IT-related enterprises in particular, and are promoting semiconductor manufacturing projects of a national scale. So far, leading manufacturers such as Toshiba, Siemens, Fujitsu and NEC have participated in national projects as technology partners.

China has three production centers with IT-related equipment, i.e. South China including Dongguan in Guangdong Province, the Beijing area including Zhongguancun, which is called China's Silicon Valley, and East China including Shanghai. South China has developed as an export base taking advantage of low-cost migrant workers who are inexhaustibly supplied from the countryside. Electric and electronics industries have accumulated mainly in Shenzhen–Dongguan–Guangzhou areas of the Pearl River delta. In Beijing, the political center, mobile phone manufacturers such as Nokia, Motorola and Ericsson have their factories. The city has a great accumulation of intellectual industries consisting of venture businesses originated from Peking University and Tsinghua University, and the internet-related entrepreneurs.

On the other hand, semiconductor manufacturers from Japan and Western countries have branched out to Shanghai one after another. The city is becoming a worldwide base for semiconductor manufacturing. Having become the factory of the world, China is now seen for its importance as a consuming market of semiconductors besides an export base.

Business opportunities for an electronic component trader

In 1997, the largest project to manufacture semiconductors in China was started jointly by the Chinese government's former Ministry of Electronics Industry and the City of Shanghai under cooperation with a leading Japanese semiconductor manufacturer. As part of the project, *Shosha* C made a proposal to establish a trading company for electronic components. Keeping pace with the development of IT-related product manufacturing in China, logistics systems and sales channels in China and abroad for electronic components were expected to become necessary. The proposal was accepted and China's first electronic component trader, Shanghai Hong Ri International Electronics Co., Ltd. (Shanhai Hong Ri), was born in 1997.

Shanghai Hong Ri aims to eventually become a window for the export and domestic sales of semiconductors manufactured by its group companies. But, its operation was started by the import of electronic components including semiconductors and liquid crystals to sell to foreign-affiliated manufacturers in China. In regard to the procurement of components for personal computers and other electronic products, the just-in-time system based on SCM (Supply Chain Management) is a global standard. Even in China, *Shosha* C is able to timely supply any electronic components, whether they are made in Japan, America, Europe or Korea, through sales and distribution channels in China and abroad developed by *Shosha* C's group companies.

Shanghai Hong Ri is entitled to receive preferential treatment as an excellent enterprise at the time of customs clearance. They are allowed to clear customs at the bonded warehouse for the parcels they received the order of and convert them to domestic cargo, so that they can deliver the components to their customers on time. They are also allowed to sell imported components in yuan renminbi. This is welcomed by their customers, whose income in yuan renminbi is on the increase reflecting their expanded sales of DVD etc.

For the construction of distribution centers and the preparation of domestic distribution network in alliance with a Japan-affiliated leading distribution company, Shanghai Hong Ri is making use of their know-how in semiconductors distribution, which has been accumulated by *Shosha* C and its group companies.

In 1997 when China was aiming to join the WTO, an inflow of smuggled goods was a headache for China. Without wiping out smuggling and other illegal practices, China was unable to build a stable financial foundation necessary to develop its industries. It was also feared that China would lose its international reputation and its foreign trade development was impeded. In order to boost the IT industry by introducing foreign capital for its technological reform, reliable and efficient distribution networks are needed in China. Zhu Rongji finally began to tighten his control over smuggling in 1998. As a result, Shanghai Hong Ri's sales increased drastically as it was an official electronic component supplier.

In 2002, they established a comprehensive contract to undertake the procurement and logistics of components on behalf of foreign-affiliated manufacturers. This means outsourcing by the manufacturers' purchasing department. Outsourcing to local distribution companies who have professional knowledge of components and capacity of just-in-time delivery will likely become popular in the future as competitions intensify. *Shosha* have expertise of electronic components and a wide range of suppliers backed by their global network, and therefore they can comply with manufacturers' requirements as mentioned above. Few enterprises except *Shosha* are in a position to make a package deal for nearly 400 kinds of components coming from more than 30 manufacturers.

The next challenge for foreign companies, who have branched out to China to utilize its low-cost and good-quality labor force, is to strengthen their cost competitiveness by procuring parts and components from domestic sources in China. After its domestic market opens as a result of the WTO membership, improvements in the logistics network including local procurements and preparations of SCM systems will become important. Business opportunities for Shanghai Hong Ri will further increase.

Inroads into China through Assistance by Local Government — Economic Cooperation with Shandong Province

Provinces and cities in China are stepping up their activities to an extent that this period is worthy to be called the "age of local areas". A soft expression such as "stepping up" may be inappropriate. The reform and open policy launched by Deng Xiaoping has quickly spread to local areas, causing fundamental changes there. Market principles have penetrated into all aspects of local economies. Commercialism and efficiency principles cover China as if they were umbrellas.

Details until the agreement is signed

It was the early spring of 2002, when *Shosha* D had momentum to establish economic cooperative relationships with the Shandong provincial government in various fields of trade and investment. At that time, *Shosha* D was already active in the Shandong Province next to Beijing and Shanghai. They had investments resulting in over 20 enterprises in food and textile industries. Their regular trade had expanded to a scale that was comparable to those in the above two cities. Since the end of the 1970's, they had been cooperating in important national projects and infrastructure constructions in the province. A large amount of loans were given to the province's Ministry of Petroleum Industry for a Shengli oilfield project in addition to Qilu petrochemical complex. They had personal connections with not only the provincial government officials in Jinan but also the top management of cities such as Qingdao, Yantai and Weihai. *Shosha* D's executives were serving as advisors to these governments. A foundation for all-out cooperative relationships was already there.

"Agreement on an overall collaboration in economy and trade" was signed in May, 2002. In March of the year, two months prior to the signing, a mission headed by the Director General of the province's Department of Foreign Trade and Economic Cooperation visited *Shosha* D in advance of a mission headed by the province's governor. Its purpose was to finalize negotiations about the agreement. There was no precedent until then of a Chinese local government concluding an agreement with a private enterprise such as *Shosha* D.

Regional characteristics of Shandong Province

Shandong Province is situated downstream of the Yellow River. The Shandong Peninsula stretches into the Yellow Sea and the Bohai Sea, from where the Liaodong Peninsula is seen across the Strait of the Bohai Sea.

The province boasts the largest agricultural output in China. It is China's leading producing center of Chinese cabbages, Welsh onions, apples, pears and dates in addition to cotton and oil crop. Besides, pig breeding and poultry farming are flourishing with Yantai as a mecca for meat processing operated mainly by Japan-based companies. Thus, it is the food processing industry of vegetables, meat and the like that is the most distinguished characteristic of Shandong Province. There are nearly 300 food processing enterprises under foreign capital in the province. Fisheries are also prosperous with fish farming operated along its long coastline. Troublesome work to cut fish and remove their bones etc. is mostly carried out by female workers in Qingdao and Yantai. Since several years ago, scheduled direct flights have become available between Narita/Osaka and Qingdao. The investment climate in this province has remarkably improved.

When launching a new business in China, it is important for the promoter to investigate the regional characteristics of its target area from the viewpoint of its compatibility with its own products, taking into account procurement of raw materials, sales channels and logistics for the products. Shandong Province is one of the best places in China for the food processing industry of meat, vegetables and fish. The food processing industry is expected to grow both in Japan and China in the future. Especially, production of value-added healthy safe foods will be needed. Under these circumstances, food processors' decisions to build their factories in Shandong Province can be justified by the regional characteristics of this province, where low-cost labor and low-price raw materials are easily available.

An example of economic cooperation

The negotiation of the agreement was finalized between *Shosha* D and the Department of Foreign Trade and Economic Cooperation of Shandong Province. *Shosha* D was all prepared to receive the economy and trade mission headed by the province's governor. *Shosha* D's business departments, especially those related to foods and textile goods, were instructed to make briefings to the mission, and their arrangements were also finished. All of a sudden, however, just before their departure, the governor became unable to visit Japan as he had to attend an important meeting in the provincial government.

Soon, a courteous letter informing the matter was received. In the letter, they promised to sign the agreement as prearranged regardless of their postponement of visiting Japan. *Shosha* D's staff was relieved. In May, 2002, *Shosha* D was visited by a mission of 16 members including the vice chairman of the province's Political Consultative Conference as a proxy for the governor. The mission members had friendly conversations with *Shosha* D's president and others, and then an "agreement on overall collaboration in trade and investment" was signed in success. After the signing, a social gathering was held and a mutual exchange was promoted in a friendly atmosphere. Through long experiences in China business, *Shosha* D's people were fully aware that mutual exchanges at top managerial levels have an extreme importance in carrying out business with China. They also knew that once heart-to-heart relationships were built with counterparts, all businesses with them would go smoothly in China.

Although the agreement is comprehensive, its outline is as follows:

1. Both parties set up "collaboration committees" respectively. *Shosha* D's president and the province's deputy governor assume the chairmanship of the committees respectively.
2. Both committees hold a regular meeting once a year to study and determine important collaboration projects for the new fiscal year, promoting them with responsibility.
3. Both parties mutually dispatch business study teams to the other party periodically to promote the collaboration.
4. The collaboration in economy and trade by both parties is omni-directional, as follows:
   * *Shosha* D expands both bilateral trade and multi-national trade through its global network. In particular, it promotes the export of spinning and weaving goods/textile products, foods and other goods produced in Shandong Province.
   * *Shosha* D actively makes collaborative investments in Shandong Province and assists its affiliated enterprises in investing in the

province, while promoting projects in connection with infrastructure, energy and State-owned enterprises' reform.

* Both parties jointly develop markets in China and third countries, and promote joint projects.
* Both parties make efforts to improve distribution structures of main cities in Shandong Province to boost its domestic demands.
* Both parties endeavor to develop and upgrade human resources in view of long-lasting all-out collaboration between the parties. Especially, they will focus on a plan to select excellent people in Shandong Province and dispatch them to *Shosha* D for training.

Following the agreement with the above contents, the project started in full scale. At first, it was agreed to establish a large-scale cold storage distribution center in Qingdao, the main city, considering that Shandong Province was the main producing district of agricultural products. This center is going to be operational around the middle of 2003, and aims to handle 100,000 tons of cargo in the future. Through this center, frozen foods and cold-storage foods will be supplied to the consumer market in China, which is expected to grow towards the future. The center is also expected to form an international cold chain, linking production centers in Shandong Province with consumers in Japan. Logistics is now the very bottleneck of China. And, *Shosha* may be responsible for its improvement as a pioneer in the distribution industry.

Shosha D has actively started to make a study to promote similar projects to the above from now on. The above example is a symbolic case that regional characteristics of a local area in China have coincided with the *Shosha*'s needs. Land is vast in China. Therefore, a firm "regional strategy" is required for each area respectively.

Chapter 3. Prospects of *Shosha*'s China Business

This chapter deals with opportunities and challenges brought to Japanese *Shosha*, as industrialization and internationalization gather pace in China. A key to success is for them to make use of China's strengths while making up for its weaknesses. *Shosha*'s visible and invisible assets accumulated through their international businesses in the past will help Chinese enterprises achieve internationalization. *Shosha* should further exhibit their advantages by utilizing their network of human resources in both Japan and China. They are expected to develop new business models in China by making full use of their assets accumulated in the past.

1. Business Opportunities by Making Use of China's Strength

Tanks to high economic growth, China is becoming attractive not merely as an export base but as a large market as well. Its increased domestic demand is shown by its booming housing and automobile markets. With an abundant labor force available, China still maintains its advantage in labor-intensive industries. It is important, therefore, for *Shosha* to acquire such business opportunities that enable them to utilize China's advantages.

1) Expansion of the market

The housing quota system of the Chinese government was abolished in 1998. Since then, the government's house leasing system has changed to a new system under which people can voluntarily purchase houses sold by developers, etc. (However, land is owned by the state and leased to people under long-term contracts). Private housing demand has been stimulated by this change, as well as by the high economic growth that boosted people's incomes. In July, 1998, Marubeni Corp. established a housing company to develop houses for Chinese people. The new company has grown satisfactorily. Housing and real estate businesses are expected to become pillar industries for the Chinese economy from now on. The Japanese housing industry imported low-cost building materials from China. With China's WTO membership, however, *Shosha* will have opportunities to enter the housing market in China in the future. By making use of their experience in sales, intermediaries and management in Japan in addition to Japanese technology, they should be able to render coordinating and consulting services to Chinese dealers as developers.

Also, the Chinese automobile industry is becoming a focus of attention in connection with the China's WTO entry. Its production volume was at a level of about 2.09 million cars in 2002. Reflecting increased income through economic growth, demand for private cars will be boosted in China, and its motorization will accelerate. Due to WTO accession, import duty on completed cars will be reduced in steps from 80–100% to 25%, and import quotas on cars will be removed by 2006. Nissho Iwai Corp. has already begun to sell Suzuki-made cars in expectation of expanded demand for cars in the future. *Shosha* will probably no longer be engaged in only the export of completed cars, but will be involved in the transfer of technology from Japan to China. They may also be involved in coordinating a tie-up that intends to make high-class cars in Japan while making popular cars in China. *Shosha* will likely have many business opportunities derived from cooperation in connection with automobile sales.

2) Production base utilizing low wages

The wage level in China is still as low as one thirtieth of that in Japan. Low wages tend to set a limit on the expansion of its domestic market, but it makes China attractive as a production base for labor-intensive products. Because of a vastly excessive labor force available in rural areas, little upward pressure is exerted to the wage level, even if the demand for manpower increases in the industrial sector of China. The country's competitiveness in labor-intensive products will be maintained for the time being. It is important for *Shosha* to recognize China's advantages of both a consumer market and production base, so as to acquire business opportunities there.

2. Business Chances by Making Up for China's Weakness

Today's China, like Japan during the 1960s, is experiencing a rapid economic growth, a large-scale migration of people from rural areas to cities, and serious environmental problems. Japanese *Shosha* have so far accumulated logistics systems, debt collection know-how, information networks, sales channels, and coordinating functions throughout the world. By making use of these assets, they can help Chinese enterprises in their economic activities. They in turn will be able to obtain business opportunities by utilizing the strengths of the Chinese market while covering China's weaknesses. Indeed, *Shosha*'s main functions accumulated in the past are sure to be their core competence in China business.

1) Protection of environment

Some of the most serious issues in industrialization are related to the deterioration in the environment. Although the emission rate per capita is relatively low because of its large population, China is ranked 2nd after the U.S.A. for total carbon dioxide emission. Not only is air pollution caused inside the country but global warming is worsened by the emissions. In China also, subsidies are curtailed to users who use coal and other fossil fuels which generate massive carbon dioxide, and efforts to improve the efficiency of energy are under way. As a result, the country's emissions peaked in 1997, despite the rapid economic growth in progress. However, about 75% of primary energy still relies on coal, which generates carbon dioxide. China is required to further accelerate replacing coal with energy with less carbon dioxide emissions. China is also ranked 1st in the world for sulfur dioxide emissions. Not only is air pollution a problem, but spreading acid rain and soil pollution are concerns as well. At the same time, water pollution has also surfaced as a negative aspect of industrialization.

To solve environmental problems, it is indispensable for China to introduce more advanced environmental technology, apart from regulations and subsidies by authorities concerned. The energy required to produce 1 ton of iron by today's steel industry in China is one and a half times more than that in Japan, for example. One of the reasons is attributable to China's delay in introducing energy-saving equipment, as compared with Japan. Under the circumstances, the know-how of Japanese enterprises accumulated through coping with serious pollution problems during its high economic growth period will help China solve the environmental problems. *Shosha* should be able to find new profitable business opportunities in connection with the environmental problems through consulting and intermediary work to introduce environmental and energy-conserving technology to China. Further, after the foundation of an environmental business is established in China by utilizing its low-cost manpower, *Shosha* may be able to expand the business worldwide in cooperation with Chinese enterprises expanding businesses overseas. In environment-related areas, Mitsui & Co. and Toyota Tsusho Corp. are promoting business to convert conventional boilers to acid rain resistant boilers in many places of China. Itochu Corp. is developing an LNG (Liquefied Natural Gas) business in Shenzhen and East China. *Shosha* have already begun to enter this business field.

However, it is difficult for private enterprises such as *Shosha* to develop this kind of business with only their own efforts. It will be necessary for them to utilize environmental ODA and the like, although such unfair practices as happened in Mongol and Kunashir in 2002 should not be repeated. They must conduct their business not only for their own sake but also to help to promote China's industrialization.

2) Technology transfer

Although called "the factory of the world", China has little world-class technology of its own, and its R&D capability is also limited. Therefore, it is necessary for China to introduce technologies from abroad to improve economic efficiency and upgrade its industrial structure. Especially, Japan's experience and technology should be most helpful to them, as Japan is ahead of the flying geese pattern, as far as industrial advancement is concerned. The most advanced technology does not necessarily need to be transferred to China. Even out-dated technology in Japan may be useful in China. For instance, production management skills such as TQC (Total Quality Control) and conventional sewing technology are no longer fresh in Japan, but such technologies were introduced to a sewing factory in China by *Shosha* as China open itself to the world. The technologies were quite helpful to improve quality of the Chinese products. This success caused a processing trade boom in Japan, by which low-cost high-quality products were manufactured in China and imported to Japan.

Targets of foreign capital investments in China are so far polarized between labor-intensive industries and the most advanced high-tech industries. The transfer of medium level technology is not active. In 2002, Mitsui & Co. entered into a comprehensive technical tie-up with Tsinghua Tongfang Co., Ltd., an enterprise established by Tsinghua University. Technology imports from Japan and human resource exchanges between the two countries are included in the cooperation agreement. Through these affiliations, not only leading-edge technologies but core and medium level technologies for production can be transferred to China. The latter technologies are core competence of Japanese SMEs. Japanese enterprises desire to enter the Chinese market to utilize the low-cost labor force, while Chinese enterprises wish to introduce labor-intensive industries and appropriate technologies which are not necessarily the most advanced technology. In this regard, *Shosha* are in a position to serve as a bridge between both parties. *Shosha*'s introduction of appropriate technologies into China by making use of their past experience in rendering services to Japanese enterprises will bring about good results to both *Shosha* themselves and Chinese enterprises. It will eventually contribute to develop industries in underdeveloped rural areas and inland regions in China.

3) Establishment of distribution systems

The challenges of Chinese enterprises exist not only in industrial technologies but also in the efficiency of logistics and coordination, which are necessary to be improved to develop Chinese industries in the future. Efficient logistics systems are needed to increase productivity and lower the cost of distribution. Although it is desirable to improve infrastructure to develop logistics, efficient distribution can be achieved even under present infrastructure, if a supply chain management (SCM) is properly conducted. When it comes to the improvement of efficiency in logistics, Japanese *Shosha* will be able to display their competence.

In fact, logistics is acting as a bottleneck hindering rapid economic growth in China. *Shosha* therefore are making efforts to provide local enterprises with logistics as efficiently as possible by making use of their bases in China and abroad. Utilizing functions of their own bases and the umbrella-type corporations, they are now establishing highly sophisticated logistics systems in cooperation with their staff stationed in China. At the same time, their head offices in Japan have set up new organizations to systematically exchange information on China business, so that knowledge and know-how can be shared, services are improved, and strategies are advanced. In the meantime, based on the know-how acquired through their subsidiaries in China, they are developing the same business in many cities in China. In addition, to cope with increasing exports from China to third countries, they are strengthening SCM functions by utilizing their distribution network. Expecting a liberalization of distribution and domestic sales as a result of the WTO membership, *Shosha* are rendering consulting services to Japanese enterprises entering into the Chinese market.

Shosha's sophisticated logistics system is also attractive to Chinese enterprises. Improved logistics systems and intermediary functions will enable them to conduct divisions of work in different parts of China and abroad. Efficient intermediary functions will provide Chinese enterprises with business opportunities in both rural and inland areas by enabling them to take advantage of regional characteristics.

4) Risk hedge

The last theme in this section is what is called the "China risk". This is a general term for risks arising from changes in Chinese policies and systems, frequent occurrences of sudden and drastic changes in market conditions, debt collection problems and other credit risks inside China, and the like. Japanese direct investments in China are divided into 3 principal types in terms of foreign ownership, namely, equity joint venture, cooperative joint venture and wholly foreign-owned enterprise. Enterprises wholly owned by foreign capital have increased to nearly a half of all enterprises. This reflects the foreign companies policy to reduce their risks by quick and unanimous decision-making. If adequate measures are taken to contain the risks, China business will be sure to be further developed. *Shosha* have improved their intermediary and debt collection functions through businesses with foreign-based companies in China and indigenous Chinese enterprises. Compared with other industries, they have the largest accumulation of information concerning the risks. *Shosha*'s roles are exhibited in such activities as settling accounts with Chinese enterprises and cooperating with them in domestic marketing. These advantageous functions will be helpful to many enterprises aiming to go to China in the future. Although Japanese enterprises planning to go to China have a concern about the "China risk", *Shosha* can mitigate their concern through proper coordination and consultation, finding good Chinese partners for them, and providing them with useful information. *Shosha* will find new business opportunities by enabling Japanese enterprises to carry out stable operations in China.

3. A Bridge between China and Foreign Countries

1) Assisting to Chinese enterprises in their internationalization

Following WTO entry, many Chinese enterprises are beginning to go beyond conventional export businesses on an OEM basis. With "let's go out" as a slogan, they are recently promoting internationalization through direct investments in foreign countries and strategic alliances with foreign enterprises. The Chinese government is also assisting enterprises when they make inroads to foreign countries.

However, Chinese enterprises do not yet have enough know-how to develop foreign markets and operate their businesses there. To solve this problem, Chinese authorities may be considering it necessary for enterprises to tie up with a partner with a role similar to that of a Japanese *Shosha*. The establishment of trading companies under joint venture was permitted by the Chinese government in September, 1997. This is evidence of the government's recognition that for promoting exports and developing industries, trading companies that assume such functions as *Shosha* render to Japanese companies are helpful partners to Chinese enterprises.

Shosha have been rendering consulting services to Japanese companies branching out abroad. They can apply their experiences to Chinese enterprises planning an inroad into foreign countries. One of such success stories is cooperation between Sumitomo Corp. and a Chinese container manufacturer, China International Marine Containers (Group)

Co., Ltd. (CIMC). After their cooperation agreement was concluded in 1990, Sumitomo Corp. provided CIMC with all the information on how to manufacture containers for export. CIMC's present market share is 40% of global container production. In 2000, CIMC was ranked No.10 in export sales among Chinese companies.

In the same way as *Shosha*, multinational corporations based in Japan and other advanced countries have enough know-how and assets for the internationalization of production, distribution, sales and coordination. So, there is no need for them to rely on *Shosha*. On the other hand, by making use of *Shosha*'s worldwide logistics system, debt collection facility, sales channels and coordinating functions, Chinese enterprises can make inroads into foreign countries more easily. By virtue of information and know-how supplied by *Shosha*, they can smoothly carry out their overseas operation.

In July, 2002, Sumitomo Corp. announced a strategic alliance with Hisense Co., Ltd. in Quingdao to export Hisense's home electrical appliances to Japan and Western countries. In December of the year, Mitsui & Co., Ltd. made public its tie-up with the SVA (Group) Co., Ltd. in Shanghai to export SVA's liquid crystal television and other high-tech products overseas as well. As seen above, by making use of *Shosha*'s function, Chinese electric manufacturers are trying to establish worldwide sales channels to expand their market shares in overseas markets. In the case of Sumitomo and Hisense above, Sumitomo Corp. is planning to supply high-end home electrical appliances to the domestic market in China with a hope to enter a mass retailer business for home electrical appliances in the future.

Recently, acquisitions of Japanese enterprises by Chinese investors have begun. Nobody had ever imagined this could happen until a few years ago. Due to a decline in stock prices and asset values under a prolonged recession in Japan, the acquisitions have become more affordable to Chinese enterprises, whose aim is to acquire brands, technologies (patents), equipment and sales channels. In this regard, *Shosha* are expected to play a pilot role, as Chinese enterprises do not have enough knowledge about laws and commercial practices in Japan.

Such cooperation provides *Shosha* with good business opportunities that can utilize their visible and invisible assets accumulated in the past. Thus, assisting Chinese enterprises in their internationalization should produce ideal cooperative relationships between Chinese enterprises and *Shosha*.

2) Business opportunities arising from economic integration in Asia

Economic integration in East Asia is still at a very early stage where China and Japan are negotiating separately FTAs with ASEAN countries. But, region-wise FTAs have already been established in EU and NAFTA countries. From now on, a call for a region-wise FTA is expected to rise in East Asia as well. In the not too distant future, an East Asian FTA will probably be accomplished comprising China, Japan, Korea and ASEAN countries.

As in the case of EU and NAFTA, how much member countries will benefit from an East Asian FTA will depend on how far the flows of trade, investment and human resources are enhanced. In this regard, *Shosha* may play an important role by applying their experience and knowledge accumulated through their bases which have long been maintained in Asian countries. Besides making efforts to expand Japan’s trade and investments with Asian countries, through bases in ASEAN countries, *Shosha* will be able to assist ASEAN enterprises in exporting their goods to China. At the same time, through their bases in China, *Shosha* will be able to assist Chinese enterprises in branching out to ASEAN countries. Thus, *Shosha* can contribute to ecomomic development throughout East Asia by coordinating all their bases in the area.

With regard to the FTA negotiations with ASEAN countries, China is seemingly ahead of Japan at present. In reality, however, the scale of trade and investment between Japan and ASEAN countries is far larger and more substantial than that between China and ASEAN. In addition, China and ASEAN are similar in their industrial structures and are competitors of each other. Even if China finishes FTA negotiations with ASEAN countries ahead of Japan, trade and investment may not expand as much as expected because business links between the two sides are still lacking.

Should this be the case, formation of an East Asian FTA might not realize a high level of economic integration as seen in EU and NAFTA. This could cause serious damage not only to China but also to potential members of the East Asian FTA including Japan. It is important that already established production and distribution networks between Japan and ASEAN countries are compatible to such networks between Japan and China. And, to increase the synergetic value of the two networks, a network between China and ASEAN countries needs to be developed to such a degree as is comparable to that of the above two networks. In short, it is necessary for East Asia to have a network through which goods and services, funds, human resources and information can move quickly and freely at all times to anywhere else in the area. There should not be any obstacle blocking the move in the network. In order to avoid the obstacle and promote trade and investment between China and ASEAN countries, it is necessary for Chinese enterprises to tie up with someone who assist them those regards, and *Shosha* have capacities to perform an important role as a facilitator for them.

Under the circumstances, *Shosha* will be able to drastically expand potential business opportunities through their business between ASEAN countries and China by becoming partners for both Japanese companies and local enterprises of the area. In this sense, it is eagerly awaited that the present FTA negotiations between ASEAN countries and China/Japan will be completed in success and an East Asian FTA will be realized in the near future.

Following WTO accession in December of 2001, China has further opened distribution and trade fields. To cope with this new situation, *Shosha* are switching their stance from import/export businesses to domestic transactions in China, to take advantage of progress in deregulation In addition, as newly emerged private enterprises have grown at an amazingly fast speed, *Shosha* are strengthening their efforts to expand transactions with them and invest in them. Moreover, in view of China's further growth in the future, *Shosha* are considering to make inroads into China not just from their headquarters in Japan but also from their various bases in Asia, America, and Europe.

ISBN4-931574-04-1
C0033 ¥500E