Bogdan Buczkowski
University of Łódź

THE IMPACT OF REGIONAL TRADE AND GLOBAL FINANCIAL CRISIS ON SMALL AND MEDIUM-SIZED ENTERPRISE SUPPORT POLICY IN JAPAN

Abstract: The financial crisis, which caused the collapse in the economy and had a significant impact on SMEs in Japan, differs from the past financial crises. It touched more export-oriented economies than domestic-demand-oriented ones. Automotive and financial companies suffered more than those in sectors less dependent on economic cycle. Japan greatly benefited from the boom in Asian countries, including China, India and Korea. The challenge now is a decline in global demand for cars and electronics, primarily in Europe and the U.S and the progress and increase of the competitiveness of those industries, together with the development of healthcare, environmental technologies and tourism in Asian countries, in particular in China. Greater regional integration could help in the internationalization of weak industries by encouraging foreign investment and increasing competition on the domestic market.

Key words: financial crisis, Japanese business model, SME support policy.

1. Introduction

Japan's postwar rapid economic development was abruptly halted in 1989 by the crisis in the market of the leveraged shares and real estate. With the costly process of restructurization, a number of necessary changes were adopted in the economy, but they failed to significantly stimulate economic growth, mainly due to a significant vulnerability to external shocks. The financial crisis, which since September 2008 has caused the economic slowdown and has had a significant impact on SMEs in Japan, differs from past financial crises because:

1) the accumulation of risk assets has reached unsustainable levels,

2) the great importance of securitization as a permanent element of the financial system is now questioned, as the major investment banks, which were the driving force behind the boom in securitization, virtually disappeared within a few weeks,

3) the crisis has touched the key industries such as the automotive industry, being the flywheel of the world economy.

Export-oriented economies have been more affected by the negative effects of the crisis than those based on domestic demand. Automotive companies and banking sectors have suffered more than companies operating in sectors less depended on economic cycle, as the production of consumer goods and healthcare.

The Japanese government tries to revive the economy by eliminating bureaucratic barriers and stimulating domestic demand. The budget for the fiscal year 2010/2011 provides for 18% cut in infrastructure spending and 10% increase in social welfare spending (to about 290 billion USD), including a free high-school education and child-rearing subsidies. Reduction in the costs of education and budgetary funds, transferred to household in the form of childcare allowances and other childcare assistance measures, are expected to increase household incomes and boost consumption growth.[1] The government is also going to stimulate economic growth through the promotion of regional trade relations and investment in green technology, tourism and healthcare.

2. Regional trade

Japan has far benefited from its neighbours remarkable economic growth, mainly in China, Korea and India. The challenge now is a decline in global demand, primarily in Europe and the U.S., for cars and electronics, and the progress and increase of competitiveness of those industries in Asian countries, as well as the promotion of their domestic capabilities in healthcare, green technology and tourism, especially in China, which may well be regarded as a locomotive of the global economic recovery.[2]

Driving force of Japanese economy, exports and investment have been the automotive industry, consumer electronics and light engineering, while many industries, including pharmaceuticals and chemicals, are not competitive on the global market and highly depend on domestic demand. Greater regional integration could help in the internationalization of weak industries by stimulating foreign investment and greater competition on the domestic market. The problem is historical resentment, still existing in Japan and neighbouring countries, as well as the *keiretsu* business practices and the financing of small high-tech starts-up.[3] Japanese SMEs foresaw the threat that would emerge from China as early as in the early 1990s, but it prompted them to climb-up the value chain through product innovations to satisfy their large customers. Product innovations enabled SMEs both to withstand

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[1] *Highlights of the Budget for FY2009. To Safeguard People's Daily Lives and the Japanese Economy*, Ministry of Finance, Tokyo, December 2008.

[2] S. Mizobata, *The Japanese Economic System under the Global Crisis: Change and Continuity*, KIER, Kyoto University, 2009.

[3] T. Clouse, Japan scrambles for a fresh start, *Global Finance*, February 2010.

competition and grow overtime. While the Japanese SMEs are exclusively focused on the domestic market, the Indian SMEs cater to the international market as well.[4]

3. *Keiretsu* business model

Keiretsu trade practices to secure business and price stability contribute to the costs increase and business risk for non-*keiretsu* companies. Similar organizational structures and business practices are transferred through Japanese foreign direct investment. Manufacturers, suppliers, retailers, banks and trading companies involved in the production and distribution of goods and capital are linked to the *keiretsu* in Japan. As it is practiced here, the parent company supplies the capital, technology and managerial expertise and is able to maximize the benefits from quasi-integration, long-term relationships and minimizing its risk. The supplier has to produce parts, invest in production equipment and organize the training of employees, according to the parent company's criteria. Most companies in Indonesia, Malaysia and Thailand have ties to the *keiretsu* in Japan in the industries in which Japanese direct investments have been focused on, namely, electronics, cars and parts, chemicals, banking, construction and metal products. Keiretsufication in those industries may affect market opportunities for non-*keiretsu* suppliers and distributors, both local and foreign, including European and American ones.[5]

4. Improvement of subcontracting system

The global financial crisis has a profound impact on SMEs that are affected by the crisis even before its onset. The deteriorating economic situation and the decline in business confidence confirm the deteriorating situation of SMEs, that are facing failure as their cash flows dry up and their economic prospects remain uncertain. During the long recession, large companies seeking to improve multi-tier subcontracting system, reduced the number of suppliers and components they used The most efficient SMEs selected by large companies could expand their business, while inefficient ones lost customers and many of them had to exit the market. A significant negative correlation was observed between the growth rate of total productivity factor and the rate of change in the number of enterprises in SMEs and large firms in four sectors: general machinery, electrical machinery, transportation equipment and precision machinery. It can be interpreted that the decrease in the number of establishments improved the growth rates of factor productivity and it is also due to the exit of inefficient SME. Only effective SMEs, which meet the requirements of large enterprises, with regard to cost, quality and supply, could survive in the current recession. It

[4] M.H.B. Subrahmanya, Nature and strategy of product innovations in SMEs, *Innovation: Management, Policy &Practice* 2009, Vol. 11.

[5] D. Manifold, *Japanese Corporate Activities in Asia: Implications for U.S-Japan Relations*, U.S. International Trade Commission, Office of Economics Working Paper, Washington, February 1997.

is expected that if a worldwide recession reduces demand in the above mentioned four industries, many small and medium-sized enterprises will have to shut down their businesses.[6] Although the decline in the number of small and medium-sized enterprises is widespread, some SMEs will still be able to start new businesses due to more flexible division of labour. The traditional business model, which depends on certain large companies, and is limited to doing business within the group, no longer works so good as in the past. Significant dependence on certain industries and a wide segmentation and specialization of manufacturing processes, make it difficult to adapt to new business requirements.

SME policy should encourage diversification and cooperation beyond traditional business groups, creating a flexible division of labor. As a result of fierce competition in neighbouring Asian countries, Japanese small and medium-sized companies are becoming less competitive in labour-intensive productions. Those who are doing well in the cities, show effective ways to survive in urban areas.[7] First, those SMEs can survive, which have unique technologies and special skills. They have no advantage in cities in mass production, but have it in the small-amount production of many varieties of products. Second, the R&D oriented business has a chance to grow in niche areas. Due to outsourcing, manufacturing is important to create more efficient links between research and development activities of SMEs in urban areas and production activity has been carried out elsewhere. Third, an effective way to relax constraints for new-industry oriented firms is to setting up industrial apartments in urban areas, where they want to start business. It is suggested that unfair trade should be regulated by the law. In some cases, parent companies demand from their subcontractors to reduce prices of components after the conclusion of the contract. Sometimes the contracts are suddenly unilaterally broken. This type of unfair practices may affect negatively SME's business.

Entry costs have increased in recent years due to technological development. SMEs cannot maintain or start-up their business without the advanced technology and skills. Technically advanced equipment and machines are necessary to meet the growing demand of customers. Starts-up by younger generation are becoming more difficult, although R&D-oriented business has a chance to grow in niche areas, so it should be supported by the state. Municipal authorities should play an active role in coordinating cooperation beyond the traditional industrial groupings and giving priority to SMEs promotion and encouraging them to use local resources.

5. The influence of financial crisis on SMEs

Governments have paid the least attention to financing small and medium-sized enterprises, although they have been much more affected by the credit crisis than

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[6] *White Paper on Small and Medium Enterprises in Japan*, Ministry of Economy, Trade and Industry, Tokyo 2009.

[7] S. Uchikawa, *Small and Medium Enterprises in Japan: Surviving the Long-term Recession*, ADBI Working Papers No. 169, October 2009.

large ones. Fairly quickly they provided the assistance for companies deemed too big to fail, thus leaving the companies deemed to be too small to protect them, when banks cut off the access to credits at the worst time of the crisis.

Small innovative firms have limited ability to finance their business, because banks prefer to compete in granting credits to large corporations, than to engage in more risky loans to SMEs, making difficult for new firms to go into new fields of activity. In Japan the access to credit information is difficult and it reduces the incentives for repayment in time. It is also difficult for banks to estimate the risk so they refrain from financing SMEs, despite government programs to assist them.

While financing of working capital for small and medium-sized enterprises is secured, the possibility of additional financing is being considered. In 1991 and 1995, although the recession had led to lower profits, banks increased long-term loans to SMEs and those loans became vulnerable assets. Regulations as to additional loans in order to avoid financial crisis led to the excessive debt of SMEs that became even more threatening.

6. Instruments of SME support policy during the crisis

The Japanese government has implemented measures to support SMEs in the current crisis and recommended solutions to increase their strength during the next recession. Terms of financing SMEs are much worse because it is difficult to obtain loans since banks have tightened their credit standards in the deteriorating economic environment. This situation is rather typical during recession, but the scale of slowdown is considerable.

Such situation has a direct impact on employment and consumer spending and threatens the current cooperation of SMEs, because even if companies are not direct exporters, they can also be affected by cooperating with direct exporters, especially that about half of the production of SMEs' automotive industry is directly or indirectly linked to exports (about 80% of parts and components are supplied to the exporting companies).

From October 31, 2008 Japanese government introduced a comprehensive system to guarantee emergency credits for SMEs affected by the worsening economic slump and weak results of the export-oriented parent companies. 20 trillion yens (about 216.6 billion U.S. dollars) have been prepared in the budget to guarantee loans for SMEs operating in 760 branches. The temporary emergency program to regional corporations guarantees banks 100% coverage of any losses related to the loans to eligible firms, in contrast to the required participation of banks in the partial losses in the ordinary guarantee system.[8]

Approximately 410.000 guarantee were issued to a total amount of about 8.8 billion yens, until the end of February 2009 and Japanese Finance Corporation has

[8] *Highlights of the Budget for FY2009…*

provided 900 billion yens of debt. A problematic issue is the chronic borrowing by SMEs as a pseudo-equitization of debt. One way to solve it is a debt-equity swap (DES) under which a creditor subscribes for newly issued shares in exchange for debt cancellation, enabling the borrower to reduce his debt burden and strengthen his financial standing. However, this scheme is beyond reach for most small and medium enterprises. More accessible is, similar to the DES, debt-debt swap (DDS) converting debt into subordinated loans that can be treated in certain situations as a capital.[9]

According to Financial Services Agency new instruction, DDS-related subordinated loans to authorized SMEs, can be treated as a capital under condition that a viable business reconstruction plan has been submitted. It also eased the conditions under which rescheduled loans to SMEs could be excluded from nonperforming loans category. Japan Finance Corporation for Small and Medium Enterprises (JASME), has launched a new specialized loan program to help SMEs to cope with challenging business environment. To help business restructuring the government clarified that the debt should be counted as a capital, if it is converted into new debt, similar to capital in nature. Such exceptional treatment can be applied under condition that SME borrower, designs and implements a viable and highly promising restructuring plan. The maximum planning horizon for restructuring business, i.e. the time in which SME is expected to restore its business, has been extended from three to five years and in exceptional cases up to 10 years, if the restructuring goes as planned. Previously, banks had been required to classify rescheduled credits as "credits requiring special attention", disclose them as nonperforming and set aside sufficient credit loss reserves with only some exceptions allowed under strict conditions.[10]

In response to the global financial crisis, the temporary law on Special Measures for Strengthening Financial Functions was revived, including a mechanism for preemptively injecting public funds to make them more accessible to local financial institutions, dealing primarily with SMEs, as well as more accessible to smaller financial institutions as it has paved the way for transferring public funds into financial cooperatives through their central organizations. The scheme, designed to increase bank capital levels, effectively prevents credit crunches in cases where banks are unable to lend due to insufficient capital caused by declines in the values of their securities holdings.

FSA launched a temporary measure, that would be effective by the end of March 2012, introducing flexibility into the capital adequacy requirements of banks subject to domestic and international capital adequacy standards. The first ones do not have to deduct valuation losses on securities from core capital, while the second ones do

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9 S. Uchikawa, *op. cit.*

10 A. Ono, I. Uessugi, Role of collateral and personal guarantees in relationship lending: Evidence from Japan's SME loan market, *Journal of Money, Credit and Banking* 2009, Vol. 41, No. 5, The Ohio State University.

not have to include valuation gains on securities with a zero risk weight as a part of supplementary capital nor deduct valuation losses on such securities from core capital.

In accordance with the Practical Solution on Measurement of Fair Value for Financial Assets, the FSA clarified the term of “fair value”, in cases when the market is in chaos, as “rationally calculated value based on management’s rational estimation”.

To help the development of SMEs, it is necessary to enhance relationship banking. Banks need to go beyond the traditional financial intermediary role and utilize investment funds and hybrid loans. Asset-based lending (ABL) allows for loans to be secured against movables and claims. It is an alternative to conventional lending that heavily relies on real-estate collateral and the personal guarantees of business owners. For security interests in movables and claims, a special registration system was established. In Japan, the access to credit information is difficult, and it reduces incentives for timely repayment of bank loans and risk assessment hinders and discourages lending to SMEs, despite government programs to assist them.[11]

One of the main advantages of relationship banking is the focus on soft (non-financial) information, which is inherently qualitative rather than relaying only on hard, i.e., quantitative information. The ability of banks to determine the creditworthiness of borrowers is what counts most in relationship banking. Within a wide range of soft information, intellectual assets, including technology, organizations, brands, networks, customer satisfaction, quality of employees, patents, management’s ideas and strategies, and various other forms of intellectual property rights have all been attracting a considerable amount of attention recently.

Recently, they attract attention and are the primary source of generating cash and the creating new value for companies. Soft information should have a visible form of documentation to be evaluated by banks. Screening potential corporate borrowers, banks should examine both soft and hard information. An important element of infrastructure for SMEs is a system capable to electronically recording monetary claims in place of traditional (paper) promissory notes, received from large companies as payment in settlements with other companies. In addition, electronic promissory notes, as opposed to paper ones, are free from the risk of loss or theft and can be divided into smaller parts and applied in to payments of multiple transactions.

To summarize, in order to improve the financial viability of small and medium-sized enterprises, it was necessary to introduce a diverse and comprehensive set of new instruments, which allows the weaker companies to stay on the market. Setting up SME is being supported by incentives such as: subsidies, low interest loans, tax cuts and the creation of incubators, as they may contribute to the creation of jobs and starting new activities, but, if unsuccessful, could lead to a greater burden

[11] T. Muramoto, *Establishing New Infrastructure to Enhance SME Financing and Relationship Banking*, Research Institute of Economy, Trade and Industry, Report No. 106, May 29, 2009.

on the state and lower bank profits. Greater regional integration could help in the internationalization of weak industries, by encouraging foreign investment and increasing competition on the domestic market.

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WPŁYW WSPÓŁPRACY REGIONALNEJ I GLOBALNEGO KRYZYSU FINANSOWEGO NA POLITYKĘ WSPIERANIA MAŁYCH I ŚREDNICH PRZEDSIĘBIORSTW W JAPONII

Streszczenie: Kryzys finansowy, który od września 2008 r. spowodował załamanie w gospodarce i wywarł znaczny wpływ na MŚP w Japonii, różni się od dotychczasowych kryzysów finansowych. Dotknął bardziej gospodarki nastawione na eksport niż kraje, których wzrost gospodarczy oparty jest na popycie wewnętrznym, a firmy z sektora motoryzacyjnego i bankowego ucierpiały bardziej niż firmy z sektorów mniej uzależnionych od koniunktury. Japonia znacznie skorzystała z dobrej koniunktury w krajach azjatyckich, w tym w Chinach, Indiach i Korei. Obecnie wyzwaniami są spadek popytu globalnego, w tym przede wszystkim w Europie i USA na samochody i elektronikę, oraz postęp i wzrost konkurencyjności tych gałęzi przemysłu, a także stymulowanie rozwoju opieki zdrowotnej, technologii ekologicznych i turystki w krajach azjatyckich, w tym przede wszystkim w Chinach. Polityka wobec MŚP ma zachęcać do dywersyfikacji i współpracy poza tradycyjnymi grupami biznesowymi, tworząc elastyczny podział pracy. Większa integracja regionalna mogłaby pomóc w internacjonalizacji słabszych branż przemysłu przez stymulowanie inwestycji zagranicznych i zwiększenie konkurencji na rynku krajowym.