How Japanese Run a Business

By WILLIAM V. RAPP

Why is it that Japanese firms are so often seen as pricing in "unfair," "anti-competitive," "uneconomic" ways? Japanese companies are commonly accused of "dumping" into world markets. Yet it is clear that if Japanese companies were in fact persistently dumping, they could hardly continue to exist for long periods, much less finance their very rapid and continued growth.

One must first note an aspect of Japanese corporate practice which is ordinarily different from that of the West. Japanese companies characteristically depend very heavily on debt as a source of corporate financing.

For the typical Japanese firm, less than 20 percent of total capital employed is owed capital (equity and retained earnings) with more than 80 percent of total capital employed being made up of short and long-term borrowings and the financing of trade receivables. United States companies characteristically obtain more of their capital from equity and retained earnings, while debt comprises a third or less of total capital.

Assume two companies, a United States company and a Japanese company, competing with each other. Assume that their costs are roughly equal, but that the Japanese company follows Japanese financial practices, and that the American company uses somewhat more debt than is customary in the United States. If both provide their shareholders an equal return (10 percent on equity and grow at a similar rate at 10 percent annually, the margin of the United States company will be roughly half that of the United States company. Therefore, given equal costs for the two companies, the Japanese company can service its debt, pay an equal return to shareholders on their portion of total capital, and yet maintain a growth rate equal to that of the United States company at a far lower price level.

Smaller interest charges contribute to a generally high level of fixed costs for a Japanese company compared with a United States company. Furthermore, owing to the nature of personnel relations in the large Japanese company, with employees essentially hired for their entire careers, all labor costs as well as sales, overhead, and interest costs, are in fact fixed for the Japanese company.

Since most costs are fixed, there is considerable incentive for the Japanese firm to operate at capacity so long as the product can be sold at prices that are somewhat above variable costs—that is, somewhat above the cost of raw materials.

Since the breakeven point is high and cannot be significantly reduced in the short run, management is constantly pressed to lower prices as necessary to ensure continued full operations as long as these prices do not drop below variable costs.

Taken together with Japanese financial practices, the "full capacity" policy means that the Japanese concern is able to price lower while maintaining required levels of returns and a high growth rate, and has a powerful incentive to price lower in order to maintain full capacity.

The current generation of Japanese business is perhaps correctly described by the 20 years of unrelenting rapid growth, and for nearly all of this time have known growth at rates virtually unprecedented in history. Further, they have a government that is committed to continue rapid growth, and the credibility of that commitment is strongly reinforced by their successful experience.

This strong sense of confidence that demand will increase at a rapid rate, and their long experience with rapidly expanding markets, has convinced them of the necessity to invest in anticipation of demand. In a national economic sense, this makes for a self-sustaining economy — the investment in anticipation of demand creates the economic conditions that bring about the increased demand.

For the individual company, it means that since capacity does not increase smoothly but rather expands in large periodic increments, there will be periods of temporary excess capacity. And it is evident that Japanese management is likely to keep that capacity as temporarily low priced, and into world markets.

But from the point of view of the Japanese company, the preoccupation with investment and market share in the domestic market is entirely reasonable. At Japanese growth rates, failure to maintain market share can very quickly lead to a disastrous competitive position.

Japanese industrial output has been growing in real terms at some 13 to 14 percent a year. This means that in the modern sector most industries are doubling in size every five years or less. Put another way, if a competitor enters a market without reducing the sales volume of other companies in the field, he will hold half the market in only five years.

As Japanese industry swings away from labor-intensive toward capital-intensive industries, the effects of scale on cost are increasingly clear. Further, in the Japanese context, growth and thus market shares have a direct effect on labor costs. Since employers are hired directly from school for their entire careers, and since their pay is essentially a direct function of their age, the average labor cost for a Japanese company is directly related to the average age of the work force.

A rapidly growing company is hiring large numbers of young people as the average age of the work force drops, labor costs also drop. Conversely, a slow-growing company in Japan has a work force that is aging steadily, and its labor costs are steadily rising. The payoff for growth then is immediate and clear.

All of these forces come together to create a business system in which rapid growth in demand stimulates rapid investment; rapid investment and thus maintained or increased market share translates directly into viable advantage high fixed costs ensure that the additional capacity will be fully utilized; and financial and competitive practices are such that margins in excess of the financial requirements for growth remain concerns in high-growth businesses.

Under these conditions, it is hardly surprising that price becomes the primary competitive weapon of the Japanese company. The United States concern characteristically prefers to compete through increased service, additional merchandising or product differentiation, and use price competition only as a last resort. And United States laws, notably the Robinson-Patman Act and ultimately the antitrust laws, reinforce this tendency and place sharp limits on the use of price as a competitive weapon. The results in terms of international competition are unfortunate.

Mr. Rapp is a staff member of the Boston Consulting Group, Inc. His article is excerpted from a talk in Pittsburgh, Sept. 28 to the National Association of Business Economists.