

A CASE STUDY : EFFECTS OF THE APPRECIATION
OF THE VALUE OF THE YEN ON THE EXPORT
BUSINESS OF A MEDIUM-SIZED PORCELAIN
MANUFACTURING COMPANY

(円高の一中規模陶磁器製造会社の輸出業務に与えた影響)

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PREFACE

This paper has been prepared based on a business the writer was involved with in 1987 and subsequent research made during the summer of

1988 in order to investigate the effect of the acute appreciation of the value of the yen, which started in 1984, on the export business of the corporation. The value of the yen against the U.S. dollar rose as much as twice from ¥260 to ¥130 in less than three years. The writer traced in detail a chain of various actions the management of the subject corporation had taken to steer the course of the company in this adverse environment. The writer has attempted to represent in this paper the problems encountered by the company in historical sequence. The writer, therefore, hopes that this paper will serve as a helpful reading material for students majoring in international business.

Prior to 1984 the company had experienced a gradual slowdown of sales in its foreign markets because of the entries into the market of lower priced but good quality merchandise made by other manufacturers, both domestic and overseas. The appreciation of the yen, however, triggered a further reduction in foreign sales. As a result the company's sales agents overseas started to terminate their business relations with the company.

In the summer of 1987, the company severed relations with its last and most powerful sole distributor in the United States. Ever since, the company has been trying to reenter the American market, but has not succeeded so far.

In order to make up for the lost markets, the company directed its new marketing effort to European countries. Its effort has born fruit to some extent and at present the company is trying to expand the market.

I. BACKGROUND OF THE COMPANY

The company, one of the oldest in the industry, is located in a town, Saga Prefecture, where porcelain manufacturing first started in the middle

of the 17th century. It was incorporated toward the end of the 19th century. Its share capital at present is 2 billion yen and the number of employees is about 400. The company has actively engaged in the exportation of its products since its incorporation. At the heyday of its business, the share of the export business occupied 60 percent of the total sales of the company. Since 1965 the company has received citations from the Government on several occasions for the great contribution the company made to the nation's exports.

The export performance since 1978 shown below indicates the geographical distribution of sales and vicissitudes of business in various markets.

TABLE I GEOGRAPHICAL DISTRIBUTION OF SALES
(Unit : Thousand Yen)

	U. S. A.	(%)	CANADA	(%)	EUROPE	(%)	OTHER	(%)	TOTAL
1978	368	43	9	1	274	32	212	24	863
1979	58,121	45	9,483	7	2,016	2	60,250	46	129,870
1980	103,708	76	16,306	12	3,236	2	13,804	10	137,054
1981	66,011	51	5,907	5	14,637	11	42,526	33	129,081
1982	57,459	58	2,361	2	14,573	15	24,058	25	98,451
1983	82,483	67	3,337	3	9,210	7	28,965	23	123,995
1984	42,208	63	737	1	5,537	8	19,020	28	67,502
1985	29,723	33	3,964	4	29,495	32	28,125	32	91,307
1986	12,024	34	601	2	11,325	32	11,539	32	35,489
1987	266	1	222	1	13,568	51	12,562	47	26,618
1988*	—0—		1,100	8	10,500	80	1,500	12	13,100

Note : OTHER includes Asia, Hawaii, Australia, New Zealand and other areas.

* : Seven months.

II. FOREIGN MARKETS

Until 1985 the company had maintained for almost twenty years exclusive distributors, one each in Australia, the Bahamas, Canada and the United States. All the distributors, except the one in the United States, had terminated their business relations with the subject company

by the spring of 1986 mainly because of the appreciation of the value of the yen. One of the letters of termination of business relations sent by the distributors to the subject is shown below.

EXHIBIT I

A LETTER OF TERMINATION OF BUSINESS RELATIONS

April 10, 1986

Gentlemen:

During the past two years our tourist-related business has suffered somewhat from the effects of a strong dollar and the competition offered from resort areas which are not dollar denominated.

This fact, coupled with the unfortunate realisation that sales of your products have not achieved anywhere near the anticipated level have forced us to the very reluctant conclusion that we should discontinue stocking this line. This has been very disappointing to me personally as I have always liked and admired the product. Regretfully economic good sense must over-ride aesthetic appreciation in this case.

Please feel free therefore to negotiate with possible new interested importers for your products.

We like to thank you for your most kind co-operation over the past few years and hope that the new importer might be able to do this prestigious line more justice in future.

Yours very truly,

Signed

President

Alpha Company

As shown in the statistics given in TABLE I, the distributors in the respective territories had gradually lost sales volume. The major causes

which led the distributors to discontinue their business relations with the subject seems to lie in the gradual advance in the value of the yen since 1985 plus a lack of effort on the part of the subject in providing the distributors with sufficient assistance and a failure in maintaining a close communication with the distributors. (The assistance relates to advertising, participation in trade fairs and providing various incentives.) During almost ten years of mutual business, not a single executive or export manager of the subject had visited the distributors for a courtesy call or for any particular business purpose. Communication between the subject and distributors was dependent upon letters or telexes exchanged at the time of placement of orders and no more than that, enough reason for alienation in their relations.

III. WITHDRAWAL FROM THE U.S. MARKET

A. *The Effect of the Appreciation of the Yen*

The movement in the exchange rates of the yen against the U.S. dollar since 1985 is shown below.

The company appointed an exclusive distributor and agent in the United States in 1969. The agent had managed to sell well until the end of 1985 when the yen's exchange rate for U.S. dollar was still at the level of ¥200. The value of the yen against the U.S. dollar, however, continued to advance. The agent called the subject in March 1986 saying that something must be done in order to continue his business and asked someone on the executive level to visit him immediately for discussion. To this request, the subject replied that a visit by the agent would be preferable because it would enable him to discuss his problems with various key personnel of the company. Thus, the agent was invited to the subject

company. He arrived at the company on April 2, 1986.

TABLE II YEN-U. S. DOLLAR EXCHANGE RATE

(Source : Bank of Tokyo Monthly Reports)

Month	1985	1986	1987	1988
1	254.78	192.65	152.30	127.18
2	259.00	180.45	153.15	128.12
3	250.70	179.65	145.65	124.50
4	251.40	168.10	139.65	124.82
5	251.78	172.05	144.15	124.80
6	248.95	163.95	146.75	132.20
7	236.65	154.05	149.25	132.50
8	237.10	156.05	142.35	135.10
9	216.00	153.63	146.35	134.45
10	211.80	161.45	138.55	
11	202.05	162.20	132.45	
12	200.60	160.10	122.00	

B. *A Meeting with the U.S. Agent*

A meeting with the agent was held for three consecutive days from the next day of his arrival. The subject company was represented by the export manager, the controller and the chief executive officer.

The agent explained the situation at his company as follows: For the past five years, sales at the retail level had continually dwindled. The causes were analyzed to be (1) unemployment, (2) inflation, (3) a rise in nationalist sentiment, (4) inclination towards products with a countrylike flavor, and (5) decline in popularity of oriental style. In addition to these causes, the subject failed to provide proper merchandise reflecting the trend in the market and allowed the price of products to increase. Thus, merchandise ceased to be procured by department stores, which had been major sales outlets.

The retail price of merchandise he bought from the subject had increased as much as five times since 1970. Furthermore, a 15% increase in

price had now become necessary in order to cover the depreciation of the U.S. Dollar for the past six months.

With reference to the merchandise, the quality was excellent, although highly priced. (This high price is mainly due to the production system of the company, still observing a traditional porcelain manufacturing technique.) The agent's customers were the upper one third of the market's wealthy population. However, since the brand name of the subject had not penetrated enough into the market, there was a gap between the price and the value recognized by customers of the merchandise. Compared with other Japanese merchandise, such as electrical appliances, whose prices in the United States are not so much different from the prices in the Japanese domestic market, the subject company's products had been priced 2.3 to 2.5 times as high as those in Japan. The agent thought the ideal price would be 1.3 to 1.5 times of the Japanese domestic price. He said that at current prices the subject company's merchandise would not cover even the upper five percent of the total population of the U.S. market. He stressed that unless a much broader market base was established, no profit would be realized. For this purpose, introduction of a new line of merchandise appealing to the U.S. market was suggested.

The agent also explained the financial side of his company as follows:

The agent had not been selling enough and also the gross profit on sales had been minimum. The business for 1983 resulted in a loss of \$140,000, for 1984 was a loss of \$34,000, for 1985 was break-even and for 1986 was an expected loss of \$20,000 to \$30,000. With no extra cash being available, he was not in a position to put out advertising or to participate in trade shows. If this condition should be sustained, he would not be able to obtain bank credit, thus preventing him from further purchasing of merchandise from the subject. Under such circumstances,

the agent had striven hard to curtail costs as much as possible. For example, personnel expenses had been reduced from \$129,000 in 1982 to \$86,000 in 1984; and rent was reduced from \$42,000 in 1983 to \$38,000 in 1984 by closing a display store in New York City. On the other hand, interest expenses had increased from \$40,000 in 1982 to \$50,000 in 1985, being one sixth of total expenses; also, expenses for sales promotions had increased, but these were considered necessary to revitalize the weakening market.

After having explained the financial situation at his company, the agent presented proposals for improvement. They included (1) an across-the-board 25 percent reduction in the agent's purchase price from the subject, (2) establishment of a new price structure suitable to the market, (3) fixing the exchange rate of the yen against the U.S. dollar to ¥200, (4) a capital infusion by the subject, or establishment of a joint venture company, and (5) a liquidation of part of the inventory, namely to eliminate dead stocks.

C. *Tentative Solutions Arrived at by Both Parties*

The subject evaluated the above mentioned proposals. Regarding the 25 percent price reduction, it was so drastic that it was hardly acceptable to them. And it was feared that even if it was accepted, the continued upward trend of the value of the yen would eventually force the subject to make another price adjustment. It was deemed, therefore, that a complete review of the sales policy in the United States was necessary to correct the situation rather than a simple adjustment of the price. To implement this program, the subject decided to dispatch management personnel to the United States to study the market.

With reference to the capital infusion, or acquiring a share of the

agent, the agent was willing to enter into a partnership arrangement. He proposed to grant the subject a 50% interest for the sum of U.S. \$425,000. All of this payment would be used by the agent to reduce his debt, thus making the subject's investment in the company much more valuable as it would make the new company essentially debt free. The loan interest would be saved. Also, the agent's tax loss carryover would guarantee a good start at the outset.

To this proposal, the subject offered an alternative measure. It was a partial assumption by the subject of the agent's bank liability in the amount of \$250,000 out of the total outstanding of \$350,000. Under this plan the agent was to repay the amount to the subject later from the profit he would earn in the new company. The subject requested the agent that the first-class stock certificates in the agent's possession be placed in an escrow account to protect the subject's investment, namely the assumption of bank liability. The agent showed his interest in this proposal and agreed to provide the subject with the financial statements of his company covering the period from 1982 to 1985.

Regarding the partial liquidation of old inventory, the agent offered to sell the inventory back to the subject at the original price he bought it at. The total cost would become about \$75,000, or ¥12,750,000 based on the most recent yen/U.S. dollar exchange rate of 170.00. The money thus raised would be applied directly to the agent's remaining bank loan and it was assumed that this would reduce interest costs considerably.

When these plans should be carried out, it was assumed that the new company would be able to stand on a sound and profitable basis. It was further assumed that the agent's current tax situation would allow for the new company to retain its profit in full for a few years in the beginning.

Thus a fundamental agreement was reached. Only one point remain-

ing to be solved was percentage of ownership in the new joint venture company.

The agent had already built a network of experienced sales people, many with showrooms in the most important merchandise marts in the country, who have connections with buyers all over the United States. The agent's warehouse and office were well located and equipped and had room for expansion when needed. So the joint venture program seemed very promising. All this agreement, however, could not solve or alleviate the immediate predicament on the part of the agent which was ever being aggravated by the weakening U.S. dollar. As a solution for the time being, therefore, a 15 percent price cut was made in all of the f.o.b. price to the agent. Thus the meeting ended.

D. *Further Analysis of Problems*

After the meeting, further analysis was made by the agent to find out the major reasons why his company which had been profitable for years was now operating at a deficit. The reasons were sought in price, product design, consumer recognition and profitability.

Price: The quality of the subject's products is obviously superior to other suppliers', but the perceived value is not evident to the mass market customers. Most U.S. shoppers do not understand why they should pay for the subject's product almost three times as much as the price for a similar oriental piece from Japan, Taiwan, China or Korea.

The subject's prices to the agent, as an importer and wholesaler, are almost the same as charged to Japanese retailers. To this price must be added shipping charges, duty, insurance, agent's costs including commis-

sion and a reasonable profit. Retailers in the United States add at least 100 percent and as much as 110-120 percent for their mark-up. Since the agent is starting with such a high initial cost the resulting retail price is out of line. A way must be found to keep the initial price lower.

Design: The design includes both product design and the variety and number of products sold in the U.S. market. Although the agent has tried to represent the entire line of the subject's products in the market and has carried a wide range of inventory items, many of them just do not appeal to the American buyer. This has created a large expense in both storage costs and interest charges.

It is hoped that the subject would regularly arrange to have its design staff working with the agent in the United States to adapt the shapes and patterns to the U.S. market. There is a need to have at least 25 to 30 new introductions each year (12-15 twice a year). These could be market tested and those that do not sell well could be dropped.

Consumer recognition: This is probably the most difficult problem of all, as it involves considerable amounts of time and money, but considered the most important. The agent has sold to retail stores throughout the country covering all 50 states, Puerto Rico and the Virgin Islands and 5,000 different customers over the years. The retail customer is not familiar enough with the subject's name and the desire to collect has not been strong enough.

To counter this more promotion is needed. With proper attention to design and a more realistic retail price structure, the next step is to imple-

ment a schedule that includes in-store promotions (both selling shows and teaching seminars) as well as more travel with the sales people to educate and inspire consumers.

An effort to motivate both sales people and retailers is required in order to maintain more consistent sales. One way of achieving this is to offer special discounts for advertising or to extend normal 30 day terms to 60 or 90 days. Another thought is to test areas with a house salesman who would work on salary and only sell the subject's products.

Any of these ideas require that either an office manager or a traveling sales manager be hired to closely follow up progress.

Profitability: The agent spent in excess of \$250,000 on its three show-rooms located in New York and New Jersey, and \$40,000 was spent one year on a trade advertising campaign, but none of the efforts have produced results that it would have liked. It is assumed that despite these disappointments, by cutting costs the agent would be able to operate at a breakeven point of about \$600,000 if the agent's high interest costs can be eliminated. Sales would be enhanced further with the proper product mix and support from the subject.

The findings from the above mentioned study were to be incorporated in the policies of the operation of the new company under consideration.

E. *Fruitless Efforts*

The negotiation between the subject and the agent continued until July, 1987. In the end, however, it collapsed over the disagreement in the purchase price offered by the subject for the dead stock and the amount of capital infusion.

When the agent returned to the United States after the meeting, he sent the subject its financial statements for the past three years for evaluation. Both parties agreed to have the statements audited and inventories examined by respective public accountants to determine a fair value. Before the formal audit was conducted the initial purchase value, including that of dead stock offered by the subject based on its preliminary analysis of the financial statements, was far below the value believed by the agent. Also, the percentage of ownership in the post-merger company and other merger technicalities involving the accounting treatment revealed complications which would require more time to study on the part of the subject. With a considerable time already past and with deteriorating financial conditions on the part of the agent, to continue the negotiation further became a burden to the agent. The negotiation was called off in July 1987.

After the collapse in the negotiation, the agent in his final attempt participated in the trade fair in New York City held in August 1987. The result was enough to convince him that it had become impossible to continue the sale of the subject's products at the prevailing price. Thereupon, the agent finally decided to close his company.

Reviewing the process of the unsuccessful long negotiation, it is feared that the subject's management paid too much attention to the immediate dollar and cent effect of the acquisition of the agent company, not sufficiently giving thought to the market potential the agent had built over many years. If the subject's management had paid more careful attention to the personal relationship which had been built with the agent over the years, other amicable solutions might have been found out, thus saving the company for the agent and the market for the subject.

IV. FEASIBILITY STUDY OF INCORPORATION

When the agent notified the subject of his intention to close his company, the subject had to make a decision as to whether it would keep its business presence in the United States or withdraw from the U.S. market completely.

The subject sent its vice president and export manager to the United States in August 1987. They met with the agent. At this meeting the agent said that if the subject should decide to continue its business in the United States it would be important to maintain its high reputation built up by the agent. In order to assure that, the agent again stressed that the subject should buy back the stock merchandise remaining unsold at cost. The cost would be converted at the then prevailing exchange rate, which was also favorable to the subject. Otherwise, the agent would be forced to sell the stock to discounters. The latter would give a very damaging effect to the subject's market in the future. The subject, however, decided not to buy back the stock anyway, thinking the merchandise almost valueless. The meeting ended with both parties understanding that the subject would start to investigate whether there was any possibility of establishing its own company in the United States and that the agent would wind up his company. The exclusive agency contract which had been in effect for about twenty years thus terminated.

Now that each party had chosen its own course of future action, the export manager made a study of the expenses expected to be incurred in the event of an independent subsidiary company being incorporated in the United States. New York City was selected as a potential site to establish the new company. He visited several leading Japanese banks, real estate brokers and a customs broker to collect information necessary for establi-

shing a new U.S. corporation. Following are the findings:

Rent: In maintaining a store in New York City, expenses which will take the heaviest toll in the operational outlay are rent and personnel expenses. Rental spaces available on Columbus Circle, Fifth Avenue, Madison Avenue, and Eastside between 45th and 70th Streets in Manhattan were looked into.

It was found that the clientele in the Columbus Circle area was not as good as in other places examined such as Fifth Avenue, Madison Avenue and upper Lexington Avenue. Also, stores as the Columbus Circle area were not attractive. Madison Avenue, north of 60th Street, was worth taking into consideration, but a vacancy was hard to find. There was a considerable difference in rent between the space on the first floor and that on the second floor. As to a store space, the annual rent for one square foot on the first floor was on the average \$600 to \$700, while the same on the second floor was \$200. But in either case, a space with less than 1,000 square feet was hardly available. In Manhattan, the vacancy rate for store space was said to be 7 to 8 percent in the central area and 12 to 13 percent in the southern area. The rent at a store space on the 52nd Street, Fifth Avenue, one of the best commercial locations, was \$1,000 or a little less per square foot.

The store rent was very high as explained above, but the office rent was fairly reasonable, \$45 to \$70 per square foot at a first class location. If the space was located under the street level, the rent was about one half the price of the counterpart on the second floor.

The measurement of the space includes walls. And if there is a corridor, a lobby or a toilet room, the rent will be shared with other

tenants or paid solely by a tenant. Therefore, the loss factor of a space is said to be 25 percent on the average, and the least loss factor 15 percent. This means that usually 75 percent of a given space is usable. An office space less than 2,000 square feet is rarely found. This means that an office space less than that will have to be sublet.

The broker's commission is paid in practice by the owner of the building and not by the tenant.

A breakeven sales point was computed on the assumption of renting a store space of 1,000 square feet on a Fifth Avenue location at an annual rent of \$500 per square foot. The company calculated how many vases, each costing \$100, must be sold daily to generate enough margin of profit to cover the rental expense. The calculation was made as follows:

Total annual rent:

$$1,000\text{sq. ft.} \times \$500 = \$500,000$$

Total number of vases to be sold per year to cover the annual rent:

$$\$500,000 \div \$100 = 5,000 \text{ pieces}$$

Total number of vases to be sold per day:

$$5,000 \text{ pieces} \div 312 \text{ days} = 16 \text{ pcs.}$$

Daily required pieces to be sold when the profit ratio is 50 percent:

$$16 \text{ pieces} \div 0.5 = 32 \text{ pieces}$$

As shown in the above computation, at least 32 \$100 vases must be sold every day only to cover the annual rent of \$500,000 for a store space of 1,000 square feet. It seemed to be an impossible dream to realize.

Personnel Expenses: The annual salary per clerical person with a high-school graduate qualification, including a warehouse keeper, is between \$20,000 and \$30,000. In addition, medical and social security expenses

and other fringe benefit costs will add up to another 50% of the salary. A clerk with a knowledge of Japanese will not be available for an annual salary of less than \$30,000. The salary for an office manager is at least \$40,000 per year, to which another 40 to 50% of the amount must be added on as incidental expenses. Required personnel in the new office will be recruited through the assistance of Japanese banks located in New York City. It is considered a good idea to employ a Japanese person who has retired with good enough experience from one of those banks.

Expenses for Home Office Personnel: Many Japanese, aged less than 30, who have been sent from their head office in Japan live in the Westchester area, in the suburbs of New York City. The commuting time to Manhattan is a little in excess of one hour. The apartment rent there is \$1,400 to \$1,800 per month. In the case of an independent house, the average monthly rent is \$2,500. In the Queens district, however, the rent for a condominium including the first and second floors is \$1,200 to \$1,500. All told, including medical and other incidental expenses, a company outlays \$70,000 to \$80,000 per year for one home office employee.

Attorney's Fee: An attorney's service is required in establishing a corporation. The fee is from \$7,000 to \$10,000 depending upon the work involved. If the incorporation is urgently needed, the legal procedures can be completed in a week.

Public Accountant's Fee: A public accountant will prepare tax returns for each Japanese employee and for the corporation. The service fee is \$1,000 for a person and \$2,000 for the corporation per year, respectively. Additional monthly fees are expected for various other services rendered.

Warehouse expenses: Storage charges are 30 cents per cubic foot per day, or \$9.00 per cubic foot per month. Special handling charges must be paid when the cargo is brought into or taken out of the warehouse. To this is added insurance premiums.

Other Expenses: Other expenses include communications, advertising, shipping, electricity, and other various office management costs.

Promotion: As a means of advertising, renting a display window along the passageway in a large railway station compound or in a luxury hotel was considered. To grasp a rough idea of expenses for this purpose, a study was conducted at one of the most luxurious hotels in New York City. At this hotel the rental charge for a display window which is fixed into the wall costs \$320 per month and a showcase in the hall \$425. In either case, a rental contract is required on an annual basis.

Sometimes a large scale sales promotion is given in a hotel, to which sales reps and customers are invited. The rental charge for a banquet hall varies according to season. During the summer months, the rental charge is \$10,000 for 24 hours. The charge is the same for weekdays and weekends. To this charge will be added other expenses to be incurred covering food and drink, equipment rental, personal services, etc.

Having examined the outcome of the above mentioned studies, the subject's management arrived at the conclusion that to do business by itself establishing a corporation in New York City is very costly and it would not be an easy matter to conduct business at a profit. Thus, the project of establishing a company in the United States was aborted.

The subject completely withdrew from the U.S. market by the end of 1987. Since then the subject has been making every effort to enter the

United States again. For example, they are sending out direct mail soliciting for business to importers, wholesalers, department stores and various companies listed in directories obtained from chambers of commerce and from banks both in Japan and the United States. So far no favorable responses have been received from prospective customers.

V. SEEKING ENTRY INTO THE EUROPEAN MARKET

When the business in the United States fell to a very low level in 1986, the subject started to direct its sales efforts to the European market. Up until then, sales activities in European countries had been very slow and the amount of sales was meager. Customers were a London branch of a Tokyo-based Japanese department store and other small local individual importers living in various countries. The subject reviewed all the inquiries previously received. Communication with them had halted since the foreign exchange markets became unstable. In this environment, however, the economies in both Italy and Spain started to pick up in 1987. This opened up an opportunity for the subject to resume business negotiation with previously interested parties in both countries. As a result, an exclusive dealership contract was concluded with an Italian importer/distributor. Under this contract, the business was to be done on a trial basis of one year starting from January 1987.

As of the summer of 1988, the markets in Spain, Great Britain and Norway are being tested in cooperation with various importers in these countries. The aforementioned Italian business is in its second year.

If the subject's current efforts in the European market prove successful, the subject will regain confidence and will try to enter into the U.S.

market again more aggressively.

A. Appointment of An Exclusive Distributor in Italy

In the following, the case with the Italian dealer is reviewed.

Prior to the conclusion of a formal contract between the subject and the dealer in December 1986, six months were required for negotiation to solve various problems. Initially the Italian dealer learned of the existence of the subject through the assistance of the Japanese Consulate in Milan, Italy. During the six months, letters and telex were exchanged between the two parties to confirm basic terms of transactions which included price, shipping method and payment. The credit check on the dealer was made by the subject's bankers. As usual with many European companies, a detailed credit report on the dealer was not available. The credit report simply said, "Their bank -XYZ- didn't disclose any figures about client's activity. However, the bank informed us that from the financial point of view the company is well managed and no inconvenience has been registered in their relationship. Payments are regular." The subject accepted the report as it was and did not pursue the credit matter further.

One issue presented a problem. It related to the payment method. The subject proposed that payment be based on a letter of credit. To this, the Italian dealer counter-proposed saying that a letter of guarantee would be better, because it is less cumbersome to process and less expensive as to the bank charges than a letter of credit is. The dealer introduced the text of the letter of guarantee as follows:

"Messrs. have irrevocably authorized us to pay you the sum of ...
... at its relative maturity date, i.e., on The sum is in payment of
goods received by them.

"At the request of said company, we hereby undertake to pay you

at the relative date, i.e., on (on the understanding that the relevant transfer to your country must be effected in compliance with the exchange control regulations in force between our two countries at the time of the transfer). Our undertaking will expire and will consequently be null and void upon receipt by you of said amount. Yours faithfully, Signed."

The subject studied the nature of the letter of guarantee of payment to see if it was acceptable or not. The following negative factors were found: (1) The instrument is an authorization to the bank by a client to pay a stated amount on his behalf. In case of insufficient funds in the client's account, the bank may not be able to pay. Also, the party of last recourse is not expressly given, (2) The instrument does not expressly guarantee the payment. As a result, the subject's bank may not discount the draft with the same strength as a letter of credit, (3) The instrument does not provide terms of payment and other conditions of shipment, (4) There is no wording as to exceptions such as changes in the exchange control law in the countries involved, and (5) The instrument is nothing more than a memorandum with no legal enforcement attached. With such findings, the subject answered the dealer that a letter of guarantee as an instrument of payment was not acceptable. The dealer concurred.

Before drafting a contract of business, fundamental terms were agreed upon by both parties. The terms were: (1) The period of contract is one year, (2) Price is based on the f.o.b. Japanese port and denominated in Japanese yen, (3) The minimum purchase amount is on a monthly average ¥500,000 to ¥800,000, and (4) Payment is due 90 days after the date of the Bill of Lading and to be paid in the Japanese currency. Incorporating these fundamental terms, a detailed draft was compiled. Each clause of the draft was examined by both parties concerned. The final contract is shown in the following. (With the purpose of concealing the names of the

parties concerned, the subject's name has been changed to ABC and the dealer's to XYZ.)

EXHIBIT II

DISTRIBUTORSHIP AGREEMENT

THIS AGREEMENT made and entered into this 20th day of December, 1986 by and between ABC, a corporation organized and existing under the laws of Japan with its principal office at....., Saga-ken, Japan (hereinafter called "MANUFACTURER") and XYZ,, Italy, a corporation organized and existing under the laws of Italy, with its principal office at, (hereinafter called "DISTRIBUTOR").

WITNESSETH:

WHEREAS, MANUFACTURER is engaged in the manufacture of ABC's products in Japan and sale thereof worldwide, including Japan, and

WHEREAS, DISTRIBUTOR desires to deal in and sell the products made by the MANUFACTURER.

Each party depends on the good faith of the other with respect to the performance under this agreement.

NOW, THEREFORE, in consideration of premises and of the mutual obligations hereunder set forth, the parties hereto agree as follows:

Article 1, Business

Both MANUFACTURER and DISTRIBUTOR shall act as Principals, and not as Agents.

Article 2, Definitions

When used in this Agreement, each of the following terms shall have the meaning attributed to it below.

- (a) "PRODUCTS" shall mean porcelain wares made by MANUFACTURER.
- (b) "TERRITORY" shall mean the country domain of Italy.

Article 3, Distributorship

- (1) MANUFACTURER hereby grants to DISTRIBUTOR the sole and exclusive right to distribute the PRODUCTS in the TERRITORY during the term and subject to the provisions and conditions hereinafter set forth.
- (2) DISTRIBUTOR shall not sell or export, nor cause any third party to sell or export the PRODUCTS outside the TERRITORY.

Article 4, Orders and Shipments

- (1) MANUFACTURER shall sell PRODUCTS to DISTRIBUTOR for resale in the TERRITORY in accordance with the terms of this Agreement.
DISTRIBUTOR shall from time to time place orders with MANUFACTURER. The orders shall not be binding unless and until accepted by MANUFACTURER.
MANUFACTURER agrees to supply DISTRIBUTOR with PRODUCTS to enable fulfilment of the minimum purchases as set forth in Article 6 hereof.
MANUFACTURER agrees to extend its best efforts to accept all order as submitted by DISTRIBUTOR in excess of said minimum purchases.
- (2) The terms of delivery shall be FOB Japanese Port as defined in "Incoterms 1980".
- (3) MANUFACTURER shall be responsible for packaging the PRODUCTS in such manner to ensure except for perils of the sea safe and undamaged delivery.
- (4) MANUFACTURER shall make its best efforts to ship the PRODUCTS according to the shipping conditions agreed upon by both parties and to obtain DISTRIBUTOR'S con-

sent, if unable to conform to them. However, if any cause beyond the control of MANUFACTURER prevents MANUFACTURER from completely filling orders accepted by MANUFACTURER in accordance with Article 4 (1), DISTRIBUTOR shall allow MANUFACTURER to delay shipments or accept partial shipments.

Article 5, Price and Terms of Payment

- (1) MANUFACTURER will establish FOB Japanese Port prices which will apply to all orders it will receive from DISTRIBUTOR up to December 31, 1987.

As a guideline for the price structure, parties hereto will be governed by the price list submitted by MANUFACTURER. MANUFACTURER shall charge DISTRIBUTOR for each purchase of products the amount of the listed price with the deduction of ten per cent therefrom.

- (2) Within a reasonable time after receipt of MANUFACTURER's confirmation of order, DISTRIBUTOR shall open an irrevocable Letter of Credit in Japanese yen in favor of MANUFACTURER, such Letter of Credit shall contain terms, inter alia, covering the total price and additional charges and/or expenses to be borne by DISTRIBUTOR.

MANUFACTURER shall collect the purchase price due by drawing under the credit a draft payable at 90 days after the date of the Bill of Lading.

- (3) The opening charge for the Letter of Credit shall be borne by MANUFACTURER.

- (4) Currency for payments under the preceding paragraph shall be in Japanese yen.

Article 6, Minimum Purchase Guarantee

DISTRIBUTOR guarantees monthly minimum purchases of the PRODUCTS from MANUFACTURER in not less than the amount (in Japanese Yen) of ¥500,000 to ¥800,000

on a FOB Japanese Port basis.

For the purpose of this Article, the PRODUCTS are considered purchased when shipped by MANUFACTURER.

Article 7, Inspection and Warrantee

- (1) The PRODUCTS shall be inspected by the official inspector representing Japanese Pottery Inspection Association.
- (2) DISTRIBUTOR shall bear the risk of any loss or damage to the PRODUCTS, from whatever cause arising, from the time the PRODUCTS are delivered to vessel in Japan in the manner provided in Article 4.
- (3) Claims by DISTRIBUTOR in regard to any defect in the PRODUCTS must be in writing and must be dispatched by DISTRIBUTOR with full particulars within one month after receipt of the PRODUCTS. In case of those claims are found justifiable by MANUFACTURER, MANUFACTURER will replace the defective parts when returned, but in no event are any PRODUCTS be returned without the prior written consent of MANUFACTURER. Except provided in the preceding sentence hereof, no claim shall be made at any time by DISTRIBUTOR for loss or damages, direct or indirect, asserted to result from defects in the products or by reason of failure or mistake of shipment. The foregoing is all warranty or guaranty, expressed or implied, undertaken by MANUFACTURER.

Article 8, Stock

- (1) DISTRIBUTOR shall maintain adequate stocks of the PRODUCTS throughout the TERRITORY to keep them available for ready supply upon its customers' service.
- (2) Whenever MANUFACTURER has received any complaint as to the PRODUCTS from any dealer or customer in the TERRITORY, MANUFACTURER, DISTRIBUTOR shall immediately make investigation and take a proper action.

Article 9, Report

DISTRIBUTOR shall promptly make periodical reports to MANUFACTURER on the sales of the PRODUCTS, the inventory of the PRODUCTS, general market conditions and others as MANUFACTURER requires.

Article 10, Marketing and Advertisement

- (1) DISTRIBUTOR shall undertake for its own account sales, marketing, advertisement and sales promotions of the PRODUCTS and devote its best efforts toward obtaining the largest sales volume of the PRODUCTS in the TERRITORY.
- (2) MANUFACTURER shall make available to DISTRIBUTOR at reasonable charge advertising materials for marketing of PRODUCTS, such as pamphlets, leaflets, catalogs, and the like.

Article 11, Industrial Property Rights

- (1) DISTRIBUTOR acknowledges that any and all the trademarks, patents and other industrial property rights used or embodied in or in connection with the PRODUCTS remain to be sole properties of MANUFACTURER, and shall not in any way question or dispute them.
- (2) If DISTRIBUTOR shall have found that MANUFACTURER's trademarks, patents or other industrial property rights are disputed or infringed upon by a third party, DISTRIBUTOR shall promptly inform MANUFACTURER thereof and assist MANUFACTURER to take steps necessary to protect its rights.
- (3) MANUFACTURER shall not be responsible for any claim of infringement or alleged infringement of patents, designs, trademarks or other rights brought by a third party in relation to the PRODUCTS. DISTRIBUTOR shall forthwith inform MANUFACTURER thereof and take appropriate

steps of defence against the claim at its own cost. MANUFACTURER shall assist DISTRIBUTOR to take such steps except financially.

Article 12, Force Majeure

MANUFACTURER shall not be liable in any manner for failure or delay upon fulfilment of all or part of this Agreement, directly or indirectly owing to any causes or circumstances beyond MANUFACTURER's control, including Acts of God, Governmental orders or restriction, war, war like conditions, hostilities, sanctions, mobilization, blockade, embargo, detention, revolution, riot, looting, strike, lockout, plague or other epidemics, fire and flood.

Article 13, Assignment

Neither party shall assign, transfer or otherwise dispose of this Agreement in whole or in part to any individual, firm or corporation without the prior consent of the other party.

Article 14, Term

The term of this Agreement shall be one year from the effective date of this Agreement. (This Agreement shall be deemed to have terminated on 31st December, 1987)

Article 15, Termination

(1) MANUFACTURER shall have the right to terminate this Agreement if:

- (a) MANUFACTURER shall at any time consider that any changes in the management personnel or ownership of the shares of DISTRIBUTOR would adversely affect the sale of the PRODUCTS in the TERRITORY pursuant to this Agreement.
- (b) DISTRIBUTOR should at any time commit any breach of this Agreement or fail to perform any of its obliga-

tions under Article 6.

- (2) At the termination of this Agreement, DISTRIBUTOR shall endeavor to make orderly withdrawal from the market causing no adverse effect to MANUFACTURER.

Article 16, Governing Law

This Agreement shall be governed by the laws of Japan.

Article 17, Entire Agreement

This Agreement constitutes the entire agreement between the parties hereto and supersedes all previous negotiation, agreements, commitments in respect thereto, and shall not be released, discharged, changed or modified in any manner, except by instruments signed by duly authorized officers or representatives of each parties thereto.

Article 18, Arbitration

All disputes, controversies, or differences which may arise between the parties, out of or in relation to or in connection with this Agreement, or for breach thereof and which cannot be settled amicably, shall be finally settled by arbitration in Japan under the rules of the Japan Commercial Arbitration Association, whose award shall be final and binding upon both MANUFACTURER and DISTRIBUTOR.

Article 19, Notice

- (1) All notices to be given hereunder shall be in writing and sent by registered airmail to the addresses stated above or to such addresses as are notified in writing by the parties. If either party has changed its address, a written notice thereof shall be given to the other party.
- (2) All notices shall be deemed to have been given on the day when such notice is received by registered mail.

Article 20, Effective Date

This Agreement shall not be effective until executed by the parties hereo.

IN WITNESS WHEREOF the parties hereto have caused this Agreement to be executed by duly authorized representatives of both parties on day and year first above written.

Attest: (Manufacturer)
ABC

By By

Attest: (Distributor)
XYZ

By By

The above mentioned contract covers all the important areas conceivable in future business engagement. Specially noted is the termination clause in Article 15, the second paragraph of which requires that the distributor exercise due care in making an orderly withdrawal from the market at the termination of their business relations. This clause is provided in order to keep the market in a trouble-free condition so that the subject may enter into the market at a later date. It often happens that when a business relationship has ended, the previous agent sells out his stock merchandise to discounters, which sometimes causes an irreparable damage to the reputation of the manufacturer, making the return of the company to the market quite difficult.

B. *Business Performance in Italy*

After both parties exchanged the signed Agreement, regular business started from January 1987. The subject sent the distributor additional

samples, catalogs and leaflets, and other advertising materials such as video tapes introducing factories and porcelain manufacturing. Shipments of merchandise went on normally.

The exchange rate of the yen continued to advance. In April it reached the level of ¥140 against US\$1.00. When the business negotiation with the Italian partner began in July 1986, the exchange rate was about ¥155 for US\$1.00. This means that the yen increased about 11 percent against the U.S. dollar over the ten months. Under this circumstance, it is quite natural for the Italian distributor to have felt apprehensive about his future business. In the middle of April, the distributor sent a telex to the subject requesting a reduction in price. The telex reads as follows:

“... AT THE MOMENT OUR PROBLEM IS THE INCREASED VALUE OF JAPANESE YEN COMPARED WITH ITALIAN LIRA. AT THE BEGINNING OF THE YEAR, WHEN WE FIXED OUR SELLING PRICES 1 YEN WAS WORTH ABOUT 8.40 LIT., WHILE TODAY, AS A CONSEQUENCE OF THE HEAVY LOSS OF US DOLLAR ON WORLDWIDE MARKET, THE QUOTATION WAS INCREASED TO 9.10 LIT. UNFORTUNATELY THIS CONSIDERABLE INCREASE PLAYS AGAINST US. HAVING DECIDED NOT TO RAISE THE PRICES OF YOUR PRODUCTS OTHERWISE, WE WOULD BE LESS COMPETITIVE AND WE WOULD RISK TO EXCEED THE LIMITS OF THE MARKET-LEVEL OF OUR CUSTOMERS. SO, WE DO NOT ASK YOU FOR ANY DISCOUNT, BUT IN CONSIDERATION OF OUR WORK ABOUT THE DISTRIBUTION OF YOUR PRODUCTS ON THE ITALIAN MARKET, WE ASK YOU FOR THE C.I.F. CONDITION ON OUR PRICES. WE HOPE THAT YOU WON'T CONSIDER THIS REQUEST AS AN HABIT, BUT THAT YOU UNDERSTAND HOW MUCH WE ARE DOING FOR DISTRIBUTING YOUR ARTICLES AMONG THE BEST ITALIAN SHOPS.”

In response to this request, the subject answered that while the Italian situation was understandable, the export price was fixed at minimum and barely making break-even and therefore an across-the-board price cut was not possible. As a compromising measure, the subject proposed that until such time when the Italian lira rose again to the previous level, the subject would ship the merchandise ordered on a c.i.f. basis and both insurance premium and ocean freight would be assumed by the subject. This proposal was accepted by the Italian partner and put into effect immediately.

In December, the yen's value rose further reaching ¥122.00 for US\$ 1.00. At this point a 10 percent over-all price deduction was made by the subject at the request of the Italian partner in addition to the assumption of bank charges resulting from the opening of a letter of credit and payment of ocean freight charges. This new price is to be reverted to the previous one once the exchange rate returns to the level prevailing in June 1986, the possibility of which seems remote.

Throughout 1987, other efforts were mutually made to organize sales promotions and merchandise planning. The performance for the first year of business was found to be satisfactory for both parties in spite of the problems of foreign exchange. They decided to continue their relationship in 1988 and further on if both parties agree to. The termination clause in the Agreement, therefore, was changed to read as follows:

Article 15, Termination

- (1) The term of this agreement shall be one year from the effective date of this agreement. (This agreement shall be deemed to have terminated on 31st December, 1987)
- (2) Either party shall be entitled to terminate the distributor's appointment as Manufacturer's distributor in Italy by six months' notice in writing expiring December 31. Without such

prior notice, the term shall automatically be extended for another year ending 31st December.

(3) Same as the old paragraph (2)

C. *Countermeasures for the High Value of the Yen*

During 1987, the value of the yen rose from ¥152.30 against US\$1.00 in January to ¥122.00 in December, an increase of 20 percent. As explained in the previous section, the subject had conceded on each occasion when a price adjustment was requested by the Italian partner. In July 1988, the Italian partner suggested that the currency for transaction be changed to the Deutsche mark which is more stable than the Japanese yen. To this suggestion, the subject replied saying that the yen/U.S. dollar rate had stabilized at the vicinity of ¥133 and this trend would probably continue for the next few months and that the only uncertainty existing now was the effect on the foreign exchange market of the outcome of the presidential election of the United States in November. The subject, therefore, suggested that should the change in the transaction currency need to take place, the best time would be in January of 1989 and added that the European Currency Unit would be more favorable than the Deutsche mark.

The Deutsche mark has been one of the most stable currencies over the years. If the agent can pay for his imports in Deutsche marks, he will be more likely to maintain his price in the market for an extended period because he is less susceptible to foreign exchange losses. It will also enable him to make a longer term plan for his business compared with when he is trading with the Japanese yen. When the Deutsche mark is used, part of the exchange risk will be transferred to the subject.

The European Currency Unit is the only quasi-fixed foreign currency existing at present. It was created in 1981 under the European Monetary

System and has since grown popular because of its stability. The European Monetary System was established in March 1979 among European Community nations with the purpose of bringing Europe toward closer economic integration and to avoid trade disruptions arising from fluctuating currency values. Eight nations including Belgium, Denmark, France, Ireland, Luxembourg, The Netherlands, and West Germany agreed to intervene in the foreign exchange markets to prevent their currencies from fluctuating in value against each other any more than 2.5 percent around parity in bilateral rates. And Italy is to keep the margin of fluctuation within 6 percent against the other currencies. Thus, the exchange rates of currencies within the European Monetary System will not move wildly. But against the currencies outside of the EMS, for example the Japanese yen or the U.S. dollar, the currencies of the member nations will rise or fall together, rather than fluctuating separately. There is a tendency that within the EMS the Deutsche mark is strong and it sometimes rises suddenly against the U.S. dollar and as a result other member currencies necessarily rise against the U.S. dollar. The ECU has been determined by taking account of the weight of each currency in a basket of all nine European Community currencies. (The September 1988 issue of *Economic Review of Federal Reserve Bank of Dallas* reports in the page 12 that the ECU is "currently, a basket of five currencies: the U.S. dollar, the Japanese yen, the British pound, the German mark, and the French franc".)

While the subject was suggesting holding until next January the changing of the transaction currency from the Japanese yen to the neutral currency of either the Deutsche mark or the European Currency Unit, the Deutsche mark started to weaken, touching off yen buying. On August 26, the distributor sent the subject the following telex reading in part "...THE JAPANESE YEN HAS REACHED ITS HISTORIC ALL TOP COMPARED

TO THE ITALIAN LIRA, BEING QUOTED 10.55. AT THIS POINT WITHOUT ANY MEASURES BY YOUR SIDE, WE ARE FORCED TO CHANGE OUR SELLING PRICES, HAVING JOINED WITH THE QUOTATION OF OUR BREAK-EVEN POINT. WE MUST FACE NEXT TRADE SHOW WHICH WILL BE HELD IN SEPTEMBER WITH NEW PRICE-LIST. WITH YOUR HELP WE WILL MAINTAIN OUR OLD PRICE. IF WE SHOULD HAVE TO CHANGE OUR PRICE AT PRESENT, THIS CHANGE WILL SURELY BRING REMARKABLE REPERCUSSIONS ON OUR SALES. WE RELY ON YOUR HELP AND ON YOUR IMMEDIATE REPLY BEING THIS A STATE OF EMERGENCY.”

Upon receipt of this telex, the subject had an internal conference including the export manager, the controller and the factory manager to seek any possibility left for making any further price allowance. The controller wanted to have figures such as inflation rates and other economic indicators to back up the Italian partner's assertion. However, with a limited time available for them to reach a conclusion, they decided not to comply with their request at this time. The subject sent out a telex to the Italian distributor explaining that they had made every possible effort to meet the request, but the current circumstances made it difficult to concede further.

It remains to be seen how the Italian distributor reacts; whether they will decide to continue to do business or to stop marketing the Japanese porcelain as the price is too high, or whether they will switch supplier from the subject to another party whose price is more competitive. It seems at this point that the best solution for the subject to keep the business is to change the transaction currency from the yen to the ECU immediately and assist in advertising within a certain percentage margin of the last year's sales realized by the Italian distributor.