J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 30A **August 9, 1996**

JAPAN'S SOGO SHOSHA: OLD DOGS AND NEW TRICKS

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SUMMARY

In the wake of the severe recession of the early 1990s and intensified global competition, corporate restructuring and business reengineering have become the bywords of Japanese executives discussing their companies' strategic plans. For Japan's general trading companies or sogo shosha this kind of planning is nothing new. As long as a decade ago some domestic and foreign pundits labeled the general trading firms "economic dinosaurs" whose extinction was imminent. Since then sogo shosha executives have been plotting ways to utilize their firms' specific strengths to survive in rapidly changing business and economic environments. Besides focusing on such fundamentals as boosting productivity and return on investment, trading company executives have touted diversification as a key objective. While a few of the top sogo shosha have ranged farther afield of traditional business lines than their peers, all have opened themselves to greater risks as a result of diversification. So far the general traders not only have managed to avoid the fate of the dinosaurs but have set the pace in some ways for the rest of the Japanese business world. More than a few critics remain skeptical of the sogo shoshas' long-term prospects, however, arguing that, while these old dogs may have learned some new tricks, they have not performed skillfully.

A Long, Successful Pedigree

Japan's top general trading companies trace their lineage back more than a hundred years to enterprising individuals who built businesses selling products such as jute throughout the region from Osaka to Edo, the former name of the Tokyo area. By stressing delivery of high-quality products (even for standardized items like jute), reliable service and close ties with both producers and customers, the predecessors of today's big trading houses steadily increased their reach and scope of business. By the late 1800s, when Japan began a mad dash to join the club of modern, industrialized

[1]Hiromasa Kubo, "Can Japanese Trading Houses Truly be Seen as Multinationals?" *The Japan Times*, July 29, 1996, p. 14.

nations, these trading houses were in a position to play important roles in the expansion of Japanese trade to a global scale.

By the advent of World War II *sogo shosha* were critical components of the military-industrial complex that made Japan a regional power. After the war, even though they had been reduced in size by American occupation authorities concerned with the overconcentration of economic power, general trading companies played a critical role in supplying raw materials and other imports to the national reconstruction effort. Alongside domestic consumer goods makers, *sogo shosha* were the standard-bearers for Japanese commercial interests around the globe in the postwar era. They also continued to play an important role in domestic trade and distribution.

What sets Japan's 16 or so general trading companies apart from the nation's roughly 1,600 other trading firms can be summed in one word: size. Firms like Mitsubishi Corp., Mitsui & Co., Ltd., Itochu Corp., Sumitomo Corp., Marubeni Corp. and Nissho Iwai Corp. handle around 25,000 different products each and employ tens of thousands of people in hundreds of offices, subsidiaries and joint ventures around the globe. They purchase from abroad a significant portion of the huge volume of industrial and agricultural inputs that keep the economy operating and help domestic firms export and overseas firms to sell in Japan. Their export operations are built on a solid foundation anchored in the distribution system of the nation; in fact, general traders handle a large percentage of in-country "trade." *Sogo shosha* do not merely trade goods, moreover. They are deeply involved in developing basic natural resources, intermediate goods and higher value-added items. *Sogo shosha* are especially important investors in and partners with countries rich in natural resources.

The central nervous system of these globe-spanning firms is a complex communications and information network. Gathering information and building ties with local businesses and communities often give these companies valuable insights into new trade opportunities. Because they combine global networks of offices with in-the-field intelligence-gathering operations, *sogo shosha* do not need to wait passively for trade opportunities to develop; they can pursue them actively. In addition, *sogo shosha* use their information contacts and relations with domestic and foreign firms to assess and distribute the risks inherent in global trade and investment transactions. If a trading company finds that it does not have the necessary expertise to tap a potentially profitable business opportunity, it often brings in another member of its corporate group or *keiretsu* that does. Coupled with an ear close to

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JEI Report (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $80 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Periodicals postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue N.W., Washington, D.C. 20036.

the ground for potential problems, such as political instability in a country of business interest or questionable financial health on the part of a possible partner, general traders have a reasonably good record of avoiding missteps in their foreign trade and investment deals. Some business analysts charge, however, that *sogo shosha* are too conservative in their risk assessments and, consequently, miss important opportunities.

A final aspect that makes general trading companies stand head and shoulders above other businesses in the field is their involvement in trade finance. They provide short-term financing linked to specific trade contracts to all clients, a valuable service in the context of Japan's financial system. Banks willingly lend funds to *sogo shosha* because of their solid credit ratings. General trading companies then turn around and extend credit to Japanese firms that do not have automatic access to bank loans. *Sogo shosha,* in short, have developed sophisticated commodities trading skills and, backed by their financial strength, are significant players in global markets.

Other characteristics also typify *sogo shosha*, although some of these are undergoing reconsideration.

- The bulk of their business is in products that do not require after-sales service. Exports and sales abroad of products that require this kind of follow-up, such as motor vehicles and consumer electronics, are handled directly by the manufacturer. As trading companies have added more final and high technology goods to their product mix, however, this attribute has become less applicable.

- Strong ties to resource-rich countries, which are, in many cases, developing nations, is a notable characteristic, one arising from raw materials still forming the bulk of their trading volumes. As such, *sogo shosha* are in a ground-floor position to service local needs, an advantage not enjoyed by most competitors in the United States and Europe.

- Profit margins traditionally have been razor thin, mainly because general traders deal in intensely competitive markets, such as commodities, and add relatively little additional value to the products.

- *Sogo shosha* are loosely regulated, most often by the Ministry of International Trade and Industry which oversees their heavy involvement in energy resources. Since they are not under the guidance of the Ministry of Finance, *sogo shosha* have been freer to develop their financial skills and tailor financial products to meet the demands of the market than true financial-sector players.

Old Tricks No Longer Enough

Beginning in the 1980s Japanese corporations, including *sogo shosha*, found that developments at home were remaking the economic landscape on which they had based their so-far successful business strategies. At the same time Japan's general trading companies, with their extensive overseas operations, were more vulnerable to changes abroad than most other Japanese firms, making them the first to feel the negative effects of any shifts. While these challenges might also give them a headstart in responding to the changes occurring domestically and internationally, it is a point of debate whether *sogo shosha* have been moving effectively to address the new business environment.

- Slower Economic Growth. When the Japanese economy was rebuilding and catching up with the United States, the nation's appetite for imported industrial and agricultural raw materials was insatiable. *Sogo shosha* accordingly enjoyed growing demand for their intermediary trade services, and their sales grew annually at a healthy pace. When the Japanese economy had caught up with its industrial peers, its natural rate of growth slowed. This translated into a slower increase in demand for the inputs handled by *sogo shosha* and, thus, slower sales growth.

• Changing Composition of Trade. On the industrial side the twin oil shocks of the 1970s set Japan on a long-term drive to reduce dependence on oil imports, a *sogo shosha* staple. Furthermore, energy-intensive industries, such as aluminum and other metals and petrochemicals, became less competitive, and capacity began to flow out of Japan to overseas facilities, again reducing demand from important trading company customers. On the consumer side Japanese tastes were becoming more sophisticated and individual. Increasingly affluent consumers could afford designer-label goods, cutting demand for the mass-market goods that *sogo shosha* traditionally handled. Retailers also began to shift toward buying directly from manufacturers, cutting out trading company middlemen.

• Technological Maturation of Japanese Industry. *Sogo shosha* were important conduits for the inflow of foreign technology during the postwar reconstruction and rebuilding periods of the Japanese economy. By the 1980s, however, key Japanese industries — such as steel, integrated circuits and consumer electronics — not only had caught up technologically with the rest of the world but were at the cutting edge in many cases. Thus, trading firms no longer could earn money simply by importing foreign high technology goods.

• Financial Market Deregulation. Beginning in 1980 the Ministry of Finance initiated significant reforms in foreign exchange control and foreign investment laws and regulations. This allowed a growing number of Japanese firms to seek financing in overseas markets. The trade financing advantage of a *sogo shosha*, thus, was dulled considerably. At the same time, though, financial deregulation freed *sogo shosha* to enter a wider range of financial activities, both at home and abroad. Trading firms have experimented with more complex and creative leasing agreements for commercial aircraft, for example. They also have moved decisively into commodities trading with some notable wins and losses.

• Yen's Appreciation. Beginning in the mid-1980s the yen began to appreciate sharply against the dollar and other currencies. While this greatly increased the international buying power of the Japanese currency, it also sharply shrank the profits earned overseas when selling Japanese products for dollars and other currencies. Trading companies consequently found their profit margins on commodities trading and overseas operations squeezed by the yen's rise. Although they began to hedge their foreign currency risks aggressively, it was like trying to hold back a flood by sticking a finger in the dike.

Over the longer term the strong yen has encouraged Japanese manufacturers to move production facilities overseas, again cutting into the domestic customer base of the *sogo shosha*. Simultaneously, however, the stronger yen has spurred import demand, particularly for manufactured products. Trading companies have tried to take advantage of this shift.

• Deflation of the "Bubble" Economy. Like most other Japanese financial and nonfinancial companies, *sogo shosha* were swept up in the speculative fever of the late 1980s' bubble economy boom. Investing in real estate and financial instruments generated significant profits during this period. The anything-goes business environment also encouraged *sogo shosha* to enter such fields as financial consulting on foreign mergers and acquisitions and foreign real estate development.

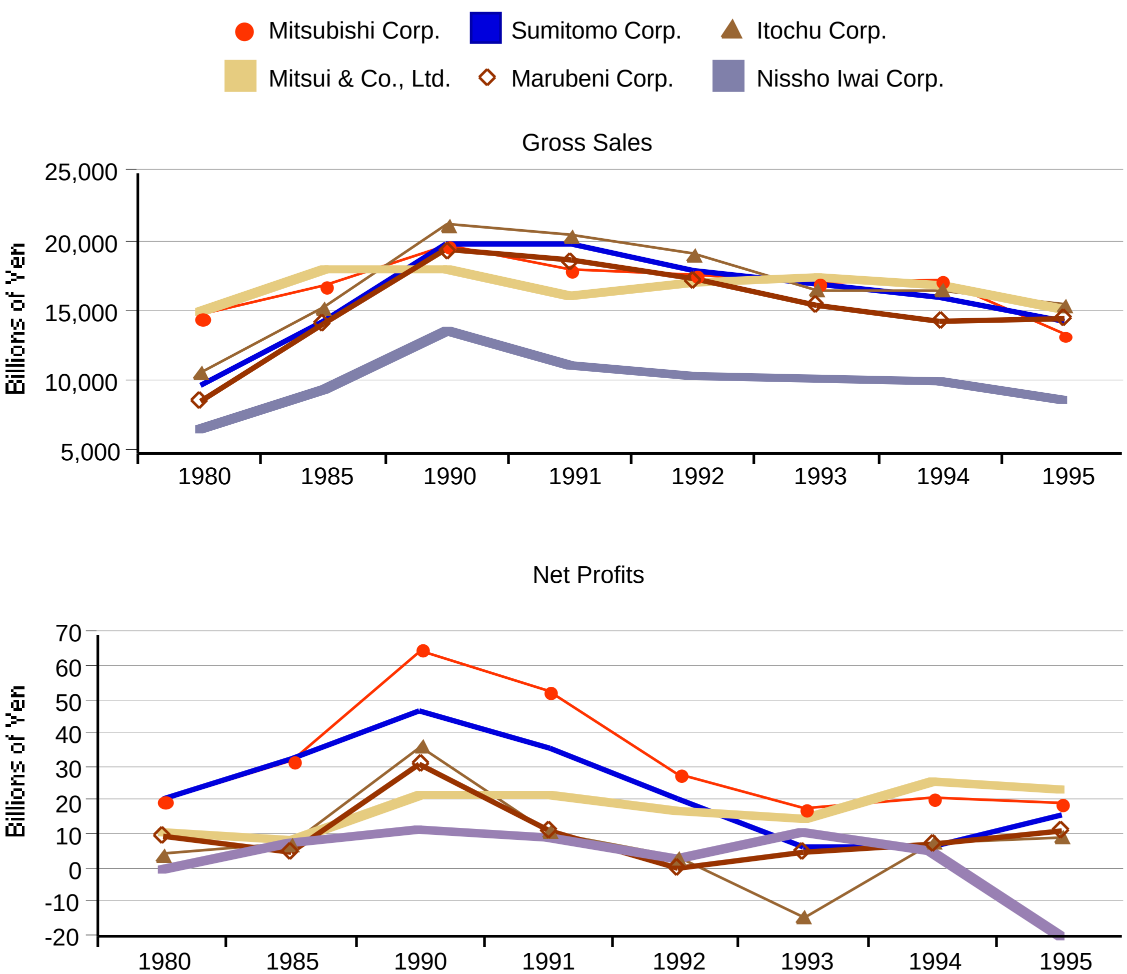
The deflation of the speculative bubble in the early 1990s was particularly painful for general traders, as losses on financial and real estate investments accumulated. The trading giants have tried to tough it out, refusing to write off losses in the hope that domestic property and stock markets would recover to levels near their late 1980s' highs. While Japanese equity prices have recovered somewhat, real estate prices remain at mercilessly low levels. Trading companies reluctantly have begun to clean the postbubble mess off their books. Itochu, for example, raised its loan-loss reserves to ¥18.8 billion ($188 million at ¥100=$1.00) in FY 1995 in anticipation of a planned pullout from the domestic real estate market. Nissho Iwai also has decided to bite the bullet by canceling ¥100 billion ($1 billion) worth of specified money trusts (the Japanese equivalent of mutual funds) and taking a ¥35.2 billion ($352 million) loss.[2]

[2]Yuri Yamamoto, "Trading Firms Profit From Interest Rates," *The Nikkei Weekly*, July 27, 1996, p. 10.

• Early 1990s' Recession. The deflation of the bubble economy pushed Japan's economy into a record-setting postwar recession. Besides the obvious negative effects on sales and profits, the recession impacted the psyches of Japanese managers and employees as well. While Japanese firms quickly had shrugged off the effects of the high yen-induced slowdown of 1985 and 1986, the early 1990s' economic downturn was unprecedented in both its length and depth. "Tough-it-out" strategies, which had gotten companies through previous slowdowns, became less viable as the recession wore on. Sales weakened and have yet to fully recover. The pressure to reengineer core business practices became irresistible.

The latest business results of the top *sogo shosha* indicate that some dealt better with the recession than others (see Table and Figure 1). Record low domestic interest rates, by reducing the cost of borrowing, have helped trading companies, just as they have helped banks. Those companies that invested heavily in high technology lines of business seem to be putting poor business results behind them more quickly than firms that did not. Asian trade also appears to be a hot growth area, and *sogo shosha*, if they already had not done so, are positioning themselves in these rapidly developing markets. These are just some of the new tricks that may revitalize the *sogo shosha* fortunes.

Figure 1: Gross Sales and Net Profits of Selected Sogo Shosha, FY 1980- FY 1995



Sources: Company annual reports and *Japan Company Handbook*, various years

Recent Consolidated Business Results of Selected Sogo Shosha

(in billions of yen except per share figures in yen)

Fiscal Year	Gross Trading Volume*	Net Profit (Loss)	Total Assets	Net Income per Share	Dividend per Share
Mitsubishi Corp.					
1990	¥19,726.5	¥65.3	¥11,930.5	¥40.86	¥8.0
1991	18,121.7	52.7	10,262.3	33.06	8.0
1992	17,793.3	28.7	9,277.1	18.10	8.0
1993	17,276.3	18.4	8,737.5	11.72	8.0
1994	17,466.6	21.7	9,488.9	13.84	8.0
1995**	13,496.1	20.3	n.a.	n.a.	n.a.
1996***	11,500.0	26.0	n.a.	n.a.	n.a.
Sumitomo Corp.					
1990	20,018.7	47.1	5,978.1	44.31	8.0
1991	19,936.7	36.5	6,137.8	32.32	8.0
1992	18,027.0	20.5	5,382.6	19.23	8.0
1993	17,000.3	7.3	5,009.6	6.86	8.0
1994	16,139.5	7.3	5,121.9	6.83	8.0
1995**	14,387.8	16.3	n.a.	n.a.	n.a.
1996***	12,500.0	18.0	n.a.	n.a.	n.a.
Marubeni Corp.					
1990	19,468.4	34.1	9,443.9	22.75	6.0
1991	18,657.4	11.2	8,780.7	7.53	6.0
1992	17,325.5	1.1	8,067.1	0.74	6.0
1993	15,592.3	5.5	7,059.4	3.68	6.0
1994	14,918.9	10.4	6,844.0	5.2	6.0
1995	15,545.3	15.1	n.a.	n.a.	n.a.
1996***	13,000.0	15.0	n.a.	n.a.	n.a.
Itochu Corp.					
1990	21,303.6	37.2	8,226.5	2.6	6.0
1991	20,610.5	11.8	8,283.2	8.3	6.0
1992	19,277.7	4.0	7,144.1	2.8	6.0
1993	16,742.5	(14.1)	6,449.2	(9.9)	6.0
1994	16,670.9	8.1	6,432.4	5.7	6.0
1995	16,327.8	1.7	7,030.8	8.2	n.a.
1996***	13,500.0	11.0	n.a.	n.a.	n.a.
Mitsui & Co., Ltd.					
1990	18,234.1	22.2	9,615.7	14.40	6.5
1991	16,163.7	22.6	8,507.0	14.60	7.0
1992	17,156.3	17.5	8,023.0	11.05	7.0
1993	17,637.1	15.3	7,391.3	9.75	7.0
1994	17,035.0	26.2	7,161.8	15.75	7.5
1995**	15,182.0	24.0	n.a.	n.a.	n.a.
1996***	13,000.0	25.5	n.a.	n.a.	n.a.
Nissho Iwai Corp.					
1990	13,671.8	11.7	5,475.9	14.93	5.0
1991	11,317.8	9.5	4,932.6	12.15	5.0
1992	10,636.1	3.2	4,720.8	4.14	5.0
1993	10,300.8	10.7	4,698.1	13.69	5.0
1994	10,020.5	5.2	4,899.4	6.68	5.0
1995**	8,688.0	(20.0)	n.a.	n.a.	n.a.
1996***	7,200.0	13.0	n.a.	n.a.	n.a.

*Export and import operations only.
**Unconsolidated results.
***Company projections.

Sources: Company annual reports and *Japan Company Handbook*, various years.

Learning New Tricks

In response to the various forces reshaping the economic and competitive landscapes trading company executives began to restructure and reengineer their businesses long before these actions became widespread phenomena in Japan. Not surprisingly, one of the first areas that came under examination was employment. Although they have sought to pare personnel expenses, *sogo shosha* quickly realized that experienced and locally well-connected staffs around the world were one of their greatest business development resources. Downsizing, thus, was not a significant option for general traders. *Sogo shosha* executives found plenty of other options, however.

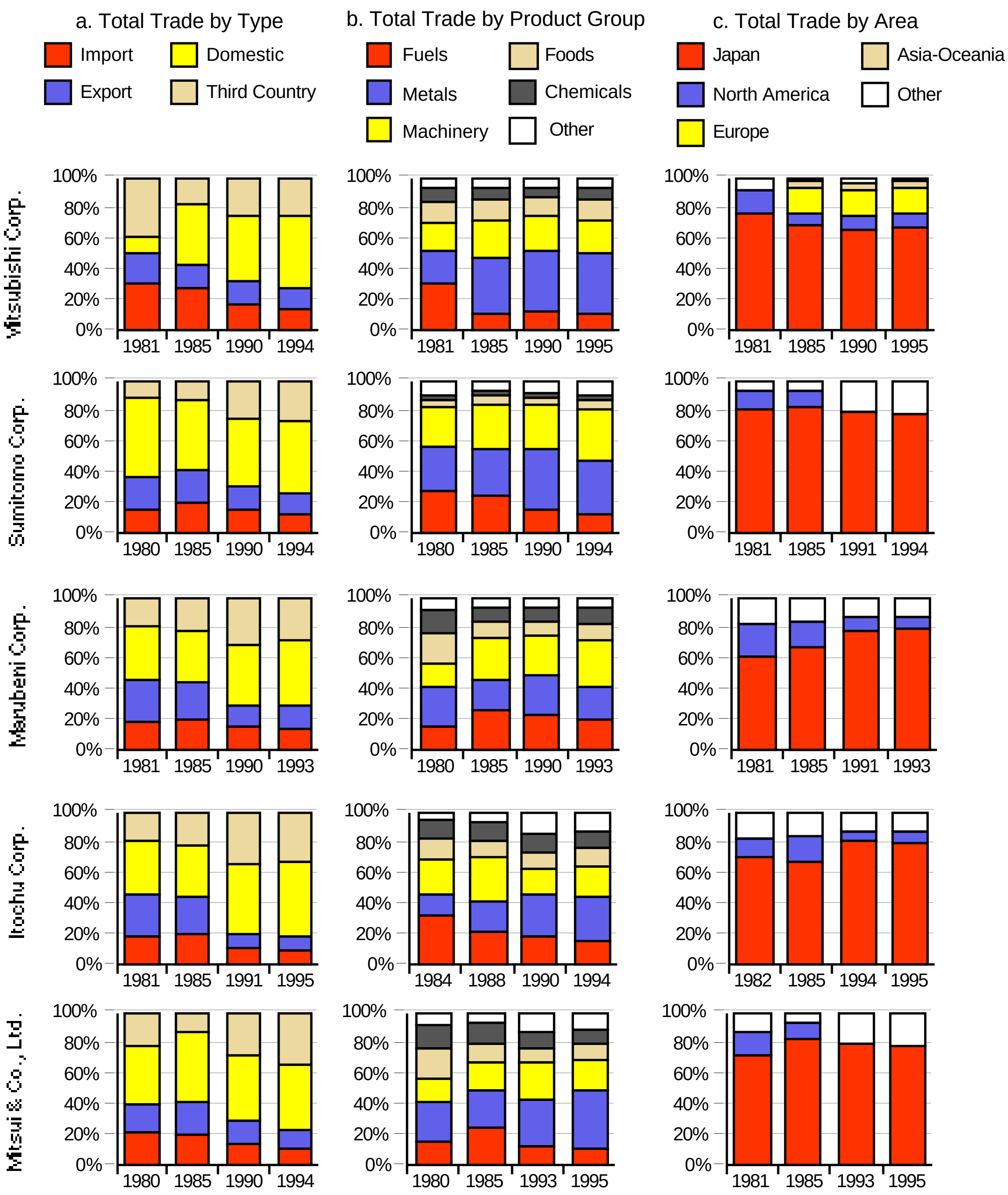
Increasing Activities as Middlemen between Non-Japanese Buyers and Sellers. *Sogo shosha* already were using their existing global network of offices to build a position in so-called third-country trade before the business environment at home and abroad started to change in the 1980s. Initially they focused on countries with underdeveloped domestic trade and distribution infrastructure, reasoning that they could provide these functions (see Figure 2a). Realizing simultaneously, however, that these markets could not yet generate adequate demand to justify their costs, trading firms set their sights higher up the development ladder, zeroing in on markets with emerging classes of consumers. *Sogo shosha* have found more success in promoting this kind of business, whether in Southeast Asia, the People's Republic of China, South Asia or the Middle East. Similar activity also appears to be picking up in Eastern Europe.

Raising Proportion of Intermediate and Value-Added Goods in Trade Mix. Trading companies' main job in the initial postwar period was to ensure that the supply lines feeding raw materials to Japan's rapid reconstruction and rebuilding efforts were kept full and flowing. This remains a core business even now. Given their middleman role, which typically does not convert materials to new forms, as well as the competitive nature of global commodities markets, however, trading companies never have earned more than a slim profit from handling bulk commodities. Over time they steadily have worked to upgrade their product mix on the import side to goods with higher value-added or higher profit margins, moving more into intermediate products like steel and textiles and then into final goods, including both consumer goods and capital goods (see Figure 2b). As they have become more involved in consumer goods, general traders have had to devote attention to such areas as downstream marketing and promotions to ensure that strong demand is generated for their products (or the goods they deliver to retailers). For example, trading firms have helped to build brand-name identifications in emerging Asian markets for such products as fashion clothing, consumer electronics and sporting goods.

Moving into High Technology Goods and Services. In careful stages general trading companies have expanded the scope of their dealings to include high technology products. Focusing on high technology products that complement existing lines of business was the first step. One or more *sogo shosha*, for example, have moved into areas like developing alternative energy sources, new or exotic materials and biotechnology — activities that complement their existing energy, metals and chemicals divisions. Mitsubishi, for one, is working with an Australian firm to develop a ship-based plant to convert natural gas into methanol. The self-contained seafaring conversion plant could tap the numerous small offshore gas deposits spread throughout the Asia-Pacific region. In some cases companies are extending these new activities to new solutions, such as bioreactors for producing methanol from animal and plant waste.

In the next and current stage trading companies are jumping into entirely new high technology fields, focusing on ones that have high potential for growth. Nissho Iwai has been working hard to build a position in the space development market, working with American space shuttle contractors, for instance. The company hopes to apply what it learns to helping Japan build its unmanned HOPE space shuttle. In another telling example Mitsubishi tied up in 1989 with Gupta Technologies, Inc. to import, customize for the Japanese market and sell the Menlo Park, California-based firm's personal computer programs and since then has signed computer software and hardware deals with several other American firms. Mitsubishi also has been involved in studying theater missile defense systems for the

Figure 2: Trade Characteristics of Selected Sogo Shosha



Notes: 1. Years shown are fiscal years. 2. In Trade by Area North America, Europe and Asia-Oceania are included in Other where not shown seperately. 3. In Trade by Product Group: For Sumitomo Corp. and Itochu Corp. fuels equals fuels and chemicals; chemicals equals textiles. For Marubeni Corp., fuels equals energy and chemicals; chemicals equals textiles; and food equals agrimarine products.

Sources: Company annual reports and *Japan Company Handbook*, various years.

Japan Defense Agency and, thus, has strengthened ties with Lockheed Martin Corp. and Raytheon Co., which provide missiles and radar systems, respectively, for the U.S. theater high-altitude area defense system.

Investing in high technology lines of business appears to be paying off for general traders. Mitsubishi earned 10 percent of its FY 1995 gross profits from such endeavors, even though they accounted for only 3.8 percent of total revenues in the year through March 1996. Itochu said in its FY 1995 annual report that investments that year in high technology projects hit ¥108 billion ($1.1 billion), while Mitsui reported sinking ¥92 billion ($920 million) into high technology businesses in the April 1995-March 1996 period.[3]

Expanding Role of Services in Trading Activities. Since the traditional role of trading firms is to act as middlemen between buyers and sellers, the trading houses already are services-oriented at heart. To support their import-export businesses trading firms became involved in trade finance and trade-promotion consulting as well. Therefore, *sogo shosha* had a solid foundation on which to build in taking the next step of offering a broader line of financial and consulting services both at home and abroad. As Japanese firms sharply increased their direct investments abroad in the second half of the 1980s, general traders began providing advice to Japanese clients on mergers and acquisitions — in some cases setting up specialized subsidiaries to ferret out takeover prospects and to ensure that all the negotiations and legal work went smoothly.

The spread of the Japanese-honed “just-in-time” delivery system for keeping parts inventories at factories lean and wringing inefficiencies out of the supply process also has provided *sogo shosha* with new business opportunities. They have offered their expertise in this area to foreign manufacturers and to nonmanufacturing companies at home, hoping in part to win the actual distribution work whenever possible.

Sometimes a service originally intended for employees can become an unexpected revenue center. In 1990 Mitsubishi took a 75 percent stake in a Hong Kong-based travel agency, Double Fortune Travel Ltd., to provide travel services to Hong Kong and China for its employees. Within two years, however, Double Fortune Travel was booking tours to the British colony, China and Vietnam for a wide range of Japanese firms. The travel agent hopes to widen the scope of its services even further by marketing its tours through Mitsubishi’s global communications network.

As Japan’s consumers increasingly have focused on leisure activities and their quality of life, Mitsubishi spotted the rising demand for sophisticated local entertainment and in 1991 launched The Asian Beat, a series of music videos featuring Asian artists and showcasing various Asian cultures. Japan’s top trader followed this move in 1993 with a contract for the Japanese broadcast rights to Orion Pictures Corp.’s movies, including such films as *The Silence of the Lambs* and *Robocop*.

Moreover, given their experience in using and operating global communications networks, general trading firms early on understood the importance of state-of-the-art communications services. Trading companies quickly jumped into the current generated by the arrival in the mid-1980s of a new telecommunications regulatory environment that produced not only a privatized Nippon Telegraph and Telephone Corp. but opened domestic and international communications services to competition. With 29 other Japanese firms, Mitsubishi established Space Communications Corp. in 1985 and ushered in the era of private satellite services in Japan. After enduring several launch failures, SCC’s Superbird series of satellites now provide telephone, data and video feeds to all of Japan. Nissho Iwai is part owner and manager of Japan Satellite Systems Inc., which also provides domestic and international telephone services as well as video broadcasting and data transmission. Several *sogo shosha* have formed ventures with other domestic companies aimed at the mobile telephone market, especially personal handyphones, Japan’s version of this country’s personal communications system. Competition has pushed down the cost of a personal handyphones system and sparked a boom in sales.

[3] *Ibid*.

Diversifying into Nontrade Business Lines. General traders also have dipped their toes into venture capital funding, real estate and other "pure" financial activities. Particularly during the late 1980s' speculative boom, several *sogo shosha* became more deeply involved in domestic and overseas property deals. During the 1980s as well, when it was easy to turn a profit on pure financial investments, general trading companies invested heavily in specified money trusts, the Japanese equivalent of mutual funds. Most top trading firms also set up venture capital operations in the late 1980s and early 1990s, either by backing an existing venture capital fund or by establishing a group within existing departments. While venture enterprises sometimes were supported to win access to potentially important technologies, the expectation of profit more often was the driving force.

The rapidly growing economies of Southeast and South Asia have proven to be fertile grounds for trading companies as they expand outside their traditional business lines. These countries need to build significant amounts of economic infrastructure to support their high growth rates and are looking to foreign investors to fill the gap. *Sogo shosha,* with their project management experience and deep financial resources, are investigating eagerly the opportunities to "build-operate-transfer" such infrastructure projects. Itochu and Mitsubishi, for example, are participating in an Indonesian BOT project to build a 3.5-mile, ¥24 billion ($240 million) bridge. The two firms will join with a Japanese and an Indonesian government agency to collect tolls before turning the bridge over to the Indonesian authorities in 2025. Japanese trading companies also are helping to build airport terminals in the Philippines (Mitsui and Marubeni) as well as water supply and sewer systems in Jakarta (Mitsui). Trading companies estimate that as much as $630 billion worth of BOT projects will come up for bidding in China, Southeast Asia and South Asia by 2010, and they hope to cash in.[4]

Perhaps the most intriguing business development effort being pursued by *sogo shosha* is in multimedia and Internet services. Like most Japanese firms, trading companies were quick to set up World Wide Web sites and home pages, but these lacked meaningful content. Hoping to turn their Web sites into technology showcases, some companies are investing in interactive three-dimensional sites that will introduce Web surfers to the broad range of services they offer. *Sogo shosha* also are exploring how to use the new 3-D interactive technology to conduct simultaneous meetings of employees scattered around the world. If successful, some firms likely will offer this service to customers, giving a new twist to their traditional roles as middlemen.

Investing in Emerging Markets. Along with high technology investments, *sogo shosha* executives currently see investing in Asian ventures as "the two wheels for growth." The first wave of *sogo shosha* investments were targeted at the members of the Association of Southeast Asian Nations — Brunei, Indonesia, Malaysia, The Philippines, Singapore, Thailand and, most recently, Vietnam. Mitsubishi, for example, has been instrumental in helping Malaysia develop its Proton indigenous car. Mitsui also is involved in another Indonesian minicar venture, Perodua Bhd. Over the past year most top *sogo shosha* have opened investment fund ventures in the region, aiming at enlarging their roles. Mitsubishi has tied up with Temasek Holdings Ltd. of Singapore and Bangkok Bank, assembling a $100 million fund to invest in local high technology ventures. This fund followed Mitsubishi's establishment of MC Capital Asia Pte. in Singapore to take charge of its Asian investments. Mitsubishi's move mimics steps by Sumitomo and Mitsui in setting up Singapore-based merchant banks to direct investments in Asia.

The next wave of *sogo shosha* investments hit China's shores. As Beijing pursued its plans to open up to foreign investors and implement economic reforms, trading firms all established numerous ventures in China. Besides targeting economic infrastructure development, Chinese operations include handling trade and local production of consumer goods and other light manufactures.

Vietnam and Cambodia are heating up as locales for *sogo shosha* activity, as these countries also move to restructure their economies along market-oriented lines. Just down the road in *sogo shosha* strategic investment planning lie Myanmar (the former Burma) and Laos. Even though they do not

[4] "Traders' Mantra: 'Build, Operate, Transfer,'" *The Nikkei Weekly,* April 29, 1996, p.18.

expect much business in the next several years, most *sogo shosha* are establishing operations in these two countries, which are beginning to emerge from decades of economic central planning.

Finally, general traders are reaching out to new markets in South Asia. India's economic reforms have improved the environment for foreign investment and, even though recent political changes have raised some doubts, trading firms are conducting regular business development trips to the region.

Promoting Environmentally Sound Products. Japanese trading companies slowly have added a "green" tint to their activities by developing and promoting environmentally sound products and processes. On top of their efforts to develop less polluting alternative energy sources trading companies have instituted recycling programs tailored to their needs. For example, in cooperation with Kodama Plastics Co., Ltd., a Mitsubishi subsidiary, Mitsubishi Shoji Plastics Corp. began offering in 1992 a complete life cycle for industrial plastic drum cans; this process follows the increasingly popular containers from original molding to industrial use and through recycling into other plastic products. Another Mitsubishi subsidiary developed in 1993 a simple system for extracting pure water from salt water or impure fresh water without the use of electricity, oil or special machinery.

Boosting Corporate Philanthropy. Although Japanese trading companies always have sought to be upstanding members of whichever local community they operate in, their conception of good corporate citizenship previously went only so far as buying local products and supporting the local economy. Beginning in the 1980s in the United States and then spreading to other countries, trading firms have expanded their involvement at the local level overseas to programs for the arts, education and social welfare. This new focus partly was in reaction to the greater Japanese manufacturing presence abroad, which gave these trading company partners a much higher profile in the local community, and partly a consequence of trading firms' status as top-ranked (and, therefore, seemingly deep-pocketed) Japanese corporations.

New Tricks Prove Tricky

It is almost axiomatic that exposure to risk rises whenever something new is attempted. Japanese trading companies' plunge into new technologies and diversified lines of business is no exception. Even with a long history of experience in complex international trade deals, top executives at Mitsubishi, Mitsui and their rivals knew their companies were entering terra incognita in venturing outside their core activities. The big trading firms' track records in new ventures have been mixed, with some failures due to their own missteps but others due to factors beyond their control.

The most troubled ventures have been those born during the late 1980s' bubble economy. Traders that invested in real estate and mutual funds have watched the value of their portfolios plunge to half the record levels seen at the height of the bubble economy. After years of hoping that property and stock values would return to their previous highs, some general traders finally are liquidating their positions and realizing the associated losses.

Of equal concern to outside observers are signs that trading companies have spread their resources too widely by moving into new lines of business helter-skelter without overall strategic vision and planning. Two recent affairs dramatically have brought to light the risks being taken by *sogo shosha*:

- Prepaid pachinko cards. Playing pachinko — a kind of vertical pinball — is a national obsession in Japan; each day millions of Japanese pump millions of yen into pachinko machines for hours at a time. National police and tax authorities long have suspected that pachinko parlor operators underreport their incomes and that organized crime is involved in this national pastime. In addition, Japanese experts believe that a significant portion of pachinko parlor profits is funneled to North Korea by sympathetic Korean parlor owners. In order to restrain these activities Japanese authorities advocated in 1993 the universal adoption of an electronic prepaid card system that would replace the traditional cash/token system. Mitsubishi and Sumitomo, together with NTT, developed the necessary hardware and software using NTT's prepaid telephone cards as the model. With some administrative strong-arming by the government, pachinko parlor operators began installing the new system in large numbers in 1994. The two trading companies set up subsidiaries — Nippon Leisure Card System K.K. (Mitsubishi) and Nihon Game Card K.K. (Sumitomo) — to sell cards to the public and redeem card-use claims from pachinko parlor owners.

The ventures went well until the January 1995 Great Hanshin Earthquake, which devastated the Kobe-Osaka area. In the quake's aftermath pachinko parlors were vandalized, and pachinko card vending machines were stolen. Soon after Nippon Leisure Card and Nihon Game Card began noticing that card-use claims by pachinko parlor owners were outstripping legitimate sales of pachinko cards. It soon became apparent that someone had taken apart the stolen card vending machines, cracked the encryption security system for the cards, and begun making and selling counterfeit cards.

Rather than cause chaos among players and parlor owners by shutting down the prepaid card system, both trading company subsidiaries continued to honor all payment claims made by pachinko parlor owners. As a result, Nippon Leisure Card posted a ¥29 billion ($290 million) net loss in FY 1995, forcing parent Mitsubishi to set aside ¥5 billion ($50 million) as a loss reserve. Much to the relief of Sumitomo Corp. officials Nihon Game Card's losses were smaller at ¥8 billion ($80 million).[5] The two subsidiaries, again in cooperation with NTT, are preparing to introduce a new counterfeit-proof card system by early next year, but they still expect to be in the red for FY 1996. Despite their sour experience, both parent trading companies have announced that they will stick with the effort.

- Copper Commodities Trading. While the pachinko card fiasco is an embarrassment to Mitsubishi and Sumitomo, it has not threatened seriously their overall financial health. In June, however, corporate Japan was stunned to find out that a well-respected Sumitomo employee who directed the company's copper trading activities had concealed up to an estimated $1.8 billion in trading losses over the past decade (see *JEI Report* No. 23B, June 21, 1996). The discovery not only roiled global copper markets but triggered investigations by authorities in Great Britain and the United States of Sumitomo and the commodities brokerages with which it dealt.

Sumitomo executives claimed that the company's head copper trader, Yasuo Hamanaka, had operated without the consent or the knowledge of superiors. As the details have unfolded, however, some observers have become skeptical that one man working alone could have planned such an elaborate scheme and kept so many balls in the air for so long a time without accomplices. Whatever the final outcome of the investigations, the revelations certainly will cause an enduring black mark on Sumitomo's reputation.

The shock waves from the affair have been amplified because Sumitomo is known in the business world for its conservatism and strong top-down management style. The *sogo shosha*'s efforts to diversify and to focus more on profits appear to have worked together to loosen internal safeguards enough to allow Mr. Hamanaka's long run of unchecked trading. Given that several other elite Japanese corporations in the past few years have suffered big trading losses by rogue employees, many analysts found it surprising that Sumitomo executives had not tightened internal checks and procedures. Observers immediately began to speculate that Sumitomo and other big companies were hiding more such unexpected losses, but so far those worries have not panned out. Sumitomo executives, by carefully orchestrating the company's annual shareholder meeting (see *JEI Report* No. 26B, July 12, 1996) and allegedly secreting Mr. Hamanaka away from authorities, have managed to date to avoid serious image problems for the company.

Outlook: Combining The Old And The New

The Sumitomo copper trading scandal presents an image problem for all *sogo shosha*. More important perhaps, it highlights how difficult it can be to combine old and new business practices and

[5] Yamamoto, *op. cit.*

strategies. Yet, this is exactly what trading company executives have decided is the best bet to assure their companies' future growth. For some observers a key test of management's real commitment to reengineering and restructuring is its willingness to adopt and *utilize* personal computers linked together in local area and wide area networks.

Trading companies long have prided themselves as being information-driven organizations but, like many other large Japanese corporations that had invested heavily in mainframe computers, they were slow to introduce PCs, LANs and WANs. Control of information has been a key to power for upper managers in the hierarchical structure of the Japanese corporation. Big companies in Japan — the *sogo shosha* included — now are rushing to buy PCs, install LANs and WANs and train employees to use them. Yet, merely having these tools is not sufficient incentive to use them. According to a recent survey by Fujitsu Research Institute, more than 60 percent of American managers responded that computers were essential to their jobs compared with only 8 percent for their Japanese counterparts.[6] Another survey showed that about two-thirds of top Japanese firms have installed internal e-mail systems but only a handful actively use them.

Analysts cite inflexible management practices and bureaucratic turf fighting as the major road blocks to effective utilization of networked PCs in Japanese corporations. One top *sogo shosha* has developed an internal strategic plan to address these issues. It calls for flattening the hierarchical management pyramid by linking all PCs and making data available to anyone; changes in decisionmaking processes and local autonomy are listed as well. Yet the person in charge of developing this plan is skeptical that it will be implemented fully, despite the fact that his mandate came directly from senior management. As the Internet becomes not only a means of communicating and sharing information globally but a global marketplace as well, *sogo shosha* will come under even greater pressure to change their traditional management practices.

As the Sumitomo copper case illustrates, however, sound managerial controls must accompany restructuring and reengineering. Observers wonder if general traders can balance the need for local decisionmaking and entrepreneurial thinking with the centrifugal forces generated by decentralization and diversification. While this question also is being addressed to other Japanese corporations, the same observers point out that the issue is particularly relevant to *sogo shosha*, which, besides having an unusually large network of offices, affiliates and joint ventures and a high number of employees spread around the globe, have been pushing quickly into new fields. From the outside it is difficult to judge whether trading company executives are putting their money where their mouths are by implementing effective internal checks against illegal activities.

Accordingly, some experts continue to question whether *sogo shosha* have a future that is as bright as trading company executives foresee. At the same time, however, initial reports of general trading companies' demise clearly were premature. Japan's giant global traders have proven over the last decade or so that they can marshal their strengths in response to rapidly changing business and economic conditions at home as well as overseas. With their increasingly heavy emphasis on investments in high technology fields and emerging markets, it is becoming apparent that general traders are trying to graft merchant banking operations on top of their existing trade functions, creating a new kind of investment trading company. *Sogo shosha* have shown that old dogs can indeed learn new tricks, but the question remains: Can they perform them well enough to continue to prosper?

Sakura Nishimoto provided research assistance.

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[6] Ray K. Tsuchiyama, "New PCs, Old Mind-Sets Collide at Managers' Desks," *The Nikkei Weekly*, June 17, 1996, p. 7.