UNITED STATES - JAPAN TRADE RELATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

JULY 15, 1998

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UNITED STATES-JAPAN TRADE RELATIONS

WEDNESDAY, JULY 15, 1998

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON TRADE,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:30 p.m., in room 1100, Longworth House Office Building, Hon. Philip M. Crane (Chairman of the Subcommittee) presiding.

[The advisories announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TRADE

FOR IMMEDIATE RELEASE
July 6, 1998
No. TR-28

CONTACT: (202) 225-1721

Crane Announces Hearing on United States-Japan Trade Relations

Congressman Philip M. Crane (R-IL), Chairman, Subcommittee on Trade of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on United States-Japan trade relations. **The hearing will take place on Wednesday, July 15, 1998, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:30 p.m.**

Oral testimony at this hearing will be from both invited and public witnesses. Invited witnesses include the Honorable Richard Fisher, Deputy United States Trade Representative. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

Buying almost $66 billion in U.S. products annually, Japan ranks second only to Canada as the largest market for U.S. goods and services. However, the persistent bilateral trade deficit with Japan ($56 billion in 1997), although attributed in large measure to macro-economic imbalances between the two countries, continues to focus attention on achieving steady improvements in market access for U.S. goods and services.

In 1993, the United States concluded the Framework for a New Economic Partnership with Japan. This umbrella agreement identified macro-economic goals and outlined areas for sector specific and structural negotiations. The Administration has negotiated 19 agreements under the Framework in key sectors such as automobiles and auto parts, financial services, and investment. In 1997, the United States concluded nine new agreements with Japan, the most comprehensive of which was the Enhanced Initiative on Deregulation and Competition Policy, announced by President Clinton and Prime Minister Hashimoto in June. The World Trade Organization (WTO) and Asia Pacific Economic Cooperation Group (APEC) also offer significant opportunities for the United States to work cooperatively with other countries to break down trade barriers to U.S. exports in the Japanese market.

The recent financial crisis facing Asian economies, including the sharp economic downturn in Japan, has highlighted the fact that recovery of the Japanese economy, which accounts for almost three fourth's of the total Gross Domestic Product of East Asia, is key to pulling the entire region out of recession. Observers have noted that economic events in Asia may slow the growth of the U.S. economy. As a result, the Administration has urged Japan to accelerate efforts to undertake broad structural reforms such as deregulation of its economy, fundamental reform of the banking system, improving transparency, and opening its distribution system to eliminate exclusionary and discriminatory business practices.

FOCUS OF THE HEARING:

The focus of the hearing will be to review overall U.S. trade policy toward Japan and to evaluate the effectiveness of the various sectoral agreements, as well as other trade initiatives in APEC and the WTO, in increasing U.S. market access in Japan. The hearing will address the current bilateral trade agenda, including the outcome of WTO dispute settlement cases involving Japan, the effects of the Asian financial crisis and the economic downturn in Japan on bilateral trade relations, and prospects for necessary systemic reforms and economic recovery in Japan.

(MORE)

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Thursday, July 9, 1998. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Subcommittee on Trade will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee on Trade staff at (202) 225-6649.

In view of the limited time available to hear witnesses, the Subcommittee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record, in accordance with House Rules.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies, along with an *IBM compatible 3.5-inch diskette in WordPerfect 5.1 format,* of their prepared statement for review by Members prior to the hearing. **Testimony should arrive at the Subcommittee on Trade office, room 1104 Longworth House Office Building, no later than close of business Monday, July 13, 1998.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should *submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label*, by the close of business, Wednesday, July 29, 1998, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Trade office, room 1104 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at "http://www.house.gov/ways_means/".

(MORE)

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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*****NOTICE – CHANGE IN TIME*****

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TRADE

FOR IMMEDIATE RELEASE
July 14, 1998
No. TR-28-Revised

CONTACT: (202) 225-6649

Time Change for Subcommittee Hearing on Wednesday, July 15, 1998, on United States-Japan Trade Relations

Congressman Philip M. Crane (R-IL), Chairman of the Subcommittee on Trade, Committee on Ways and Means, today announced that the Subcommittee hearing on United States-Japan Trade Relations, previously scheduled for Wednesday, July 15, 1998, at 1:30 p.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will be held instead at 2:30 p.m.**

All other details for the hearing remain the same. (See Subcommittee press release No. TR-28, dated July 6, 1998.)

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Chairman CRANE. Please take seats. We're running just a little bit late, and we're going to be interrupted by votes over the course of the afternoon. And so, I would like to welcome you all to our hearing of the Ways and Means Trade Subcommittee to consider the U.S. trade agenda with Japan in the context of the broad range of measures that Japan must take to address the difficult and painful economic situation it faces.

Sunday's stunning defeat of the ruling LDP Party, resulting in the resignation of Prime Minister Hashimoto, and the cancellation of next week's state visit has thrust Japan into a period of political transition. Japan must now focus on identifying new leadership capable of navigating a more credible record to economic recovery.

Because Japan is our largest trading partner, and perhaps most important ally in Asia, accounting for over two-thirds of the region's GDP, the stakes are high not only for the Japanese people, but also for the United States and the rest of the world. At this time of uncertainty, it is critically important that the USTR's trade agenda with Japan, including broad structural reforms such as deregulation of its economy, fundamental reform of the banking system, improved transparency, and the opening of its distribution system to eliminate exclusionary business practices remain steady and undeterred.

I firmly believe that successful implementation of these same measures will contribute substantially to moving Japan in the direction of economic health and long-term growth. The danger of inaction in terms of Japan's participation in multi-lateral organizations such as the WTO and APEC and in Japan's implementation of existing trade agreements remains a real threat to the welfare of the Japanese people and to U.S. economic and security interests in the region.

I want to warmly welcome our colleagues, Sandy Levin and Doug Bereuter, both long-time observers of Japan. Their comments should help us put the recent history of Japan's economic ups and downs, ranging from the booming 1980's to the stagnant recessionary lost decade of the 1990's into better perspective. And I also want to recognize, too, the testimony we will receive in this first panel from our distinguished colleague, Lindsey Graham, from South Carolina.

I might mention that Members will want to turn their attention to Doug's resolution H. Res. 392, which has been sequentially referred to the Ways and Means Committee until July 17. Sandy and Amo also have a bill, I know, they will want to discuss. We will then hear from a strong panel of academics that will discuss the economy and bilateral relationship more generally and a panel of witnesses from the private sector.

Earlier this afternoon, the subcommittee held an executive session with Deputy USTR, Richard Fisher, and we had a good discussion about the U.S. trade agenda with Japan.

I now would like to yield to our distinguished ranking Minority Member, Mr. Matsui.

Mr. MATSUI. Thank you very much, Mr. Chairman. I'm going to submit my statement for the record. I appreciate your holding this hearing today.

Thank you.

[The opening statement was not available at the time of printing.]

Chairman CRANE. Thank you.

And now if our witnesses will please sit down at the dais there. I think it's Sandy in the first one. Right. Okay, we've got Doug in his seat. And, Lindsey, you're at the far end here.

And we'll proceed in order with—oh, wait. No, no. You guys got turned around. No, that's okay. He can change. I mean, we want to make sure everyone addresses you properly. Because the people here on the panel may not recognize you offhand.

All kidding aside, let's get on to serious business, and we'll proceed first with Sandy Levin. And, guys, as I've mentioned before try and keep your oral testimony to 5 minutes or less. All written submissions will be made a part of the permanent record.

Sandy.

STATEMENT OF HON. SANDER M. LEVIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. LEVIN. Thank you, Mr. Chairman.

As you mentioned in your opening statement that I think very well describes the issue, much has changed since you originally scheduled this hearing. As you mentioned, Doug Bereuter and Mr. Houghton and I have presented resolutions that were an effort to keep the spotlight on the problem areas within trade matters with Japan. The election has occurred. Japan is in transition, and, as a result, I think, we need to be careful and perhaps brief about what we say.

Let me just say a few words. At some point, it was clear, I think, that the Japanese policy seemed more than not a win-lose proposition—a win proposition for the Japanese, and a lose proposition for those who were excluded from their market. But in recent years, I think it's been increasingly clear that more than not their policies have been a lose-lose proposition, losing for them and losing for everybody else.

Until now—and this subcommittee has been so much a part of this—there have been so many efforts by the United States to try to pry open the Japanese market to help them deregulate. And we've tried virtually everything: 301—changing it. Super 301. All kinds of agreements.

Now, with the election, the Japanese appear to be at another crossroads. And I just want to say, I think we should do everything that we can, though we have to realize the limitations to try to help Japan decide on its own the correct options. There was an article today in the Washington Post which talked about the presently prevailing parties split on whether they should fix their economy or ensure their reelection. I think it's important for the world that they fix their economy. And there are several legs to that: bank restructuring, the whole issue of the weakness of their currency, and trade deregulation. And we're here today, and our resolutions addressed it, to express the strong belief that trade deregulation has to be part of the reform of the Japanese economy. The argument may be that they're in a weakened position, but actually with the weakness of the yen, this is a more opportune time for the Japanese to deregulate over a reasonable time on a broad basis.

Enough said. I'm not going to go, Mr. Chairman, members, into specific areas like automotive or flat glass or whatever it is. You have, as mentioned, two resolutions before you. I don't think it's clear when would be an opportune time to bring these up on the floor—whether they should be combined. There's no pride of authorship here. But I do think at an opportune and appropriate moment the Congress, the House should once again consider this whole issue of trade policy with Japan—the essential need for them to deregulate, to open up their markets, to terminate their exclusionary policies. It will be much better for the Japanese consumer, who can then participate in the renovation or the rejuvenation of the Japanese economy. And it will surely be better for the business people and the workers, as well as, in the end, the consumers of America.

Thank you very much.

[The prepared statement follows:]

Testimony of the Hon. Sander Levin

On United States-Japan Trade Relations

Before the House Ways and Means Trade Subcommittee

July 15, 1998

Thank you, Mr. Chairman, for giving me the opportunity to express my views on United States-Japan trade relations at this critical moment.

Few areas have been as besieged by rigid theories or by the pitfalls of an either/or framework as trade policy.

The issue has been cast as a choice between free trade and protectionism, or between unilateralism and multilateralism, while our persistent trade imbalance is described by economists as either irrelevant or fateful.

As our trade imbalance with Japan grew in the 1970s and 1980s, the dominant voice was that of complacency. Suggestions to act vigorously were usually dismissed as protectionism. There were some efforts, MOSS and then SII — and I participated quite actively in both — but they were handicapped either by rigid opposition or ambivalent execution.

Nevertheless, in 1988, several of us sought to legislate a more vigorous trade policy by enacting Super 301 and by adding language to regular 301 that attacked a growing and pernicious form of trade barrier — foreign government toleration of anticompetitive practices.

And in the last few years, under the leadership of the Clinton Administration, there has been an effort to work the ground that lies between the extremes of unreciprocal free trade and rigid protectionism.

These efforts look at bottom-line results. They aim to open foreign markets, not build walls around our markets. They start with the proposition that "free" trade isn't truly free if one side is rigged. And they recognize that trade imbalances can undermine particular sectors important to the American economy.

This results-oriented approach has been applied to a number of sectors involving a number of nations. Special attention has been given to the country with which we have had the largest deficit: Japan. And particular importance was placed on the largest single component of that bilateral deficit: autos and auto parts, which consistently have accounted for a whopping two-thirds of our bilateral trade deficit with Japan. Auto parts alone have made up 20 percent of the deficit. Other targeted sectors include glass, semiconductors, film, air cargo, telecommunications, medical equipment and insurance.

For a time, this results-oriented approach helped bring some progress on the overall bilateral trade deficit with Japan. In 1995, the bilateral trade deficit declined by more than 10%, the first year-to-year decline since 1990. Foreign vehicle sales in Japan were up 30% overall in 1995, including a 30% increase for U.S.-built Big 3 vehicles and an overall 46% increase for Big 3 vehicles produced worldwide. Foreign auto parts sales in Japan were up 13.5% January-November 1995 over the previous year, while Japanese transplant facilities in the U.S. reportedly used more domestic parts. And important progress was made in deregulating the aftermarket for auto parts.

As a consequence of this results-oriented approach, eager Japanese consumers for the first time were beginning to have some real, though still very limited, opportunities to buy American cars and other American goods and services. And many U.S. companies for the first time were reaching levels of production that justified the huge investments needed to target the Japanese market.

These positive trends continued in 1996, but then were reversed abruptly in 1997 and 1998 with the collapse of the yen and the onset of the present economic crisis throughout Asia.

The current situation shows how multi-faceted trade issues really are and how they resist the false dichotomy of "protectionism versus free trade." For example, the efforts in Congress to actively press Japan and other nations to open markets to U.S.-made goods — once derided as protectionism — are now being aggressively pursued by the IMF, Treasury and other staid agencies. At the same time, it's apparent that market forces themselves — rather than just inter-governmental action — are forcing Japan and its imitators to open their markets. Though it took longer than many hoped, with unnecessary loss of whole industries in the United States, and though we are only just beginning to see the changes that are needed to resolve permanently the present crisis, the weaknesses in Japan's wholesale attempt to manipulate markets have been exposed.

One lesson we can take from the current situation is that, while market forces in the very long term help discipline countries that try to rig their markets, we can save everyone a lot of pain and agony by insisting on market opening and other market-based policies in the near and middle term.

With that in mind, I join with the many policymakers and pundits who for many months now have been calling on Japan to take action on its own to shore up its banking system, stimulate its economy, and implement regulatory reform. But I would urge that while these steps are necessary, they are not sufficient. More can and must be done, particularly by the U.S., to insist on and, where possible, stimulate change. This weekend's electoral setback for Japan's ruling party is no excuse for complacency.

When new leadership is chosen in Japan, it will be appropriate, indeed most likely indispensable, that we insist on market access, one of the cornerstones upon which any economic recovery must be built. To those who suggest that Japan and other economies are too fragile at this moment to abide competition from without, I say there is no better time to open the markets because the weak currencies of the region provide natural protection from import surges. Then, as their economies and currencies rebound, we will all grow together. This may also be a propitious time to secure the more active support of Europe in favor of opening Japan's market, because Europe's quota on Japanese automotive sales is set to expire in the near future, opening Europe up to the kinds of destructive trade imbalances we've had for years.

Specific steps that can be taken to ensure market access include:

- Continue to insist that it is not acceptable for Japan to export its way out of the current crisis, and take action if Japan attempts to do so;
- Extend Super 301, either legislatively or by executive order, as requested in the May 5, 1998 letter I and other Members of Congress sent to the President. Super 301 has proven to be one of the most potent market-opening tools, and we should continue to have it available and to use it;
- Identify ways to strengthen regular Section 301, such as by expanding the remedies to include WTO-legal civil fines, which were used effectively by the Federal Maritime Commission last year to force Japan to open up its ports;
- Vigorously enforce existing bilateral trade agreements and commitments, such as those covering flat glass, autos and auto parts, film, insurance and telecommunications;
- Fully fund the IMF;
- Reward countries that undertake the market-opening and other market-based solutions that the U.S. supports. Korean President Kim Dae Jung in particular seems committed to bold action and should be supported if he is able to follow through; and

- Pass a resolution calling upon Japan to meet its commitments to remove market access barriers in the film, auto and auto parts, glass, telecommunications and other sectors and on the President to exercise fully existing authority to achieve these objectives. Either the Houghton-Levin resolution (H. Con. Res. 233), or the Bereuter-Berman resolution (H. Res. 392), or some combination thereof may be appropriate.

As President Kennedy once noted, every crisis has two aspects: one posing a threat, the other presenting an opportunity. The strength of the U.S. economy has so far insulated us from the worst impacts of the present crisis, but it must not blind us to the profound nature of the threat. And we must not miss this incredible opportunity to leave our imprint on the fastest growing part of the globe and ensure peace and prosperity well into the next century.

Chairman CRANE. Thank you, Sandy.

Our next witness will be our colleague, Doug Bereuter.

STATEMENT OF HON. DOUG BEREUTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. BEREUTER. Thank you, Mr. Chairman, Mr. Matsui, members of the subcommittee, and Mr. Rangel. Thank you for permitting me to be here for the testimony today. I want to commend you for holding this timely hearing after the shocking elections in Japan, and Prime Minister Hashimoto's recent resignation.

I've got a couple of paragraphs you can read for yourself about what a recent top political pundit in Japan, Mr. Neufer, had to say about the implications of that.

Mr. Chairman, I think it's important to note that the people of Japan have spoken to their government officials about the need for economic reform. It's now more important than ever that the United States send a clear and unequivocal message, seconding that call for reform.

As the chairman of the Asia Pacific Subcommittee, I've been concerned about the impact of the Asian financial crisis on the United States for some time. Approximately a year ago, Thailand's financial crisis was described by the President of the United States and many other experts as a "small glitch in the road." Now, one year later, Japan and Hong Kong are in recession. Indonesia's 32-year ruler, Suharto, is gone. Russia stands in desperate need of more international assistance. And the world is pleading with China not to devalue its currency. Despite Chairman Greenspan's intentional—I think intentional—downplaying of the crisis so as not to disrupt the markets, the Asia financial crisis threat is real, significant, and unfortunately not a short-term problem. Mr. Chairman, I felt compelled to testify before you today, not to extol, however, the dangers of the Asia financial crisis to the United States. Most members do have some appreciation for this problem.

Instead, I'm here to discuss the important role that Japan can play in alleviating the effects of that crisis. They should be second engine of growth in the region. And they're not. They're a drag on the economy. They're cutting back on their imports dramatically from east and southeast Asian countries. They're headed for a negative GNP next year, according to all predictions. Only the Japanese have the resources to help themselves. And they do not have a record of having the necessary resolve to make those changes.

Though the financial crisis presents a serious threat to our national interest, it also provides an opportunity for the U.S. Government to pursue a more consistent and balanced trade and foreign policy agenda with Japan. Even more important, the crisis provides an opportunity for Japan to act responsibly and bolster the perception within the American public that it's a partner as well as an economic competitor.

Now, first, we do need to acknowledge that Japan has responded to the crisis by acting to protect its self-interests in the region in several meaningful ways. And I list those there. I'm not going to go over them because of time. But they are significant.

But there's another troubling side to all Japan's effort and its traditional response to the crisis. The reality is that neither Japan nor any other country has actually dispersed second-line credits.

Moreover, all of Japan's financial assistance—commitments, structural adjustment loans, and export-import credits—even taken altogether are still an inadequate alternative to a strong Japanese economy. Therefore, the primary question remains is the Japanese government prepared to make the fundamental economic, structural, and regulatory changes necessary to strengthen its economy.

Now the resolution that I've offered, to which referred to International Relations Committee, a subsequent referral to Banking and to this committee, is broad as reflecting those jurisdictions. It is not strictly trade. It goes to a number of important issues.

U.S. officials representing both Republic and Democratic administrations have long called for Japan, for example, to deregulate its economy and remove informal barriers to trade. More recently, U.S. Treasury and Federal Reserve officials have called upon Japan to take the tough steps necessary to reform the financial sectors of their economy. Those officials calls for deregulation are being belatedly and grudgingly heated. Under Prime Minister Hashimoto's leadership, the seemingly all-powerful Minister of Finance bureaucrats finally proposed an ambitious but problematic financial sector big-bang and a bridge loan—a bridge bank to close bankrupt financial institutions. While these moves are in the right directions, knowledgeable observers have frankly been underwhelmed by the scale and scope of these and other proposed reforms. To paraphrase Secretary Rubin, "it's time for Japan to move beyond virtual reforms to real reforms." And that certainly does involve a permanent tax cut for individual Japanese because they're not—they're not confident in their economy, and they're not investing. And they're not saving in financial institutions at least. Reportedly the biggest single consumer item in Japan is home safes. I invite your attention to the last section in my remarks related to House Resolution 392. I think it's the appropriate advice for the House to give to the Japanese, not to pile on, but to let them know how very important we think their partnership in dealing with the Asian financial crisis really is—for their sake, for east and southeast Asia, and also because of its implications on us. And the details are forthwritten in that section.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT BY THE HONORABLE DOUG BEREUTER

BEFORE THE WAYS AND MEANS COMMITTEE

U.S. - Japan Trade and Economic Relations

July 15, 1998

I. INTRODUCTION

Mr. Chairman (Mr. Crane), Ranking Member (Mr. Matsui) and Members of the Trade Subcommittee, thank you for permitting me to testify today on this very important subject. Let me commend you for holding this timely hearing after shocking elections in Japan and Prime Minister Hashimoto's recent resignation.

One of the top political pundits in Japan, John Neuffer of the publication *Behind the Screen,* recently analyzed Japan's upper house elections this way. He writes:

> The single-most important issue in the poll was the [Liberal Democratic Party] LDP's mismanagement of the economy. Though the party passed a massive fiscal stimulus package in the Diet last month and established a plan to bail out the nation's troubled banks, voters have obviously grown tired of the LDP's dithering and begrudging approach to fixing the economy.
>
> ...[T]he LDP misjudged the depth of voter concern over Japan's full-blown recession. But what really drove the public nuts was Hashimoto's desperate, last-ditch attempt to save his job by calling for tax cuts just four days before polling began. Seeing the move as a shameless attempt to pump up the LDP vote, the public sent an unambiguous signal that it was tired being played as the fool.

Mr. Chairman, the people of Japan have spoken to their government officials about the need for economic reform; it is now more important than ever that the United States send a clear and unequivocal message seconding that call for reform. I, like you, am very disappointed that the Administration has not used the excellent timing of your hearing to testify and see the hearing as an opportunity to state our nation's own interest in economic reform in Japan. It is frankly an abdication of the Administration's responsibility not to publicly address the single most important economic issue threatening our nation's prosperity and worldwide economic growth.

As the Chairman of the Asia and the Pacific Subcommittee, I have been very concerned about the impact of the Asian Financial Crisis on the United States for some time. Approximately one year ago, Thailand's financial crisis was described by the President of the United States and many other experts as a "a few small glitches in the road." Now, one year later, Japan and Hong Kong are in recession, Indonesia's thirty-two year ruler, Sueharto, is gone, Russia stands in desperate need of

The inevitable refocusing on the importance of America's security relationship -- coupled with a nearly complete lack of attention toward Japanese-American trade issues in the second term -- has predictably damaged America's credibility on the issue of its willingness to be steady and appropriately tough on trade issues with Japan. This lack of credibility on trade issues was also exacerbated by the Administration's overstatement of its Japan-trade successes during the President's campaign for a second term.

For example, on March 28, 1996, USTR Deputy Ira Shapiro testified before this subcommittee that U.S. flat glass exports to Japan had increased 93% as a result of USTR's negotiated glass agreement with that country. What Ambassador Shapiro failed to note, however, was that U.S. flat glass sales to the notoriously closed construction industry in Japan had increased from approximately one-half of 1% to a whopping whole 1% of the market!

IV. JAPAN'S ROLE IN THE ASIAN FINANCIAL CRISIS

Though the current financial crisis presents a serious threat to our national interest, it also provides an opportunity for the U.S. government to pursue a more consistent and balanced trade and foreign policy agenda with Japan. Even more important, the crisis provides an opportunity for Japan to act responsibly and bolster the perception within the American public that it is a partner as well as an economic competitor.

First, we must acknowledge that Japan has responded to the crisis by acting to protect its self-interests in the region in meaningful ways. For example, without question it has been the largest financial contributor to the most troubled Asian economies, providing $19 billion in second-line credits to South Korea, Thailand, and Indonesia. Additionally, Japan has made substantial structural adjustment loans and extended export credits to Indonesia to help contain the financial crisis.

But there is a troubling side to all of Japan's efforts and its traditional response to this crisis. **The reality is that neither Japan nor any other country has actually disbursed second-line credits. Moreover, all of Japan's financial assistance, commitments, structural adjustment loans, and export/import credits – even taken altogether – are still an inadequate alternative to a strong Japanese economy. Therefore, the primary question remains: Is the Japanese government prepared to make the fundamental economic, structural, and regulatory changes necessary to strengthen its economy?**

Japan is the world's second largest economy and accounts for an amazing three-fourths of total East Asian Gross Domestic Product. It certainly has the potential to play a leading role in pulling the region out of the financial crisis by serving as its "engine of growth." The United States' response to the Mexican crisis is a good example of how Japan could jointly serve with the United States and Europe as the "engine of growth" for Korea, Thailand, and Indonesia.

As everyone recalls, Mexico suffered a precipitous devaluation of the peso because of its government and private sector's over-reliance on short-term debt. While many people focus on the United States efforts to stabilize the peso with the use of our exchange stabilization funds, fewer people have focused on how the United States, almost singlehandedly, helped Mexico export out of its proposed an ambitious but problematic financial sector "big bang" and a "bridge bank" to close bankrupt financial institutions. While these moves are in the right direction, knowledgeable observers have, frankly, been underwhelmed by the scale and scope of these and other proposed reforms. To paraphrase Secretary Rubin, it is time for Japan to move beyond "virtual reforms" to "real reforms."

Nevertheless, Japan's political leaders have stubbornly refused to abandon their export-dominated economic model while undermining Korea, Thailand, and Indonesia's recovery from the Asian Financial Crisis. Consider two macroeconomic statistics which reinforce this stark conclusion:

- Japan's current account surplus with the world has risen from \$65.8 billion in 1995 to \$93.5 billion in 1997. It is expected to exceed \$100 billion in 1998.

- From 1952 to 1995, the total foreign direct investment in Japan was approximately 0.7% compared to 7% in the United States. It has shown little sign of improvement in recent years according to USTR.

And there is an abundance of microeconomic evidence that suggests the Japanese market is still very closed in many ways. For example:

- In the insurance sector, Japanese companies control 98% of the life business in Japan and 97% of the non-life business.

- The foreign-manufactured share of the Japanese commercial computer market is almost four times that of the private sector.

- The World Competitiveness Yearbook ranks Japan 18th in overall competitiveness. Over-regulation is a key factor in their low ranking. For example, in food processing and textiles, Japanese productivity is one-third of U.S. levels.

VI. HOUSE RESOLUTION 392

Mr. Chairman, I have made a request to our leadership that next week the House of Representatives should consider House Resolution 392, introduced by myself on March 24, 1998. The purpose of this resolution is to stress the urgent need for Japan to more effectively address its economic and financial problems and open its markets by eliminating informal barriers to trade and investment. The resolution notes that Japan plays a crucial stabilizing role in the Asia-Pacific region and that it must make a more effective contribution to leading the Asia-Pacific region out of its current financial crisis, insuring against global recession, and reinforcing regional stability and security.

House Resolution 392 reinforces the Administration's strategy to focus on key deregulation and competition policy initiatives in Japan. For example, House Resolution 392 urges Japan to undertake a broader and faster deregulation of its economy, open its distribution system and eliminate exclusionary and discriminatory business practices. These initiatives are aimed at helping highly competitive industries and companies like those in the telecommunications, pharmaceutical, and consumer goods industries gain access to the Japanese consumer.

Chairman CRANE. Thank you, Doug.

And our final witness: our distinguished colleague from South Carolina, Lindsey Graham.

STATEMENT OF HON. LINDSEY GRAHAM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

Mr. GRAHAM. Thank you, Mr. Chairman.

I come to the committee today with a little different approach to the problem. And I know the problem is real and I want to be part of the solution to maintain a good, strong relationship with Japan. And I hope Japan can make the corrections they need, with our assistance, to get economy in that part of the world going.

But when you talk about U.S.-Japanese trade relations, people in the third congressional district of South Carolina take notice for a variety of reasons. But one of the dominant reasons is that in my district we employ 1,200 folks with Fuji Photofilm U.S.A., making a variety of products, including photographic film, paper, quicksnap cameras, and videocassettes.

Fuji Film U.S.A., Mr. Chairman, has invested over a $1 billion in my district. About every other week, we expand, and it has brought a quality of life and good paying jobs to my district that would be very hard to duplicate. And we're very much appreciative of what Fuji Film has done in South Carolina. Fuji Film and Kodak were in a dispute, I think some of our friends from New York will recall, about the idea of whether or not the film market was open and available in a fair manner to Kodak film. Kodak and Fuji share about the same market share in each other's country—9 or 10 percent Fuji market share in the United States; about the same for Kodak in Japan. The dispute was brought to the attention of the U.S. Trade Representative, and the U.S. Trade Representative, at Fuji's request, picked an impartial arbitrator. And the U.S. Trade Representative chose to take the dispute between Kodak and Fuji and send it to the WTO. And, as you know, Mr. Chairman, the WTO ruled not very long ago that basically the concerns of Kodak were not founded in law or fact. And I've been to Japan myself to look at the availability of Kodak film. What I want this committee to understand is that what problems we have with Japan, they are real. But let's focus on the real problems. And one of those problems is not film access. The WTO has ruled. Let's take the film case and put it on the shelf, roll up our sleeves, and go to work on the real problems facing both countries. And I would just like to submit my comments for the record.

And I appreciate you very much listening to how U.S.-Japanese trade relations affect a small town in South Carolina.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF HONORABLE LINDSEY GRAHAM

SUBCOMMITTEE ON TRADE

COMMITTEE ON WAYS AND MEANS

HEARING ON U.S.-JAPAN TRADE RELATIONS

JULY 15, 1998

THANK YOU MR. CHAIRMAN.

I APPRECIATE THE OPPORTUNITY TO BE PRESENT AT THIS HEARING OF THE TRADE SUBCOMMITTEE. U.S.-JAPAN TRADE RELATIONS ARE IMPORTANT TO OUR ENTIRE ECONOMY, BUT NOWHERE DO THEY HAVE MORE OF AN IMPACT THAN IN SOUTH CAROLINA AND IN MY DISTRICT.

AS YOU MAY KNOW, FUJI PHOTO FILM U.S.A. HAS A MASSIVE MANUFACTURING AND DISTRIBUTION FACILITY IN MY DISTRICT. FUJIFILM EMPLOYS 1,200 ASSOCIATES IN GREENWOOD, MAKING A WIDE VARIETY OF PRODUCTS INCLUDING PHOTOGRAPHIC FILM AND PAPER, QUICKSNAP CAMERAS, AND VIDEOCASSETTES.

IN MY DISTRICT WE HAVE A STAKE IN THE FUTURE OF U.S.-JAPAN RELATIONS. WE WANT AMERICA'S ECONOMIC RELATIONSHIP WITH JAPAN TO BE SMOOTH, STRONG, AND PRODUCTIVE FOR BOTH SIDES. WE ARE CONCERNED ABOUT CONDITIONS ON BOTH SIDES OF THE PACIFIC THAT MIGHT HURT THAT RELATIONSHIP.

SO I WORRY ABOUT SITUATIONS LIKE THE FUJIFILM-KODAK FILM CASE, WHICH WAS DECIDED BY THE WORLD TRADE ORGANIZATION IN MARCH, AND SHOULD BE OVER. KODAK TRIED TO MAKE A CASE, AND LOST. THE U.S. CHOSE TO GO TO THE WTO, AND A NEUTRAL PANEL OF EXPERTS DECIDED THAT THE JAPANESE GOVERNMENT WAS NOT INVOLVED IN THE SHAPING OF THE FILM MARKET IN JAPAN.

THE FILM CASE IS FINISHED. IT'S NOW UP TO KODAK TO MAKE THE KIND OF COMMITMENT IN JAPAN THAT FUJIFILM HAS MADE IN THE U.S.A., AND ESPECIALLY IN SOUTH CAROLINA.

BUT I ALSO WORRY ABOUT JAPAN'S FUTURE AS A PARTNER IN TRADE AND INVESTMENT. I KNOW WE ARE GOING TO HEAR TODAY ABOUT REAL PROBLEMS IN THE JAPANESE ECONOMY AND MARKETS THAT NEED TO BE ADDRESSED QUICKLY AND EFFECTIVELY IF OUR VITAL RELATIONSHIP IS TO REMAIN HEALTHY. I HOPE THE NEW LEADERSHIP IN

JAPAN WILL LISTEN CLOSELY TO WHAT OUR WITNESSES HAVE TO SAY TODAY AND WILL TAKE THEIR SUGGESTIONS SERIOUSLY.

OUR TWO COUNTRIES HAVE A GREAT RECORD OF COOPERATION AND SUCCESS, AND NOW THAT IS BEING TESTED BY THE ECONOMIC CRISIS IN JAPAN. I HOPE WE IN CONGRESS WILL DO EVERYTHING WE CAN TO SUPPORT THE IMPORTANT GOAL OF JAPANESE RECOVERY.

THANK YOU AGAIN FOR THE OPPORTUNITY TO PARTICIPATE TODAY.

Chairman CRANE. Thank you, Lindsey. And I thank all of you. Are there any questions? Mr. Matsui.

Mr. MATSUI. Well, no, I would just like to thank all three of the witnesses. I might just point out that I'm on Mr. Bereuter's bill and the Houghton-Levin legislation as well. I've looked at the bills, as one might expect, and I don't see anything particularly inflammatory in them. They're very thoughtful resolutions, and they really deal with existing problems. And so, certainly it's something that we need to look at; that obviously the timing issue is one that is somewhat unfortunate. But this is something that I think we need to make some statement on.

Thank you.

Mr. LEVIN. Thank you. I think, Mr. Matsui, they're probably more salient today than they were when they were introduced. The timing we need to be sensitive to.

Chairman CRANE. I think Mr. Houghton wanted to make a statement.

Mr. HOUGHTON. Thank you very much, Mr. Chairman.

Just a couple of comments.

First of all, thanks very much for holding this hearing. Thank you, gentlemen, for being here.

It's really a sad day because Japan is such a good friend of ours, and they're going through very difficult times. And we don't want to do anything to kick them when they're down. But at the same time, there are some things which we feel very deeply about; that mention was made of the WTO case as far as the film industry is concerned. However, in the resolution of that case, Japan claimed that the distribution system was open and that they encouraged imports and didn't tolerate restraints on competition, which certainly is not right.

The bill, H. Con. Res. 233, which Mr. Levin and I have put in, really goes to film, but that spreads out to a more generic basis. I mean, I think that, you can't get away from the facts; that you can have an impression and philosophy and different changing policies, and listening to the words. But in the case of Kodak, you know, wherever they've gone in the world, they have either 40 or 70 percent or 80 percent of any market. And Japan, despite the protestations of the Japanese government, they've got about 10 percent and cannot move off the dime—absolutely cannot do this. And Fuji is able to bring business and money into this country. They can buy up accounts, and they can do everything they want. But we can't do it there. So, clearly, there's an imbalance. I don't know how it's resolved. And whether we go ahead on these two bills individually, Mr. Chairman, or whether we combine the two, I don't know. But I think we're going after the same issue, and I think that as responsible citizens, the Japanese really ought to know how we feel, not just say, I know you're having a difficult time. We want to be your friend, which, of course, we do. But they ought to know what's happening here. And it just isn't right. And so, I think these bills put a sharp lens on that. And I think they're great. And I applaud Mr. Bereuter and Mr. Levin for their work.

Thank you.

Chairman CRANE. Thank you.

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I would just ask unanimous consent to enter into the record an op-ed piece from the Asian Wallstreet Journal, and would like to call the members' attention to the testimony of Peter Walters, of Guardian Industries, whose testimony has been submitted for the record. And I think he very succinctly explains the problems that the U.S. glass manufacturers face with Japanese trade barriers, and it explains the failings of the 1995 U.S.-Japan flat glass agreement. I hope that we can continue to work constructively with the U.S. Trade Representative to ensure that the terms of this agreement are abided by all parties.

Thank you, Mr. Chairman.

[The information follows:]

THE ASIAN WALL STREET JOURNAL THURSDAY, JUNE 25, 1998

Breaking Japan's Flat-Glass Ceiling

By Greg Rushford

American companies that gripe about Japanese protectionism haven't always practiced what they preached. From computer-maker Cray Research to photo film giant Eastman Kodak, whiners have often turned around and savaged the Japanese with the same protectionist weapons with which they claimed to have been wounded. Once in a while, though, a U.S. company comes along that's not just crying wolf about Japan.

You don't have to be a Japan basher, for example, to appreciate the deep frustration felt by Michigan-based flat-glass maker Guardian Industries. Guardian has long sought only one thing—the opportunity to compete in Japan—but has repeatedly run up against what could be called, well, Japan's flat-glass ceiling. The market for the stuff that adorns high-tech mirrored walls on skyscrapers, and windows in some automobiles and homes, is nothing to sneeze at in Japan: $5 billion in annual sales.

> *Japanese officials figure they can stonewall in cases like flat glass, which involve complex regulatory issues with which the WTO isn't equipped to deal.*

The runaround that the Japanese have given Guardian for more than a decade, alas, illustrates why Japan so frustrates even some of its best friends across the Pacific, who worry about the political backlash that Japanese protectionism fosters. Beyond that, it is but one more reminder that insulated Japanese bureaucrats routinely get away with stonewalling foreigners simply to protect policies that ultimately hurt Japanese consumers more.

During a recent meeting in Washington, Counselor Hajimi Ito, a Ministry of International Trade and Industry official, defended the government line. I told Mr. Ito that, unlike some of the chronic whiners and Japan bashers in U.S. industry, Guardian seemed to have made all the necessary, strenuous efforts to penetrate Japanese markets, but to little avail. I asked him, Was this a case of Japanese protectionism? "Let's check the numbers," he answered. "The numbers tell everything."

Mr. Ito went on to cite various statistics showing how imports of flat glass to the Japanese market have increased 24% since 1996, amounting to a 15% market share today. Mr. Ito added that it was his impression that U.S. flat-glass exports to Japan increased from 1.7 percent in 1994 to 5.8 percent in 1997. One company that had enjoyed particular success in selling to Japan was PPG Industries, Inc. (formerly Pittsburgh Plate & Glass), he said, concluding: "Japan's flat-glass market is open."

I then called Stephen Farrar, Guardian's Michigan-based director of international business. Mr. Farrar said that he agreed with Mr. Ito that the numbers told the story. Only, his numbers told a different story.

Before the U.S. and Japan signed an accord on flat glass in 1995—a document that in itself had little teeth, mainly committing the Japanese government to do little more than collect data to ensure that its market was open—Mr. Farrar said, Guardian had held about 1% of Japanese markets. Sales went to around 2% in the first six months after the 1995 agreement, but then they tapered off, he related. "Now our market share in Japan may be flirting at about 1.5 percent."

In other world markets, Mr. Farrar told me, Guardian's market share ranges between 10% and 20%, and is roughly 34% in Thailand, where the company has production facilities. "There is no market anywhere in the world except Japan where we have sustained trouble getting in." In Japan, Guardian officials say, the company has persisted despite finding obstacles at every turn, such as for example being denied the opportunity to bid on construction contracts and refusals by Japanese glass distributors to handle American glass.

Checking further, I learned that even Mr. Ito's champion, PPG Industries, agrees with Guardian. While PPG has enjoyed increased sales of glass to Japan, as Mr. Ito pointed out, they are mainly attributed to a relationship with Asahi Glass, which then sells the PPG product to Japanese automobile companies. In fact, around one fourth of the 24% increase in imports that Mr. Ito referred to comes from U.S. subsidiaries of Asahi Glass, Japan's dominant flat-glass manufacturer, and Nippon Flat Glass (a point which Mr. Ito does not dispute).

PPG Industries says that selling because of a relationship with Asahi is fine, in the short term. But Guardian and PPG executives complain that what they want is access to Japan's tightly regulated, cartel-like distribution system—the key to really opening Japanese markets.

Last month U.S. trade negotiators David Burns and Wendy Cutler pressed their counterparts from Tokyo on flat glass, and were also told that Japan's markets are open. Japanese officials did, however, promise to consider helping Guardian market its line of insulated, energy efficient windows—perhaps by working up a tax break.

Something's wrong if this is the best Japan can come up with.

Six years ago I was already writing about how Japanese officials had promised that they would take steps to ensure that Guardian was able to sell glass in Japan (this was a little-noticed piece of good news that resulted from President George Bush's otherwise disastrous January 1992 trip, when he became ill at dinner and famously threw up on Prime Minister Kiichi Miyazawa). Now, in 1998, one of the top priorities of the Office of the U.S. Trade Representative is persuading Japan to take real steps to open its flat-glass markets.

But nobody knows exactly how this can be done. Americans have been trying—many times and in many ways—to change Japan ever since Commodore Matthew Perry steamed into Tokyo Bay 143 years ago, his "black ships" belching smoke and frightening Japan into trading with the world. Today, Japan isn't much frightened of U.S. trade pressure.

After all, the days of unilateral economic sanctions from Washington became numbered (and hurrah for that) when the World Trade Organization was created in 1995. Japanese officials now figure that they can get away with stonewalling in cases like flat glass, which involve complex regulatory issues with which the WTO isn't equipped to deal.

Yet Japan is wrong blithely to brush off complaints like Guardian's. The American frustration that builds up from too many cases like this tears at the fabric of the trust necessary to maintain the vital U.S.-Japanese security relationship. Why give American isolationists ammunition?

As for MITI promises to consider giving Guardian tax breaks to sell windows, here is one more example of the Japanese government tinkering at the edges of markets. Why not deregulate all Japanese markets, and give Japanese consumers a real break? Perhaps one day soon Japan's leaders and public will connect their country's dismal economic performance of recent years and current frightening financial situation to protectionism.

"Everything else has been tried," says former high-ranking U.S. trade official Doral Cooper, "being nice, being belligerent, behind the scenes, in front of the scenes. At the end of the day, I've never seen a country liberalize its economy until it realized that was in its own best interests." And this is what's missing in Japan these days.

Mr. Rushford is editor and publisher of the Rushford Report, a Washington, D.C. newsletter on trade politics.

Mr. LEVIN. Mr. Camp. Mr. Camp.

Mr. CAMP. Yes?

Mr. LEVIN. I'll take 30 seconds. I think it's so, if I might say, appropriate that you raised it. Anybody who has any question about the comparable openness of the U.S. and Japanese distribution and regulatory systems needs only to look at flat glass, among many other examples, including photography. Our flat glass companies have been trying to get into the Japanese market with as good a product if not better and a lower price for years. And you—and the article you cite spells that out. And anybody who wants to deny the difference—look, we've got to help push Japan to open up, to deregulate. And if they don't, it's going to harm them and harm the rest of Asia, as Mr. Bereuter has said, and us eventually. It already has.

Mr. BEREUTER. Mr. Chairman, if I could——

Mr. CAMP. Well, I appreciate those. Yes, I'd be happy to yield.

Mr. BEREUTER. Mr. Chairman, if I could comment on your remarks. You brought up a particular industry and a company within it. And in my own testimony, you may have noticed there is an illustration. On March 28 of 1996, USTR Deputy Ira Shapiro came up here and testified that the U.S. flat glass exports to Japan had increased 93 percent due to USTR's efforts. What he failed to note is that the U.S. flat glass sales are in a notoriously closed construction industry. So the percentage that we have of the market has gone up a whopping one-half percent. They had one-half percent, but a 96 percent increase gives them a whole one percent of the Japanese market today, despite the fact that, as Mr. Levin said, they are extremely competitive and, in fact, should be a very dominant player in the field.

Mr. CAMP. Well, I——

Mr. BEREUTER. So those statistics can really be misleading.

Mr. CAMP. Yes, and I appreciate both of your comments on this area. And it is one that needs more attention, and I thank the chairman for the time.

Chairman CRANE. Ms. Dunn?

Ms. DUNN. Mr. Chairman, I'd just like to ask unanimous consent to enter my statement into the record.

Chairman CRANE. Without exception, so ordered.

[The opening statement of Ms. Dunn follows:]

Statement of the Honorable Jennifer Dunn of Washington
Ways and Means Subcommittee on Trade
U.S. Japan Trade Relations
July 15, 1998

Mr. Chairman -

Thank you for providing us with an opportunity to explore the important relationship between the United States and Japan.

Clearly, Japan has entered a period of great uncertainty.

With the resignation of Prime Minister Hashimoto following the Liberal Democratic Party's defeat in last weekend's election, the U.S. has a responsibility to provide Japan with the international support they need to work through their current economic and political difficulties.

Japan is critical to the stabilization of the entire Asian region. As such, we need to address both the short-term and long-term problems in a thoughtful manner.

Ironically, the U.S. concerns with Japan right now are more financial related than trade related. The value of the Yen and the level of domestic demand in Japan are raising serious questions about the ability of Japan to pull the Asian region out of the current economic crisis in which it finds itself.

These are the more immediate issues that must be addressed in order to bring more certainty to the region's economy. They in now way, however, negate the need for continued discussions about reducing Japan's tariffs on American goods and services.

It seems that Japan has an opportunity to take truly robust steps towards reforms in transparency and openness.

We need to redouble our efforts to call for leadership in Japan that will take in more imports, seriously restructure its' banking system, and stimulate domestic demand.

I am confident that this hearing will provide a healthy discussion on these issues.

Mr. Chairman, thank you again for your leadership in this area, and I look forward to working with you in the future as we attempt to help bring additional stability to Japan and the rest of Asia.

And, Richie, do you have any questions of our panelists? Well, I express appreciation to all of our panelists——

Mr. GRAHAM. Mr. Chairman? Excuse me. Could I make one quick comment just for the record, and I know you're very busy. The problems that have been expressed in other areas of the economy I'm sure are very real, and I'm sure they're problems with the Japanese market. But I want to leave the committee with this thought and this fact: in the regards to film, the dispute between Kodak and Fuji, which resides in my district with a billion dollar investment, the WTO heard the case. The WTO was selected as the arbitrator by the USTR. And if it's appropriate, I would like to have their decision entered into the record. In the area of film, it's about competition. It's about investment. It's about who's working the hardest, and who's putting the most money into the marketplaces. It's not about these other issues.

Thank you, Mr. Chairman.

[The material is being retained in the committee files.]

Chairman CRANE. Does anyone else have questions for this panel? I yield to Mr. Houghton.

Mr. HOUGHTON. With all due deference to my colleague here, the World Trade Organization is about words, and the marketplace is about facts. And the facts are not particularly very good.

Chairman CRANE. Thank you, Mr. Corning. And with that, our panel will be adjourned. And our next panel consists of Robert D. Hormats, vice chairman of Goldman Sachs; Douglas Paal, president and founder, Asia Pacific Policy Center; Clyde Prestowitz, Jr., president, Economic Strategic Institute; Brink Lindsey, director, Center for Trade Policy Studies, Cato Institute; and Kenneth Pyle, professor of history and Asian studies, University of Washington, and president of the National Bureau of Asian Research in Seattle.

And, gentlemen, as I indicated to colleagues earlier, if you could try and confine your oral testimony to roughly 5 minutes. All printed statements will be made a part of the permanent record. And we'll proceed in the order in which I introduced you.

Dr. Hormats, you will be first.

STATEMENT OF ROBERT D. HORMATS, VICE CHAIRMAN, GOLDMAN SACHS, NEW YORK, NEW YORK

Mr. HORMATS. Thank you, Mr. Chairman, Mr. Matsui, Mr. Houghton, and other members. It's good to be back to testify before this committee.

Let me be brief and make a few key points.

First, in my judgement, the world economy today faces greater danger than at any time since the oil crisis of the 1970's. There's an enormous threat to the global economy. As I say, the dangers are greater than at any time since the oil crisis. Let me identify the three major reasons why.

First, recession, a weak yen, and serious banking problems in Japan. We'll discuss those in greater detail a little bit later.

Second, faltering growth, recession, or depression in much of the rest of Asia. I've been to Asia very recently. Confidence is collapsing. Currencies are under pressure. A number of countries, Indonesia being the most difficult situation, are facing depression. Growth expectations are being steadily and dramatically downgraded. And for many countries, unemployment is going to skyrocket over the next several months.

A third element of the problem is sharply lower energy and commodity prices. Now those, in a way, are of great tax benefit for the United States. It's like a big tax cut for Americans. But it also is very harmful for the countries that export oil and export raw materials. Many large countries, Russia is a good example, have been hit badly by the collapse in energy and raw material prices.

So this is a very dangerous period for the world economy. And one has to feel pessimistic, particularly if you visit various countries of Asia.

This is also a pivotal period for the world economy. Many of these crisis countries need to come up with measures to halt the deterioration. All over Asia, major reforms are being implemented or planned. The question is: Will they be adequate and will they be implemented quickly enough? Here's where Japan's reforms must play a central role. Japan has a short time, a very short time, in which to decide whether to take the additional steps needed to boost growth, strengthen its banking system, and thereby restore confidence in its markets and its currency and become an important part of the solution to the Asian problems, or to continue to put off tough decisions and thereby suffer further erosion of its own economy and pose a growing threat to the Asian region.

I'd also make the point that the Asian crisis has not really had much of an effect on the U.S. Some would say it's beneficial, because it has helped to lower interest rates and lower prices, and thereby stave off an increase by the Fed. On the other hand, the crisis has adversely affected a large number of American companies that sell in Asia. And if the American economy were to turn down at a point in time when the Asian economies are still as weak as they currently are, that would have a devastating effect on the global economy. An interest rate increase by the Fed would also have a very adverse global effect.

A few points on the impact of Japan on Asia. First, Asia and Japan are very closely interrelated. For most countries, Japan is the biggest market for their exports—for virtually every other Asian country. They export 20 to 25 percent of their goods to Japan. But more importantly, the collapse of the yen makes Japanese goods more competitive vis a vis its neighbors in bilateral trade. And, it makes Japanese exports more competitive in third countries like the United States. One example: Korea. Seventeen percent of Korean trade is directly with Japan, but about 30 percent of Korea's exports compete head to head with Japanese exports in third country markets. China sells Japan 20 percent of its exports directly and competes with Japanese exports in third markets with about 20 percent of its exports. So, that's why the decline in the value of the yen has been so harmful in terms of its impact on these other countries—and why their currencies and their markets go down when the yen depreciates.

Let me turn to a couple of points about reform. Japan has opened up in the financial services area to a very significant degree. The foreign exchange law of April 1 and the Big Bang. Both are pluses. There are concerns, however, that I do have about Japan's new securities investor protection fund, which is meant to help out the securities companies that have gotten into trouble. I think that puts a disproportionately large share of the costs on the large international firms that operate in the Japanese market. There are ways of improving that, which I can elaborate on.

Two areas of assistance that I'll close on.

One, it seems to me, that it is extremely important today for the United States to use the expertise it has in dealing with bank workouts. We developed a lot of expertise during the savings and loan crisis. There are a lot of experienced individuals—Bill Seidman is one. There are many others in the regulatory area and the banking area that have a lot of experience. The Japanese and, indeed, every economy in Asia needs to restructure its banking system, restructure its bad loans; and particularly to get real estate collateral now frozen off the books of the banks. The U.S. can provide enormous expertise. And it seems to me that is an extremely important thing.

The second is provide some general advice on opening up their markets, and particularly ways of deregulating their economies so that they become more efficient. We've had a longstanding engagement on the trade front with the Japanese in this area. And it seems to me that a more open, efficient economy of the kind we've been urging them to do still ought to be very high on our agenda.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF ROBERT D. HORMATS

VICE CHAIRMAN, GOLDMAN SACHS (INTERNATIONAL)

COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON TRADE
UNITED STATES - JAPAN TRADE RELATIONS

July 15, 1998

Mr. Chairman and Members of the Committee,

I appreciate the opportunity to testify this afternoon on the subject of Japan. I will focus primarily on the macro economic aspects of Japan's banking problem and how it affects other parts of Asia and US-Japan relations. I will also address some aspects of Japan's financial market liberalization as it affects the US financial services industry.

First, the world economy faces greater danger today than at any time since the oil crisis of the 1970s. Several factors together create this danger:

— recession, a weak yen and serious banking problems in Japan;.

— faltering growth, recession or depression in much of the rest of Asia. Confidence throughout the region is deteriorating, unemployment and bankruptcies are on the rise, currencies are under strong downward pressure and growth projections are being sharply downgraded. In Indonesia alone, one quarter of the population will descend into poverty according the World Bank. For many countries the very measures needed to restructure the corporate sector and banking system will lead to even higher unemployment and more bankruptcies.

— sharply lower energy and commodity prices. In part the result of Asia's crisis and in part the result of a pre-existing over supply, these are a major problem for several important countries around the world. Saudi Arabia, for example, faces a 40% shortfall in estimated revenues. Many other oil producers face similar problems. Along with major domestic fiscal imbalances and tax administration problems, the collapse in energy and commodity prices is putting enormous pressure on Russia's economy, currency and markets, jeopardizing economic and political stability in that nuclear power. South Africa and parts of Latin America also have suffered severe economic problems resulting from lower energy and commodity prices. Pre-existing vulnerabilities have exacerbated the impact of this problem in many of these countries.

Second, this is a pivotal period for the world economy during which the crisis countries themselves, and the entire international community, need to come up with measures to halt the deterioration. All over Asia major reforms are being implemented or planned. The question is: Will they be adequate and will they be implemented quickly enough? If they are done correctly and expeditiously Asia can emerge as a stronger economic region with a more stable foundation for future growth. If not, the situation could deteriorate further.

Japan's reforms must play a central role in this effort. Much of what I say below will focus on what Japan should do — and do promptly. Major changes in the bank and real estate sectors, along with new stimulus, are key to the recovery of that country. Japan has a very short time in which to decide whether to take the additional steps needed to boost growth, strengthen its banking system and thereby restore confidence in its markets and its currency — thus becoming an important part of the solution of the Asian problem — or continue to put off tough decisions and thereby suffer further erosion of its own economy and pose a growing risk to the Asian and world economies.

But Japan's efforts are not in themselves sufficient to correct Asia's problems. Strong growth in China and stability of the Chinese renminbi are also critical. Continued corporate and banking reforms throughout the region are necessary as well.

A greater international effort also is needed to afford a number of Asian crisis countries greater flexibility to inject more fiscal stimulus into their economies. Additional external financing is needed to support this fiscal stimulus along with the construction of wider social safety nets (which are critical to social stability while difficult economic restructuring is being carried out).

Third, one reason the Asian crisis has not had a more severe impact on the US is that the American economy is so strong. In addition, US exports are highly diversified, with large portions going to robust economies in Europe and Latin America. Moreover, the strong dollar has been less of a problem than in the past because many of the goods and services the US exports are high valued added or proprietary and do not compete abroad primarily on the basis of price, although exchange rates certainly do affect some key manufacturing and technology sectors.

But the US must brace itself for continued large trade imbalances with Japan and much of Asia. As yet there has not been the deluge of imports from the Asian crisis economies that many expected because of their currency devaluations. This is, in part, because of the inability of many of these countries to obtain trade financing and, in part, because of difficulties they have encountered in shifting manufacturing capacity previously geared to domestic markets to produce goods for export. Also, many Asian nations compete for market share with one another and not with US domestic producers.

Inevitably East Asian exports to the US will rise. While the US deficit with them is likely to grow, this is a time when the US can afford a large trade imbalance. Strong US economic growth relative to Asia is one reason why the deficit will be large. American policy should aim not at restricting Asian imports to this country, which are one of the few ways that region can overcome the current crisis, but at promoting Asia's recovery and encouraging continued market liberalization there in order to promote increased US exports over the long term as and when Asia recovers. Now is the time to continue to reinforce the principles and policies of the WTO; these have served as a counterweight to any tendencies toward protectionist measures in the crisis economies. During this period market liberalization, encouraged by the IMF, has advanced in much of Asia. US restrictions against exports from the region could jeopardize this progress.

To the extent that the US has seen an adverse impact from Asia it is not because of increased imports from the region but because of the sharp contraction of demand there and the attendant drop in the sales of many American companies. The weakness in such sales is far from over. But the inflow of capital from Asia, and the decline in goods, energy and commodity prices resulting from weak Asian demand has had an overall benefit for much of the American economy, holding down inflation and interest rates. The Asian crisis has had the effect of weakening the pricing power of producers of manufactured goods and (largely through its boost to housing) increased the pricing power of service industries.

Nonetheless, it is not healthy for the US economy or for the international trading and economic system for a third of the world economy to be in recession or experiencing weak growth. If the US or Europe were to suffer an economic downturn in the future with Asia's economies still weak, the global impact would be extremely serious. Higher interest rates here would also have a major adverse effect on Asia if they came while that region was still in poor economic condition; that in turn would pose additional dangers for the global economy.

Let me now discuss why the economic problems of Japan are so urgent and so serious for the rest of East Asia and the international economy. I shall then discuss areas in which reforms are urgently needed and what measures Japan needs to take.

JAPAN AND THE ASIAN FINANCIAL CRISIS

The Asian financial crisis has entered a new stage. In the fall of 1997 Asia's problem was primarily a crisis of liquidity. Markets questioned whether several Asian countries had sufficient resources to service their debts. A combination of IMF stabilization programs, agreements to extend the maturities of bank loans, the raising of new money in capital markets, plus improved current account balances, largely reduced liquidity concerns for most of the region's economies.

The current crisis is more related to the deterioration in the real economies of the region — recession or depression in some countries, sharply slower growth in others, higher inflation, greatly increased unemployment and social unrest. Can Asia's economies expeditiously reform and restructure banking systems and corporate structures? Can they boost exports enough to reduce the impact of the plunge in domestic demand and investment? Can they avoid sharply higher levels of unemployment? The answers to each of these questions lie primarily in the hands of the individual countries of the region. But the faltering Japanese economy and its weak currency have adversely affected the whole region in several ways.

Japan is the largest or second largest market for virtually every economy in Asia. It accounts for about 20% of the exports of Indonesia, Malaysia, Philippines, Thailand, Korea and Taiwan. Japan's recession has led to a sharp drop in imports from the rest of Asia. Japanese imports by volume fell by 2.2% and by value by 7.9% in the first quarter of 1998. Overall Japan's trade surplus, as recorded in April, increased on a year over year basis by 35%, although its growth recently has slowed due to weaker exports to the rest of Asia.

Even more damaging to other parts of Asia has been the fall in the yen. For the major crisis economies of the region a fall in yen by 10% against the US dollar erodes exports by 4%-9%. Part of this comes from the impact on their bilateral trade directly with Japan. An even greater part for most comes from the boost a lower yen gives to Japan's competitiveness in third countries such as the US and Europe. For example, about 17% of Korean trade is with Japan, but about 30% of its exports compete head to head with Japanese exports in third country markets. For Taiwan the figures are 19% and 25% respectively. For Singapore 13% and 21% respectively. China sells Japan about 20% of its exports directly; roughly the same percentage of its exports compete with Japanese goods in third country markets. This combination of bilateral and third country competition explains the pressures on Asian currencies such as the Korean won, and on their domestic financial markets, from the yen's sharp slide in May and June, and why the strengthening of the yen after US intervention strengthened currencies and markets elsewhere in the region.

Japanese direct investment in Asia is another important factor in the economies of the region. A weaker yen slows Japanese investment, because it causes the competitive attractions of other Asian nations to diminish relative to those of Japan. So more Japanese investment is likely to stay at home. However, labor cost advantages will continue to make the region attractive for most labor-intensive Japanese industries. Also of significance is what Japanese corporations in Asia do with their earnings generated by investment already in the region. The reinvestment/new direct investment ratios for Japanese multinationals are 112% in ASEAN and 69% for the NIEs (Hong Kong, Singapore, Korea and Taiwan). A sharp drop or pullback of investment-related earnings due to a weakened Japanese economy and weak yen would worsen an already bleak investment climate in the region.

Japanese bank lending is another problem. Japanese banks have until recently accounted for 30% of foreign lending to Asia. The weakness of the Japanese banking system, coupled with general concerns about the creditworthiness of economies, banks and corporations in the Asian region, has led to a sharp drop in Japanese bank lending (and in some cases net withdrawals) throughout the area.

To its credit, Japan has responded to the Asian crisis in a number of constructive ways. It has contributed more than any other country ($18.5 billion) to IMF-sponsored assistance programs. And it supported an Asian assistance fund to complement the efforts of the IMF—an initiative opposed by the US. But Japan's credibility has been weakened by its own economic difficulties and its banking crisis. Its economic model is no longer very attractive to the region. Japan's domestic economic weakness has worsened the situation in the Asian region, thus feeding back negatively on Japan's own problems.

IMPACT ON THE WORLD ECONOMY

Largely because of the downgrades in Japan's growth prospects, growth in the OECD area is expected to be 2.5% this year and 2.3% in 1999 compared to 2.7% in 1997. Due largely to broader Asian problems, world GDP is expected to be only 2.4% in 1998 compared to 3.7% last year. Industrial production in the OECD countries has suffered more than other sectors and dropped more rapidly than GDP. Industrial production has already dropped from 5% in mid-1997 to 2% in the current quarter, and is likely to be 1% by the end of the year. This setback to industrial production in the OECD region has come largely because the decline in exports to Asia has disproportionately hit the industrial export sector.

The Asian weakness is not likely to be great enough to push the US into a recession, but it is very significantly reducing global price inflation. In the case of the US and EU, the impact of the Asian crisis in cutting inflation has been considerably greater than expected given its relatively modest impact on GDP growth. This is partly the result of its role in dramatically lowering energy and commodity prices; this drop has, in effect, constituted an enormous tax cut for Americans and Europeans.

JAPAN'S GROWTH / BANKING / REAL ESTATE / YEN CRISIS

REFORMS. There has been a tendency in the US to belittle or dismiss the reforms Japan has made in recent years. But in some areas real progress has been made or is underway. A major fiscal stimulus is planned, including tax cuts and infrastructure spending. The effective corporate tax rate has been cut from 50% to 46%; more cuts are likely. Japan is replacing a 70-year old bankruptcy law with one that should allow more expeditious bankruptcy proceedings and restructuring. It is moving toward international accounting standards. Impediments to leveraged buyouts have been eased.

More deregulation is also planned in areas such as communications, healthcare, distribution and chemicals. This will help companies obtaining input from deregulated industries because of the resulting lower costs. Some of these measures will increase the openness of Japan's economy to foreign competition. Also Japan is moving closer to international accounting standards, including consolidated accounts (scheduled for FY1999).

I have been asked specifically to comment on increased access to the Japanese market in the financial sector. The central event in this area is the deregulation known as the Big Bang. We believe that the benefits of Big Bang are real and significant; they are working well and will continue to make a big difference for foreign firms, particularly those doing business in the securities area.

One area of real progress was the April 1 Foreign Exchange Law. This incorporates a number of constructive reforms. It is a significant plus for global firms that can operate across borders to raise capital and manage money. Also, it puts pressure on Japan to deregulate further to permit new financial products and services to be offered in Japan, lest business in such products and services go offshore.

Asset management is another area of real progress. Much deregulation took place before the Big Bang. But the Big Bang advanced the process, enabling, for example, banks to distribute mutual fund products; foreign fund managers can now use banks to broaden their distribution base, a network which would have been very costly for them to create on their own. Also pension funds can now be more active in their use of money managers and investing in equities. Foreign firms benefit from both. And banks, insurance companies and trust banks in Japan can now go into different businesses.

Also, Big Bang enhances the scope for innovation. Article II of the Securities and Exchange Law will be broadened, and implemented in a more flexible way, so foreign firms do not have to get Ministry of Finance approval of every new product or variant on an old product. They can bring new products and services to market without clearances, enabling firms like mine to innovate more in Japan. It has broadened the definition of securities and brought about more flexible ways of interpreting the law. More types of derivatives are now possible and there is greater scope for asset securitization.

Implementation of Big Bank has been very good. More reforms will be implemented on December 1. Such measures have made Japan into a freer market and helped produce a more level playing field for foreign firms such as my own. And more international firms have been able to compete for the growing pension business, as emphasis on performance grows and takes priority over older, inter-firm relationships.

Additional progress could be made in improving transparency. In particular, the new Securities Investor Protection Fund that will be established on December 1 would benefit from increased MOF consultation with foreign firms. This Fund, as currently envisaged, will make the big, institutionally-oriented firms take a disproportionately large share of the cost of the liabilities for failed Japanese securities firms. The Fund is a good idea and all firms should pay a fair share. An open dialogue with foreign as well as domestic firms would help to ensure that this can be done in a way that is fair, good for the market and incorporates the views and interests of foreign firms. In conjunction with this, Japanese regulators would be well advised to require segregation of customer assets from member firm assets, a practice widely accepted as sound practice elsewhere in the OECD.

CREDIT CRUNCH. The immediate problem for the Japanese economy is a severe 'credit crunch'. Healthy banks have become increasingly reluctant to provide liquidity to weaker institutions. Bank lending to companies in need has shrunk. The Bank of Japan has injected significant amounts of liquidity into the system to prevent bankinsolvencies and stimulate loan growth. But the banks are becoming even more risk adverse, particularly with respect to small and medium sized companies. Among such companies corporate profits contracted by 29% in the first quarter of this year, and capital investment by 21%. This was the main reason for the more than 5% annualized fall in overall Japanese GDP. Historically in post-war Japan, capital investment by these firms has led recoveries.

The other problem is a "capital crunch" due to declining Japanese real estate values, the drop in the value of equities that constitute bank capital, and the weaker yen that inflated dollar assets.

The last point is one reason Japan has been so eager to halt the slide in the yen. International standards set by the Bank for International Settlements require banks to keep in their reserves capital equivalent to no less than 8% of loan values. As the yen has fallen against the dollar, the value of the dollar-denominated assets of Japanese banks relative to capital (in yen) has shot up. If banks do not have sufficient capital relative to these increased loan valuations — and some do not — they must trim loans or slow new lending.

Private sector money growth has slumped to all-time lows, and companies are reporting that the availability of credit has become very tight. What credit is available is at high real rates, as price inflation has turned negative. Credit spreads have widened for small and medium sized enterprises. The anticipated closure of weak banks, contemplated by government reforms, could lead to cancellations of crucial credit lines. This is why the concept of a "bridge bank" (to be discussed later) has been introduced.

FISCAL STIMULUS

One way the Japanese government can stimulate demand is through fiscal stimulus. Last week Prime Minister Hashimoto pledged to seek "publicly acceptable' income tax cuts next year as part of a general tax overhaul. He indicated that the minimum tax threshold would not be cut in order to finance tax cuts for higher earners. But the announcement lacked detail about the size of anticipated cuts.

Much of the uncertainty over tax cuts results from the series a difficult issues as yet unresolved within the LDP or the Government. First they must decide how to implement a tax cut above the amount of four trillion yen, which is the amount of this year's 'one time' tax cut. Unless the tax cut is above the four trillion figure, it will amount to a tax increase.

Then the government must decide whether to implement a 'permanent' tax cut. This will require some difficult decisions. One vexing question is the impact of a permanent tax cut on government debt, which at over 470 trillion yen (including central government, local government and Japan National Railways) already equals roughly 100% of GDP. The deficit to GDP ratio (4.7%) by far is the highest among the G-7 countries.

The government is unwilling to expand the tax base by lowering the threshold, or minimum, taxable income. So a decision must be made as to whether to finance a tax cut by additional deficit financing or new sales of government assets. Currently, existing fiscal consolidation legislation, which the Prime Minster originally supported as part of his long-term goal of shrinking the budget deficit, would prevent the government from issuing new deficit financing bonds. That would have to be amended to produce more fiscal stimulus in the near term. Over the long term a credible, permanent tax cut would have to be financed by lower government spending or an increase in tax revenues generated by higher growth. Otherwise the budget deficit would rise, probably forcing the government to raise taxes in coming years.

In light of this, the Japanese public is very cautious. If they believe that a big tax cut now can only be financed by higher taxes in the future, they will likely save most of this tax windfall and the simulative benefits will be watered down. Adding to their reluctance to spend will rising unemployment — which the Bank of Japan predicts could rise from the current 4.1% to 5%. And the public also sees more government money being used to address the banking problem — again raising the deficit and causing concerns about future tax increases.

BANKING PROBLEMS. At the heart of Japan's economic problem is the weakness of its domestic banking system and at the heart of that are serious problems in the real estate sector. Japan's banking problems are similar to the problems of the US Savings and Loan Associations only far greater in magnitude and far broader in scope. As a portion of GDP they are five to six times as large as the S&L problem and affect banks, securities houses, insurance companies, construction companies and real estate developers.

The banking problem and the real estate problem must be dealt with together. Measures to stabilize the banking system will be useful and constructive, but they alone will not lead to a sustained recovery of the economy, because the root the problem remains lack of recovery and liquidity in the property markets. That, in turn, requires large scale workouts (including some loan forgiveness) by banks of non-performing real estate loans, so that corporations, real estate developers and construction companies are no longer constrained by large property-related debts. The real estate development/construction sector employs almost 20% of the Japanese population and its current problems are weighing down the rest of the economy.

Banking/real estate problems have contributed to, and been exacerbated by, the weak yen. The sharp fall of the yen in June increased the value of the banks' dollar assets and thereby weakened the banks' BIS capital adequacy rations by 0.3 to 0.4. That added to the domestic credit crunch, because banks became even more reluctant to add new assets to their books. That tightening, in turn, induced new fears of further waves of business failures.

The yen's drop also put further downward pressure on bank stock values, some of which were already dropping due to concerns (exaggerated in many cases) that some banks were experiencing liquidity problems and might fail. Those concerns could have triggered a financial crisis had the yen fallen further. That would have had a disproportionate affect on the construction and real estate development industries, and their large number of employees. Recall that when the Hokkaido Takushoku Bank collapsed last November, a large number of construction companies (some of which were financially quite sound) suffered a temporary loss of working capital.

Against this backdrop, the Government of Japan was especially eager to have the US intervene to support the value of the yen. And one price to be paid, the Japanesequid, was to promise bolder action to deal with the bad loan problem.

APPROACHES TO THE BANKING / REAL ESTATE PROBLEM

There are different schools of thought on the approach that the government should take to the banking/real estate problem.

One school believes that requiring higher levels of bank reserves and mergers between banks, along with transference of bad loans off their books, will create a more stable banking system and thus an improvement in the economy. This holds that if banks were more stable because of bigger size and fewer bad loans, they would make more loans and thus the economy would improve.

The problem with this argument is that the lack of demand in the economy is to a significant degree a function of lack of liquidity in commercial real estate, i.e. the frozen collateral problem. Massive excess debt related to property-backed loans is causing much of the problem. Because so many companies are burdened with so much bad property debt, few can consider aggressive investment. It would be difficult for banks to justify new loans to them even if such banks do have fewer non-performing loans on their books, so using public money to buy up the bad loans in itself will not solve the problem of the real economy.

Another school believes the plans should be more directed at the fundamental issue of disposing of the real estate collateral related to the bad loans.

It is important to examine why this issue is so critical. Our Goldman Sachs' experts in Japan have provided this example. Suppose a bank lent one million yen to a real estate developer at the peak of the bubble and that developer used the entire proceeds to buy a property worth one million yen. Now let us assume the property is worth only 200,000 yen. The bank can take reserves against the difference, but the developer still owes it one million yen. If the bank takes the property and realizes the 200,000 in value the developer will still owe it 800,000 yen. It is unlikely the company has the resources to write down 800,000 yen and would thus have to report negative equity. So the developer will not willingly acquiesce in a situation where he is left with debt and no equity, and thus will resist transferring the property. That means the property that could be developable is sitting there undeveloped because the real estate company has no funds to develop it. There are many properties in Japan that consist of small stores or parking lots that could be developed but are not for this reason. In the US S&L crisis once collateralized properties were sold at market prices the real estate development industry thrived.

The best way for the property to move would be for the bank in question to draw down its reserves of 800,000 yen against this bad loan and provide debt forgiveness of roughly that amount to the real estate company and then receive the real estate, or equity in the company, in return. This way the property can be sold and developed by someone with the resources to do so or by the now less burdened original owner, if the equity option is used.

Why don't the banks do this? To continue the same example, the bank has already written the loan down to 200,000 yen. It must fund this remaining 200,000 yen of the loan. With interest rates of 0.5% the cost is cheap. If the economy recovers, rates will go up only on the

200,000 yen of debt. But if they go up because the economy is recovering, then the value of the real estate is likely to increase and there is a good chance that the bank will make more money by waiting then it would lose in interest expense. In addition, if the bank took the asset over, this would be a bad time to sell it. If it could own and develop the real estate that would be a different matter, but it cannot legally do so. And if the bank did sell the property, it would have little to do with the funds since loan demand is so weak.

So the government must resolve the conflict between the interests of the overall economy in seeing real estate collateral move into the hands of those who can develop it and the interests of banks and current holders who for different reasons do not have strong interests in disposing of it. If the government cannot satisfactorily address that issue, this part of the economy will remain moribund.

The numbers are formidable. Goldman Sachs analysts estimate that during the so called "bubble period" from March 1985 to March 1994, the top 19 banks lent a total of 67 trillion yen to real estate, construction and non-bank companies. Of this, they estimate that 61 trillion yen is bad debt (91%). This figure is based on an analysis of total cash available for interest payments by high risk borrowers relative to the amount of debt they have outstanding. Within this figure there is, of course, still some collateral value (roughly 22 trillion yen), so the estimate of total losses is about 39 trillion out of 61 trillion (or 63%). These analysts estimate that the top 19 banks have already taken loan losses of 40 trillion yen. The big question now is whether the government can coax the banks into giving debt forgiveness of a similar amount and liquefying the frozen collateral.

SECURITIZATION. One way of getting real estate collateral off of the books of the banks and into the market at market prices is securitization. In the US in the early 1990s, the majority of issues of securitized real estate were the result of very aggressive issuance by the Resolution Trust Company as part of its cleanup of the assets of large numbers of bankrupt banks.

Japanese banks have not had to securitize assets because the system allows banks great forbearance with non-performing loans, including tax benefits and very low interest rates which (as noted above) reduce the cost of carrying collateral associated with bad debts. Thus there have been few bankruptcies and little incentive to securitize the collateral backing non-performing loans.

Nonetheless, this is an option going forward. However, for construction or real estate development companies, most of which have not written down their non-performing assets, placing such assets in a securitized asset instrument would require them to incur losses, as in the example above. These are also numerous bureaucratic and regulatory impediments to creating highly liquid securities like US REITS.

THE FUTURE OUTLOOK

The government/LDP blueprint for reform of the banking system — the Comprehensive Plan for Financial System Revitalization — expands the scope of the plan announced last December to make available 30 trillion yen, about 215 billion dollars, of public funds to deal with banking failures and recapitalize the stronger banks. More details are to be provided at the end of this month. New legislation will be presented to the Diet. The plan aims to promote the aggressive disposal of bad loans within the banking system, improve bank disclosure, strengthen bank supervision and restructure the financial system.

The concept of the 'bridge bank' proposed by the Plan is especially important and positive. It aims to ensure that credit will be provided to well performing companies during the period of bank restructuring and thereby avoids exacerbating the credit crunch. Bad debts will be taken out of failed banks and put on the books of the Resolution and Collection Bank, which will collect the debts if possible and sell any associated collateral.

But who owns the bad debts is not as important as what is done with them. The ultimate success of this process will hang on whether it will lead to a major series of debt workouts and collateral disposition at market prices — by failed banks and by the healthier surviving banks. That will, in turn, boost investment in real estate and strengthen the real economy.

Some of the bad loans and loan collateral now on the books of the large banks can be sold to the Cooperative Credit Purchasing Corporation. In some cases loans and collateral will be securitized. And the government has indicated that it will provide tax measures to allow banks relief in writing off bad loans. Whatever the method, the key is to induce banks or whoever ends up with the loans to quickly and on a massive scale undertake debt workouts of bad loans. That will improve, and make more realistic, the balance sheets of many corporations and real estate companies who now hold these depressed real estate assets on their books at inflated, unrealistic prices. And it will move collateral (that is currently locked up)into the market at prices that will attract new buyers and new investment in real estate development on profitable terms.

On the macro front, two points are worth noting:

— The likelihood has grown that the near future will see an acceleration in the pace of structural reform. Structural reform will boost the economy's potential growth rate over the intermediate and long terms, but in the near term it will lead to an increase in deflationary pressures in the form of employment cutbacks and further declines in asset prices.

— Japan's fiscal policy stance as of the FY1998 initial budget stage was a contraction of 0.6% of GDP. However, accounting for the additional fiscal stimulus measures incorporated in the supplementary budget that recently passed the Diet, the actual fiscal stance for FY 1998 will turn positive +0.8% of GDP (or which public works will be +0.6%, personal income tax relief +0.2%). We expect a negative 0.8% growth rate for Japan for calendar year 1998 and flat growth for 1999.

Chairman CRANE. Thank you, Dr. Hormats.
Dr. Paal.

STATEMENT OF DOUGLAS H. PAAL, PRESIDENT AND FOUNDER, ASIA PACIFIC POLICY CENTER

Mr. PAAL. Thank you, Mr. Chairman. It's a pleasure to be here.

Having had the case made by previous witnesses that the situation is quite serious, I'd like to address the question of what do you do under these circumstances with respect to Japan.

Japan is at an impasse. It's in a period of incomplete political reform and incomplete economic and financial services reform. And in this period of imperfection, they've been hit by a financial crisis for which the economic system and the political system appear inadequate to deal with the situation. Under these circumstances, we face a question of what do we do as a nation. Do we do nothing? After all, it's mostly Japan's problem to solve. Or do we do something? If we decide as, typically, Americans do, that we ought to do something, the question is do we do it in a negative fashion? Do we scold or levy sanctions to find some way to put pressure on Japan. Do we combine that with a more positive approach that we adopted—generally positive approach? I think for the moment a generally positive approach toward the Japanese is the appropriate one.

The range of required actions to address the crisis in Japan is broad and primarily requires self-help by the peoples of the countries concerned in the region. But they are literally finding the ground washing out from under them as Japan's crisis deepens. First, we should avoid the temptation to assess blame or take delight in Japan's problems, coming as they do after a period of 1980's Japanese triumphalism. An American display of triumphalism now over our own improved circumstances is equally out of place.

We need publicly to avoid the finger-pointing of recent months, which has built a negative image in Japan among the Japanese public about American officials. Rather, we should treat the Japanese as the friends they truly are. We know our friends in our times of need, and so will they in their time of need.

Second, the U.S. administration needs to pull its Japan policy together in a fashion worthy of the name. Lacking anyone of personal authority or expertise on Japan in its senior ranks, the administration's policy now is an adjunct of the Treasury Department's concerns. Treasury has many fine people trying to do the right thing, but they need the help of the rest of governmental establishments. The National Security Council, for example, lacks a senior director to manage overall Asian affairs right now. It's essential that whoever is chosen for this position have the capacity to pull together a coherent Japan policy as part of overall policy toward an Asia in crisis.

Third, the President and Congress should work together to demonstrate to the Japanese people that we are on their side as they struggle to overcome the situation. I think that by creating a visible and high-ranking interagency team, consisting of the appropriate representatives from around the government, and naming a private bilateral advisory commission, which takes Bob Hormats' recommendation a slight step farther by making it more organized and official, and have them go to the Japan and offer advice and assistance where possible, we can redress some of the damage done by angry words and verbal shoving in recent months.

Let me stress again that in the end, this is Japan's problem to solve. But as many veteran observers of the Japanese scene have noted, Tokyo is currently beset by a pattern of exceptionally weak political leadership, disconnected uncharacteristically from a discredited bureaucratic elite. It's very hard to see the mechanisms whereby policy will be formed and executed expeditiously. If our help can accelerate this political process, we should give it.

Current technical advice to Japan can be supplemented by systematic visits to a broad range of the leadership. A bilateral commission, preferably led by former Federal Reserve and Resolution Trust Company officials, can create psychological pressure on the Japanese elites as they're televised going from office to office, offering ways out of their circumstances.

And what should they tell the Japanese? My fourth recommendation is to urge that the Bank of Japan be pressed to increase the money supply. For example, by buying up Japanese government bonds, they can release yen into the economy, reversing the deflationary slide that has helped erode consumer confidence. I might note that just last night the central bankers meeting in Tokyo agreed on a new yen facility for the region which would do just that with foreign purchasers of the Japanese government bonds.

Obviously, accelerated banking reform is necessary. Japan's proposed "bridge bank," meant to function like our RTC, is a necessary ingredient and should be enabled to function as soon as possible. That may be in danger in the current circumstances in Japanese politics. Bad debts and failed banks need to be confronted and liquidated. Depositors should be protected with public funds as necessary.

Taxes need to be reduced. High marginal income taxes should be reduced to G–7 levels, and capital gains taxes on real estate transfers lowered to the same sorts of levels.

Financial services need deregulation. And the Japanese markets need to be open. Japanese past assistance in the post-war era to its Asian neighbors is being wiped out, and its effect, as they linger in the patterns of the past, is being felt at home. It's time for change. But this should be done—addressed—I think at the moment in a positive sense.

Fifth, more concerted efforts are needed to deal with specific crises in the region. There is scope, for example, for a combined humanitarian and political relief initiative for Indonesia as outlined some weeks ago by former ambassador Paul Wolfowitz.

Members of the committee, in closing I want to stress that the collapse of the Japanese economic bubble seems for the moment to have been more of benefit than harm to short-term U.S. interests. But we must not overlook the aspects of our own situation that look more like a bubble everyday. Our own financial institutions have been made more healthy after the S&L crisis. American firms are increasingly productive and so on. But American stock markets are dizzyingly high and real estate values are rising. In a very real sense, the choice before us today is to let the air out of our bubble slowly and relatively harmlessly or wait for a swing in market forces to scythe through our financial institutions. The sooner we can help the Japanese stabilize their situation by facing up to the extremely tough and painful choices they themselves face, the sooner asset flows will become more stable for ourselves and the friends in Asia we have worked so hard for generations to help grow and prosper.

Thank you.

[The prepared statement follows:]

Statement of Douglas H. Paal
President, Asia Pacific Policy Center
Committee on Ways and Means
Subcommittee on Trade

July 15, 1998

Mr. Chairman and members of the Subcommittee on Trade of the Committee on Ways and Means, thank you for the opportunity to appear before you on the pressing issue of the Asian financial crisis. Events of the past weekend in Japan, with the humiliation of the Liberal Democratic Party at the polls and the resignation of Prime Minister Ryutaro Hashimoto, make exceptionally timely your consideration of the direction of Japan's and Asia's economies.

As a frequent traveler to the Asia Pacific region on behalf of the non-profit research institution I head, the Asia Pacific Policy Center, I have had repeated opportunities to observe the evolution of the current crisis first-hand. **The most important message I have to offer you from my observations is that the Asian crisis is far more severe and threatening ultimately to our own well-being than is widely perceived here.** This is, therefore, a time not for new efforts to close markets, but to identify new sources of growth, liquidity, and exchange rate stability. If the United States can summon the wisdom and means to help accomplish these objectives, we can stave off the economic dislocation and political retrogression that will almost surely occur otherwise.

Permit me to illustrate: Japan is in recession beset by a broad range of declining indicators despite a prime rate near zero, intended to stimulate lending and boost growth for the past several years. The overburden of bad debt on Japan's banking system, a weak stock market, and sagging consumer confidence render bankers less willing to extend credit, helping to shrink the economy. Due to recent partial reforms of Japan's financial services structure, more and more investors and institutions are free to move their assets offshore, a welcome development by itself, but further beggaring the banking system in Japan at a time of crisis. According to Jesper Koll, of J.P. Morgan Japan, approximately Y23 trillion will flow into the safe haven of U.S. asset markets before the end of this year. By selling these yen to buy dollars, investors are placing downward pressure on the yen that intervention by central banks alone cannot reverse. This of course reduces the prices of Japanese products and contributes to our bilateral trade imbalance.

The massive flow of money, and not just from Japan, into the safety of U.S. assets -- bonds and securities -- has created a glowing atmosphere of well-being in this country.

Our stock markets are high and climbing, yield curves on bonds have flattened, and inflation is held in check. Add these developments to our home-grown improvements in productivity and management, and a sense of invulnerability becomes impossible to avoid.

But all this will come to an end. We are not invulnerable, neither economically nor politically. In the short run, we are already seeing negative effects on sales of American exports to the region. In the longer run, the flow of money into the U.S. markets will someday reverse, when the yen and other Asian currencies reach a price so low that their assets become irresistibly cheap. That reversal may come swiftly or slowly, and the consequent American market swing downward may be brutally quick or mercifully prolonged. What we do now can affect the outcome.

Japan's prolonged crisis is dragging the region down. As Japanese banks wrestle with bad debt, they are repatriating assets from elsewhere in Asia. As the yen falls, they do so faster. Richard Koo of Nomura Research estimates that for every single yen that the currency declines against the dollar, a trillion yen are withdrawn from the available liquidity in the region. For Indonesia, Thailand, Malaysia, the Philippines, and even Singapore and Hong Kong, this means less credit available to finance exports and roll over current debt as they try to emerge from the financial crisis that began a year ago. Even China, which has performed relatively healthily, has begun to issue warnings of its concerns. By deepening the deflation and recessionary trends of the beleaguered economies, the policy impasse in Japan is raising frightening political prospects for the region.

As Fareed Zakaria noted in *The New York Times* last week, the great post-war success of the United States in building a market-oriented, increasingly democratic Asia is being put at risk. Indonesia, as a result of the crisis, has removed a dictator of thirty years standing, but at the price of losing twenty years of economic growth. The new impulse to reform is at risk of being snuffed out in social and economic chaos that may well flow back against the tide for political reform due to massive unemployment and deprivation.

In Thailand, the prolonged crisis is damaging the reputation of the newly installed and more democratically-chosen government. Malaysia's political gears are grinding as austerity to support the currency meets with discontent among the masses and especially within the dominant political elite.

Korea, led by a lifelong champion of democracy whom the Congress honored in June, Kim Dae Jong, has seen its early moves toward economic stability stall. The outlook is for increasing labor strife and continued resistance by conglomerates to painful structural readjustment, delaying needed investment. Korea, incidentally, used to be one of the best customers of American goods, running a trade deficit with us for years, but that is gone for now, awaiting a return to growth.

What needs to be done? The range of required actions to address this crisis is broad, and primarily requires self-help by the peoples of the countries concerned. But they are literally finding the ground washing out from under them as Japan's crisis deepens.

First, we should avoid the temptation to assess blame or to take delight in Japan's problems, coming as they do after a period in the 1980's of Japanese triumphalism. An American display of triumphalism over our own improved circumstances is equally out of place.

We need publicly to avoid the finger-pointing of recent months, which has built a negative image among the Japanese public of American officials. Rather, we should treat the Japanese as the friends they truly are. They are vital allies for peace and stability in the Asia Pacific region. They taught us and challenged us through competition to become the best in the world in industries where we had sagged. They have adopted peaceful, democratic ways, as evidenced in Sunday's revolt at the ballot box by a seemingly quiescent populace. We know our friends in our times of need, so too will they know us.

Second, the U.S. Administration needs to pull its Japan policy together in a fashion worthy of the name. Lacking anyone of personal authority or expertise on Japan in its senior ranks, the administration's policy has become an adjunct of the Treasury Department's concerns. Now, Treasury has many fine people trying to do the right thing, but they need the help of our foreign policy, defense and other governmental establishments. The National Security Council, for example, at this moment has not selected a Senior Director to manage overall Asian affairs. It is essential that whoever is chosen have the capacity to pull together a coherent Japan policy as part of an overall policy toward an Asia in crisis.

Third, the President and Congress should work together to **demonstrate** to the Japanese people that we are on their side as they struggle to overcome the situation. By creating a visible, high ranking **inter-agency team** and naming a private **bilateral advisory commission** to go to Japan and offer advice and assistance where possible, we can redress some of the damage done by angry words and verbal shoving.

Let me stress that in the end this is Japan's problem to solve. But as many veteran observers of the Japanese scene have noted, Tokyo is currently beset by a pattern of exceptionally weak political leadership, disconnected uncharacteristically from a discredited bureaucratic elite. It is very hard to see the mechanisms whereby policy will be formed and executed in an expeditious fashion. If our help can accelerate the political process that must precede economic recovery, then we should give it.

Current technical advice to Japan can be supplemented by systematic visits to a broad range of Japanese political leaders. A bilateral commission, preferably led by a former Federal Reserve Chairman and Resolution Trust Company (RTC) chief executive, can create psychological pressure on the Japanese elites as they extend a hand to them to overcome their inhibitions and begin to act more swiftly.

What should they tell Japan? My fourth recommendation is to urge the Bank of Japan to increase its money supply. For example, by buying up Japanese Government Bonds they can release yen into the economy, reversing the deflationary slide that has helped erode consumer confidence. As interest rates subsequently rise and the economy begins to grow again, rising rates will strengthen the value of the yen, and help improve the balance sheets of Japan's banks.

Obviously, accelerated banking reform is necessary. Japan's proposed "bridge bank," meant to function like our RTC, is a necessary ingredient and should be enabled to function as soon as possible. Bad debts and failed banks need to be confronted and liquidated. Depositors should be protected with public funds as necessary.

Taxes need to be reduced. High marginal income taxes should be reduced to G-7 levels, as should high capital gains taxes on real estate transfers.

Financial services need further deregulation. The "Big Bang," needs to be moved along faster, so that Japan's economy reverses the tendency to hollow out as asset managers move funds abroad to improve results. Naturally, too, deregulation must mean opening closed markets to absorb exports from the afflicted Asian economies. Years of Japanese assistance to Asia in the post-war era are being wiped out as the goods Japan's friends produce go unsold due to shortages of trade financing and closed Japanese markets.

Fifth, more concerted efforts are needed to deal with specific crises in the region. There is scope, for example, for a combined humanitarian and political relief initiative for Indonesia, as outlined some weeks ago by former Ambassador to Jakarta Paul Wolfowitz. American food and medical aid, assistance with distribution, and help at organizing new political parties by U.S.-funded non-governmental organizations might constitute the core of such an initiative. Ideally, we should assign a high profile individual to mount a multilateral effort to help Indonesia adjust to the many political, economic, humanitarian and other stresses it is suffering.

Members of the Committee on Ways and Means, in closing I want to stress that the collapse of the Japanese economic bubble seems for the moment to have been more of benefit than harm to short term U.S. interests. But we must not overlook the aspects of our own situation that look more like a bubble every day. Yes, our financial institutions have been made more healthy after the S&L crisis, American firms are increasingly productive, and so on. But, American stock markets are dizzyingly high, real estate values are rising.

In a very real sense, the choice before us today is to let the air out of our bubble slowly and relatively harmlessly or wait for a swing of market forces to scythe through our financial institutions. The sooner we can help the Japanese stabilize their situation by facing up to extremely tough and painful choices themselves, the sooner asset flows will become more stable for ourselves and the friends in Asia we have worked so hard for generations to help grow and prosper.

Thank you.

Chairman CRANE. Thank you, Dr. Paal.
Mr. Prestowitz.

STATEMENT OF CLYDE V. PRESTOWITZ, JR., PRESIDENT, ECONOMIC STRATEGY INSTITUTE

Mr. PRESTOWITZ. Thank you, Mr. Chairman. I'd like to reiterate the warning issued by some of the early commentators. At the moment, it seems to me that the situation in Asia is something that we haven't seen in the world since about 1930. Hundreds of millions of people are being pushed back into a poverty they only recently escaped.

The bulk of Asia and perhaps much of the rest of the world is teetering on the brink of disaster, and the key to how that turns out—whether, in fact, we do have a disaster or whether we manage to snatch victory from the jaws of defeat—is Japan. It is virtually impossible to imagine that Asia can recover without a revitalization of the Japanese economy. And it may also be the case that the global trading system cannot stand the impact of continued contraction and decline of the Japanese economy.

Over the last 25 or 30 years, the United States has had an almost unending series of trade frictions with Japan. And the United States is not alone. The European Union and, indeed, the countries of the rest of Asia have had similar kinds of disputes with Japan. And these have often been discussed in terms of market opening; in terms of possible sanctions or threats. There have been endless negotiations, and a number of agreements have been reached. Most of those agreements, according to a recent survey by the American Chamber of Commerce in Tokyo, are either not working at all or not working fully. And we could spend a lot of time talking about each one of them. Some of them have been raised already in testimony this afternoon. But I think the fact is that they are all, in fact, manifestations of a much bigger issue. And the much bigger issue is now evident from the systemic problems of the entire Japanese economy. The problem here is not a banking problem, although there is a financial crisis. It's not just a lack of stimulating in the Japanese economy, although there is a lack of stimulation. It's a systemic crisis. And I think that it has to be addressed in that manner, both by the Japanese and by those outside of Japan, including the United States, who care about this issue.

Surely, Japan needs to carry through the banking reforms that have been described. Surely, Japan could use a tax cut. I would prefer an abolition of the consumption tax, as opposed to a cut in income taxes because most Japanese don't pay income taxes. But you can quibble about that. The point is yes, they need a tax cut; yes, they need to fix the banks. They need to take whatever it is, $500 billion, a trillion dollars, and pay off the bad loans. And yet, all of that will not fix the problem in Japan.

It's a little bit like giving a blood transfusion to a patient who needs a heart transplant. He needs the blood transfusion to stay alive, but he needs the heart transplant to really get well. And the heart transplant in this case is a thorough restructuring and deregulation of the Japanese economy. It's land reform. It's creating a real market for real estate so that real estate actually trades at market values. It's getting rid of the main bank system and life-time unemployment so that you create a real labor market. It's decartelizing the structure of much of the distribution system so that manufacturers cannot tie distributors to them. It's a whole range of issues, and perhaps most importantly is establishment of a true rule of law so that bureaucrats do not have the ability to administer administrative guidance.

These are very far-reaching changes that imply very substantial social and political adjustments. They will not be easy. And it seems to me that the best thing the United States can do is to meet quickly with whoever the new Japanese leadership is to outline our own thoughts about the direction Japan might profitably go and perhaps to convene a—several meetings—an extraordinary meeting of APEC leaders to develop an Asia recovery plan on which Japan's recovery would be the central part; a meeting of the World Trade Organization to address the question of how to insulate the trading system from the impact of a continuing Japanese decline.

Thank you very much.

[The prepared statement follows:]

U.S. House of Representatives
Committee on Ways and Means, Subcommittee on Trade
Chairman, Philip M. Crane (R, IL)

Hearing on United States-Japan Trade Relations
Wednesday, July 15, 1998

Testimony by

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Mr. Chairman, perhaps the greatest challenge facing the global economy in the near term is restoring the soundness and health of the Japanese economy. To put it simply, we cannot achieve stable, long term global growth without turning Japan into a greater consumption engine than it currently is. I believe that America's bilateral trade agenda with Japan can play an important role in further liberalizing Japanese markets, but more importantly American efforts in this area can help reduce some of the institutional resistance in Japan which has contributed to Japan's current economic malaise.

Today's hearings are meant to focus on broad U.S.-Japan trade relations, including the numerous agreements that have been reached under the Framework for a New Economic Partnership with Japan which was initiated in 1993. A quick review of these agreements will show unsatisfactory results, at least to some degree, in nearly every sector. The expectations regarding penetration of Japan's automobile sector, particularly through domestic dealership agreements have not been met. The import levels of foreign flat glass into the Japanese market have been extremely disappointing and there are still concerns that Japan's flat glass cartel remains fixed in place. There are widespread complaints from American firms that Japan is still dragging its feet on implementation of the government procurement agreement. Furthermore, the American Chamber of Commerce in Japan recently released an 11-page line item set of objections and challenges to Japan's implementation of the U.S.-Japan Insurance Agreement, which was widely lauded at its signing to be the best of the accords reached under the new framework. And in yet another sector, the Chairman of the Federal Maritime Commission, Harold Creel, has recently expressed his serious concern that Japan's implementation of the agreement reached between Japan and the United States last October to reform Japan's port practices falls far short of expectations.

For those of us who have been in the trade negotiation business for some time, the failures and shortcomings of these agreements are not surprising. While I would agree that there have been some important points of progress in the sectors covered by these agreements, the process as a whole has not yielded much. Our strategy has been episodic and incremental, when in fact recent events in Japan demonstrate the great magnitude and systemic nature of Japan's economic problems.

I believe that it will not be fruitful to further pursue a trade liberalization strategy with Japan that is divorced from Japan's current economic troubles. Although I have long been an advocate of opening Japan's markets to American products, of preserving American economic interests in a relationship that has been structurally out of balance for too long, and of enforcing agreements with Japan through U.S. trade law as well as through the World Trade Organization, I think that the U.S. needs to do a better job of targeting its efforts to achieve results which both restore Japan's overall economic robustness and which preserve the interests of the United States and the global trading system.

We must do what we can to help guide Japan out of a framework in which bureaucrats within the Ministry of Finance, Ministry of International Trade and Industry, as well as across the Japanese government feel that they can regularly outperform results which the market would have provided. Japan is not only an over-regulated economy, it is one which is generally governed by an ethic of informal controls, a system of arbitrary and ambiguous enforcement – rather than a system like that in the United States in actions are legal unless specifically regulated against. Very often in Japan firms feel that they are permitted to do what the regulations actually instruct or allow them to do. Venturing into gray areas where the government has not written code – something that any entrepreneurial culture thrives on – is not a normal practice in Japan. Thus, deregulating Japanese industry will be a challenging and difficult process because the ethic and mindset of business and regulator must change and must be supported within the courts in a transparent and predictable fashion.

However more importantly, the Japanese economy is at a crucial juncture – either steps will soon be taken to restore both domestic and global confidence in Japan's long term economic prospects, or things look very bleak for both Japan and all of those nations, including the United States, which have developed an interdependent financial framework.

The electoral results in Japan are a telling exclamation point marking the seriousness of Japan's economic plight. After months of insisting its vast wealth immunizes it against the Asian economic flu, Japan now seems to be contracting an especially virulent case, with its economy now shrinking at a 2 percent annual rate. In response to domestic and foreign pressure, Prime Minister Ryutaro Hashimoto announced a $120 billion public works stimulus package and was promptly criticized by Sony Chairman Norio Ohga, who said Japan is on the verge of meltdown and joined foreign analysts in calling for tax cuts to go along with the spending. But it seems that Hashimoto and his advisors did too little too late and were handed a stunning defeat in last Sunday's Upper House election.

The message could not have come at a more crucial moment. With the continuing Asian economic crisis pushing hundreds of millions of people around the Pacific back into the poverty, Asia and much of the rest of the world is teetering on the brink of a kind of calamity not seen since 1930. Compromising over two thirds of total Asian GDP, Japan could be an engine of growth along with the United States to help pull Asia away from the edge. Over the past several years, however, stagnation and policy dithering in Japan have only exacerbated the problem. Staggering under a mountain of bad loans, Japanese banks have cut their lending to the rest of Asia, while Japanese importers have reduced their buying. At the same time, a steadily weakening Japanese yen has made Korean, Taiwanese, and other Asian exports less competitive in world markets and nearly triggered a potentially disastrous Chinese devaluation just before President Clinton's trip to Beijing. Joint U.S.-Japanese intervention in the foreign exchange markets to support the yen stopped its slide and bought a "window of opportunity" for introduction of new measures to revitalize Japan, and through it the rest of Asia. Now the question is whether Japanese leaders will heed their public and act boldly before the window shuts and a further slide of the yen triggers a total melt-down in Asia and possibly the rest of the world.

While the decision of Japan's voters is a welcome change, it does create uncertainty and the possibility of delay of important reforms. Therefore, it is important that the United States and other countries move quickly to reinforce and elaborate the message of the Japanese electorate. As soon as a new Japanese leader is chosen to replace departing Prime Minister Hashimoto, President Clinton should consider inviting him for a holiday consultation in Hawaii. The administration should urge that Japan take immediate, bold steps to restore the health of its banking system, to stimulate its economy by regenerating consumer spending, and to discourage further devaluation of the yen.

For the past several years, Japan's sick banks have been strangling the economy by cutting back on lending in an effort to repair their balance sheets and maintain capital adequacy. Recently announced plans for a government orchestrated "Total Plan" to take over and dispose of bad loans and possibly close insolvent banks while maintaining lending to credit worthy borrowers have been greeted with skepticism because the criteria for separating the good from the bad were vague while the announced two to five year time frame seemed entirely too long. In short, it looked too much like the same old thing. To prove they mean business, Japanese leaders must spell our the criteria to be used in judging which banks should be closed, and they must aim to complete the clean up in six months. They must also pass legislation to assure that Japanese depositors are guaranteed against loss.

To stimulate the economy, Japanese leaders have focused strongly on increased public works spending. Although generally rife with corruption and inefficiencies, this may be helpful in current circumstances and should be carried through as quickly as possible. It does not, however, address the problem of the extremely low level of consumer spending which is a striking aspect of the current Japanese malaise. Although there has been talk of an income tax cut as a possible remedy, such a reduction would have only a limited effect because the vast majority of Japanese currently pay little or no income tax. What is really needed is a revamping of the tax system away from the taxation of consumption. The United States should urge Japan to consider quick abolition of its consumption tax along with introduction of mortgage interest deductibility to stimulate new home buying. Other incentives such as government issued coupons for rebates on big ticket items could also be considered. While all this is aimed at jump starting the Japanese economy, Japan can only regain long term health by thorough deregulation and decartelization of Japan's business structure.

On another front, land use regulations are among the major drags on the Japanese economy. At the moment, 15 percent of metropolitan Tokyo is in vegetable patches, while the Japanese public is compelled to live in tiny houses that inhibit consumption simply because they can't hold a second telephone or television set. Rezoning, reduction of agricultural subsidies and revamping of building codes would unclog this bottleneck and unleash a tidal wave of increased consumption of all kinds.

Electricity, airline tickets, telephone calls, taxi rides, hospital stays, package delivery and most retail goods cost substantially more in Japan than elsewhere because their sale is heavily regulated. Allowing free entry into these and other regulated businesses would greatly reduce prices and thereby stimulate further consumption and economic growth. What is really needed is a revamping of the tax system away from the taxation of consumption. The United States should urge Japan to consider quick abolition of its consumption tax along with introduction of mortgage interest deductibility to stimulate new home buying. Other incentives such as government issued coupons for rebates on big ticket items could also be considered.

Finally, cartels and anti-competitive business practices constitute a major cause of excessively high prices and sluggishness in the Japanese economy. This situation could be changed dramatically by allowing corporations as well as the Fair Trade Commission to file antitrust actions. An introduction of criminal penalties along with triple damage awards would also put teeth into the anti-monopoly laws, as would substantial increase in the staff and budget of the FTC.

To ensure that Japan takes these or other recommendations seriously, it might be necessary for world leaders to convene an extraordinary session of the World Trade Organization. It was John Maynard Keynes who proposed in the 1940s that a world trade body should have emergency measures for handling threats to the trading system arising from chronic surpluses as well as from excessive deficits. Perhaps it is time for the WTO to come to grips with this long-recognized problem in a way that would encourage Japan seriously to consider a thorough opening of its market to both domestic and foreign enterprises.

Furthermore, the President and the new Prime Minister could make a joint call for an extraordinary meeting of the leaders of the Asia Pacific Economic Cooperation forum (APEC) to develop a credible Asian recovery plan. Such a meeting should include the

International Monetary Fund and the World Bank and should focus on methods of providing greater stimulus to APEC's hard hit economies.

Mr. Chairman, when Japan was doing well economically, it could easily dismiss the complaints for foreign competitors and trading partners as the protectionist whining of incompetent managers and political leaders who were avoiding the difficult decisions necessary to become competitive. But Japan's current economic slump has been generated by the very policies that foreign governments have been warning against and complaining about for years. Japan is still a rich nation, but the managers running the country have done an exceptionally poor job of marshaling resources to benefit Japan's citizens and in providing stability and growth to the global trading system.

We need to press Japan to live up to past trade agreements, but most importantly, we need to regularly and persistently send the message to Japanese officials via the Japanese public – who is listening – that they need to get out of the business of micromanaging the economy to fulfill their mercantilistic objectives and have more faith in market forces, which will benefit Japan's consumers, its economy, and the nation at large.

Chairman CRANE. Thank you, Mr. Prestowitz.
Mr. Lindsey. Dr. Lindsey, excuse me.

STATEMENT OF BRINK LINDSEY, DIRECTOR, CENTER FOR TRADE POLICY STUDIES, CATO INSTITUTE

Mr. LINDSEY. Mr. Chairman, it's Mr. Lindsey.
Chairman CRANE. Oh, it is Mr. Lindsey.
Mr. LINDSEY. Mr. Chairman, Members of the Trade Subcommittee, I appreciate the opportunity to come before you today and discuss the situation in Japan and what, if anything, the United States can do about it.

The other witnesses in their written and oral testimony have sketched a grim portrait of economic conditions in Japan. I generally concur with that assessment. Today, I'd like to spend a little bit of time, before talking about the proper U.S. response, I'd like to spend a little bit of time putting today's conditions in Japan in context. Because while Japan's serious problems are certainly cause for concern, they also ought to be some cause for embarrassment on the part of those Japan experts who not so long ago thought that the Japanese economy was a vastly superior economic model to our own.

As we discussed in a paper, to be published shortly by the Cato Institute, the so-called revisionists, including Clyde Prestowitz, sitting beside me, believed that they had discovered in Japan a new and superior form of capitalism. Well, the revisionists turned out to be wrong. In particular, they completely misread the significance of Japan's distinctive system for allocating capital. They thought it was a source of Japan's strength. But, in fact, it turned out to be an Achilles' heel.

The Japanese financial system systematically insulated decisions about allocating capital from market signals. With a heavy reliance on bank lending, an absence of transparency and full financial disclosure, and a suppression of equity markets through stable cross-share holding, the Japanese system allocated funds according to established relationships and government targeting of strategic industries rather than in pursuit of the highest market return. Revisionists praised this system for its long-term focus. In fact, the absence of market discipline and feedback produced the wild speculation of the bubble economy during the 1980's and the resulting bad debt mess of the 1990's. It has wasted the hard-earned savings of the Japanese people on a truly mind boggling scale.

To regain economic health, Japan must address the bad debt crisis. Insolvent institutions must be allowed to fail. Weak institutions must be merged into stronger ones. Good assets must be separated from bad. Bad assets must be foreclosed on and written off. Without resolution of this central problem, the Japanese financial system will remain paralyzed, and many other beneficial reforms are, therefore, unlikely to do much good. After all, it's hard to have capitalism without capital.

Well, is Japan going to do the right thing? On the positive side, the recently announced total plan does at least create a structure for dealing with the bad debt crisis that could work. But implementation is everything, and the political obstacles that stand in the way of effective follow-through are formidable. Those political obstacles may have been eased or may have worsened by the recent election results. It's too early to know. At this point, a healthy skepticism about expeditious reforms remains in order.

Whatever happens, though, we must face the fact that the United States can do very little to affect this situation. This is not a trade dispute. I disagree with the suggestion that this matter be referred to the WTO. The WTO has neither the mandate nor the competence to address domestic economic policy issues such as those that are currently afflicting Japan. This is a matter of purely domestic economic policy, albeit with international ramifications. And it will be handled or not by the Japanese in accordance with domestic political realities. It's argued, of course, and truly that Japan's problems do affect the rest of the world. Japan's economic weakness is worsening the larger crisis in east Asia. And a full-scale Japanese meltdown could drag the rest of the world into recession.

Well, while it's true that we live in an interdependent world, this is also a world of sovereign nations. As much as it pains us, we do not control the domestic economic policies of other countries. Western Europe, for example, has suffered for years now from chronic double-digit unemployment. This problem saps the vitality of that continent and may, over the long term, breed serious social pathologies.

At the root of the problem are bad policies—rigid labor market regulations and dependency-generating social insurance programs. Although we as Americans and other people around the world would surely benefit from a more dynamic Europe, we realize that we have little standing or leverage to affect domestic policies there. We need to come to the same kind of humble realization with respect to Japan.

If Japan does make necessary reforms, the process is going to be driven not by foreign political pressure, but rather by economic pressure. Japan announced its "Big-Bang" reforms not because of U.S. haggling, but because of the perception that Tokyo was becoming a financial backwater by comparison to the more competitive and dynamic markets of London and Tokyo.

Likewise, the pressure of yen leaving the country in search of a decent return will do more to promote financial restructuring than any amount of U.S. table pounding. Over the long term, the most effective thing that we can do to encourage market-oriented reforms in Japan is to set a good example. If the United States keeps its own house in order, our superior economic performance will act as a spur to the Japanese and other countries around the world to follow our lead. Apart from a good example, we can provide expertise and advice, but we ought to have appropriately humble expectations regarding what they can accomplish. Because, in the end, we cannot force the Japanese to do what's good for them.

Thank you very much for inviting me here today.

[The prepared statement follows:]

"Only Japan Can Solve Japan's Problems"

Testimony by Brink Lindsey
Director, Center for Trade Policy Studies
Cato Institute

before the Subcommittee on Trade
of the House Committee on Ways and Means
Washington, D.C.
July 15, 1998

Mr. Chairman and members of the Trade Subcommittee, I appreciate the opportunity to come before you today to discuss the current economic problems in Japan and their impact on U.S.-Japan trade relations.

Putting the matter bluntly, Japan's economy is a mess. The 1990s have been a lost decade, with growth since 1992 averaging around 1 percent a year. A recession, and perhaps a serious one, is now under way. Unemployment is at record highs. A black hole of bad debt has sucked the life out of the banking system.

Those are just the short-term problems. The deeper structural flaws of the Japanese system are even more daunting. Japan's whole system for allocating capital is broken. The rate of return on capital has now fallen below that in Europe and is less than half the U.S. rate. And over the next two decades, the working-age population will fall by 20 percent – bad news for growth, and even worse news for the country's public pension system.

These grim facts are certainly cause for concern, but they should also be cause for acute embarrassment on the part of those Japan "experts" who not so long ago were claiming that the Japanese economic model was vastly superior to our own. As we discuss in a paper to be published shortly by the Cato Institute, those so-called "revisionists" believed they had discovered in Japan a new and superior form of capitalism: the so-called capitalist development state. James Fallows put it this way back in 1989: "Japan and its acolytes, such as Taiwan and Korea, have demonstrated that in head-on industrial competition between free-trading societies and capitalist developmental states, the free traders will eventually lose." Clyde Prestowitz wrote a book that same year in which he alleged that the United States and Japan were "trading places." And as recently as 1995, Chalmers Johnson went into print with his wisecrack: "The Cold War is over, and Japan won."

What happened? Why did these men, and many others as well, get things so wrong? At the root of the matter is the fact that they completely misread the significance of Japan's distinctive system of allocating capital. They thought it was a major source of Japan's strength. It turned out to be an Achilles' heel.

The Japanese financial system systematically insulated decisions about allocating capital from market signals. With a heavy reliance on bank lending, an absence of transparency and full financial disclosure, and a suppression of equity markets through stable cross-shareholding, the Japanese system allocated funds according to established relationships and government targeting of "strategic" industries rather than in pursuit of the highest return.

The revisionists praised this system for its long-term focus. Access to "patient capital," they believed, took pressure off managers to achieve short-term profitability and freed them to concentrate on market share. In fact, however, the absence of market discipline and feedback has caused the Japanese economy to flounder, and has wasted the hard-earned savings of the Japanese people on a truly mind-boggling scale.

Despite the shortcomings of its financial system, the Japanese economy was able to perform impressively as long as it was playing technological catch-up with the more advanced West. It is much easier to grow and improve productivity quickly by adopting and adapting technologies invented elsewhere than by developing those new technologies internally. And capital can be allocated productively even when market returns are more or less ignored, provided that the trail of economic development has already been blazed. Once, however, Japan reached the technological frontier, the absence of direction from market signals became a serious hindrance.

Ultimately, the blame for Japan's current problems lies with its failure to make the transition from "capitalist development state" to a mature economy at the technological frontier. Instead of making that transition, Japan first faked prosperity by inflating the bubble economy in the late 1980s; then, after the bubble burst, it refused to introduce market accountability into the system. Rather, the Japanese authorities let the bad debt problem fester and worsen. This rot at the core of things has crippled the whole economy.

To regain economic health, Japan must address the bad debt crisis. Insolvent institutions must be allowed to fail, weak institutions must be merged into stronger ones, good assets must be separated from bad, and bad assets must be foreclosed on and written off. Without resolution of this central problem, the Japanese financial system will remain paralyzed, and any other beneficial reforms are therefore unlikely to do much good. After all, it's hard to have capitalism without capital.

In concert with cleaning up the bad debt mess, Japan does need to make additional, broader reforms if it is to recapture its former vibrancy and dynamism. Most importantly, Japan must restructure its entire financial system. It must allow foreign money in, and domestic money to leave freely. It must break down artificial barriers and allow competition to hold sway. In addition, an overhaul of Japan's tax system – and especially a reduction in marginal rates on personal and corporate income – is needed to unleash the productive energies of the Japanese people.

Will these things happen? On the positive side, the recently announced "total plan" at least creates a structure for dealing with the bad debt crisis that could work; also, the "Big Bang" reforms on financial sector deregulation are promising, and some kind of permanent tax cuts appear to be in the works. But implementation is everything, and the political obstacles that stand in the way of successful follow-through are formidable. At this point, healthy skepticism remains in order. And even if Japan does everything right, the next couple of years promise to be rough ones.

Whatever happens, we must face the fact that there is little the United States can or should do to affect the situation. This is a Japanese domestic problem, and it will be handled – or not – by the Japanese in accordance with domestic political realities. The United States can helpfully point out necessary reforms, or it can confuse the issue with bad ideas and irrelevant diversions. But whatever it does, it does from the sidelines. Japan's future is up to Japan.

It is important to distinguish our present concerns about Japanese policy from our long history of trade disputes about access to the Japanese market. Trade disputes should deal only with government policies that discriminate against goods or services of foreign origin. The dysfunctional Japanese policies at issue don't fit that description. Failure to clean up banks' bad debts does not discriminate against foreigners. Neither do punitive tax rates on corporate and personal income. Neither does the hopeless attempt to jump-start economic growth with wasteful public works spending.

It is argued, though, that Japan's problems do affect the rest of the world. Japan's economic weakness is exacerbating the larger crisis in East Asia, and a full-scale Japanese meltdown could drag the rest of the world into recession. There is validity to this line of analysis, although the point can be overstated. After all, the situation in the rest of East Asia is hurting Japan as much or more than the reverse. Furthermore, the U.S. and IMF bailout of Mexico is more to blame for the Asian crisis than anything Japan did.

Nevertheless, it is true that we live in an interconnected world. Prosperity in Japan is good for us, and problems in Japan are bad for us. Our present concerns about Japanese weakness should serve as a lesson to those who used to argue that Japanese strength was a threat to our welfare.

But if this is an interconnected world, it is also a world of sovereign nations. As much as it pains us, we do not control the domestic economic policies of other countries. Western Europe, for example, has suffered for years now from chronic double-digit unemployment. This problem saps the vitality of that continent, and may over the long term breed serious social pathologies. At the root of the problem are bad policies – namely, rigid labor market regulations and dependency-generating social insurance programs. Although Americans would certainly benefit from a more dynamic Europe, we realize that we have little standing or leverage to affect domestic policies there.

We need to come to the same realization with respect to Japan. Unfortunately, standing in the way is a longstanding dynamic in which the United States makes demands and Japan eventually makes concessions. That dynamic has been profoundly unsatisfactory to both sides: the Japanese bridle at being treated like less than a sovereign nation, while we are often frustrated when concessions turn out to be hollow and meaningless gestures.

But whatever the questionable merits of gaiatsu, or foreign pressure, in addressing specific market access issues, it stands no chance of being effective in the present situation. It has been estimated, using fairly conservative assumptions, that the Japanese bad debt mess is six times larger than the U.S. savings-and-loan crisis relative to the overall national economy. Successful resolution would surely cause a wave of bankruptcies and a dramatic rise in already record levels of unemployment. On the other hand, failure to come to grips with the problem could lead to a total collapse of the financial system. In short, the domestic stakes are so tremendous that U.S. nagging will barely even register in the balance.

If Japan does make necessary reforms, the process will be driven not by foreign political pressure, but by economic pressure. Japan announced its "Big Bang" reforms not because of U.S. haggling, but because of the perception that Tokyo was becoming a financial backwater compared to the more competitive and dynamic markets in New York and London. Likewise, the pressure of yen leaving the country in search of a decent return will do more to promote financial restructuring than any amount of U.S. table-pounding. In this regard, it should be noted that currency interventions to prop up the yen perversely alleviate that pressure, although the effect is probably only fleeting.

Over the long term, the most effective thing we can do to encourage market-oriented reforms in Japan is to set a good example. If the United States keeps its own house in order, our superior economic performance will act as a spur to the Japanese, and other countries around the world, to follow our lead. In the end, though, we cannot force the Japanese to do what's good for them.

Thank you again for inviting me here today, and I look forward to answering any of your questions.

Chairman CRANE. Thank you, Mr. Lindsey.
Dr. Pyle.

STATEMENT OF KENNETH B. PYLE, PROFESSOR, HISTORY AND ASIAN STUDIES, UNIVERSITY OF WASHINGTON, AND PRESIDENT, NATIONAL BUREAU OF ASIAN RESEARCH, SEATTLE, WASHINGTON

Mr. PYLE. Thank you, Mr. Chairman. As I understand, my assignment in this hearing it is to discuss the political background of our relations with Japan at this time. I will not attempt to discuss specific trade issues per se but rather the broader context of Japan-U.S. relations within our present—within which our present trade negotiations are set. As a result of Sunday's election, the resignation of the Prime Minister, present gaping vacuum of political leadership have further exacerbated what I believe had already become the greatest political economic crisis Japan has faced since World War II.

It is a systemic crisis. The problem is not only the prolonged economic slump, the unresolved banking crisis, and the uncertain progress of deregulation, but rather in a long succession of crises in this decade, since the end of the Cold War, Japan has shown a bewildering lack of purpose and direction, a pattern of paralysis and immobilism in its policy making, and a dismaying lack of leadership.

In addition to the failures, to deal with the economic and financial crisis, there are many other examples of immobilism. At the beginning of the decade in the Gulf War, there was the utter failure of Japan to muster coherent support for the international coalition. And then, during our standoff with North Korea over its nuclear program in 1994, Japan was unable to decide whether it could provide backup assistance for U.S. forces should there be a conflict right next door on the peninsula.

Japan has reluctantly agreed to our insistence on a revision of the Defense Cooperation Guidelines, but there is a mountain of legislation that will be required to make these guidelines operational. And the whole issue of whether Japan is willing to engage in collective self-defense remains unresolved.

In the Kobe earthquake and the nerve gas attack in the Tokyo subways in 1995, and then in the 1996 Peruvian hostage crisis at the Japan ambassador's residence, Japan demonstrated an appalling lack of effective crisis management. Japanese leadership has also failed to reach consensus about responsibility for its militarist past, at great cost to Japan's international standing.

In short, there is a broad pattern of systemic stalemate, a paralysis of institutions and policymaking that cast doubt on the likelihood of Japan's ability to contribute to solution of the Asian financial crisis, or to achieve any time soon the long promised opening of Japanese markets to trade and investment.

The Japanese system, which worked so well during the high-growth period and during the unique circumstances of the Cold War, and which only a decade ago was widely expected to offer world leadership, is floundering. The Japanese ship of state today is adrift, and there's presently no one at the helm.

Five years ago, when the LDP was overthrown after 38 years of one-party rule, many observers in Japan and abroad thought the upheaval would lead to sweeping reforms and bring to power new faces, reformers with new ideas of openness and change and a new sense of national purpose.

Since then, however, politics have been in a rudderless state. Parties have experienced a dizzying display of realignments. In less than five years, we've had four changes of government, six prime ministers, and the sharing of power by 11 political parties. The opposition parties proved even less able than the LDP to provide decisive leadership.

Today, the LDP again has a majority in the lower house, but has just lost its hope of controlling the upper house. The opposition parties are fragmented, the reformers in disarray, and the electorate so alienated that fully half of the voters support no party. Moreover, the LDP itself is internally divided over fundamental issues of reform and economic policy.

The bureaucracy, which gave Japan strong purposeful leadership through the post-war decades, is today demoralized and disoriented by scandals, turf struggles, and a lack of clear direction. At the same time, it is holding fast to its power and influence.

How are we to account for the paralysis of Japan's political leadership since the end of the Cold War? There are, of course, immediate causes, such as fundamental disagreement over whether tax cuts and stimulative spending would worsen already substantial government deficits and undermine the fiscal discipline required to deal with Japan's rapidly aging population. But if we look for deeper causes of this immobilism, they are to be found in the legacy of the policies and institutions that remain from the catch up period and the unique role that Japan played in the international system during the Cold War period. The century-long campaign to catch up with western industrial economies left many deeply entrenched interests and institutions, especially the iron triangles among bureaucracy, industry, and ruling party, which are resistant to reforms.

Moreover, the post war exclusive concentration on economic growth left many political strategic institutions undeveloped, including the weak prime ministership.

Another fundamental reason is the consensual decision making process of Japan. It is ponderous in times of uncertainty. And in Japan's post Cold War external environment, there are huge uncertainties, including the globalization of capital markets, the rise of China, the prospect of Korean unification, and so on.

Historically, in such times of uncertainty in its external environment, Japan has typically held back, watched and waited for trends to clarify. Japan is not disposed to international leadership. It is typically adaptive to its environment, opportunistic and pragmatic, moved by national self interests. It has a powerful conservative tradition in its society and politics. Most Japanese policy makers are deeply resistant to American-style, market-led reforms, which they are believe are too unpredictable in their social consequences. Many policy makers, such as Mr. Sakakibara, the key MOF official in international trade matters, still have faith in a Japanese-style capitalism.

What all this adds up to in my judgement is a continuing and prolonged period of drift and instability in Japanese politics, making Japan a difficult and uncertain partner for the U.S. in world political economic affairs. Despite the fact that many of its fundamentals are good, there is little prospect that Japan will muster the leadership to quickly stimulate its economy, boldly reform its financial institutions, and thereby strengthening the yen and help lead Asia out of regional contagion.

On the contrary, Japan appears to be cutting back in critical ways. Accordingly, this systemic fatigue and gridlock in the politics of our principal ally in the region enhances the imperative for American leadership. We will have no choice but to continue prodding and pressuring Japan, both bilaterally and, when possible, multilaterally to take steps its system is resisting. There is very deep resentment of American hectoring, and we need to be wise in how we do it.

Fortunately, as a result of America's restored economic and political influence, Japan has a renewed appreciation of the indispensability of its alliance with us. And we possess very considerable leverage.

Thank you.

[The prepared statement follows:]

Testimony of Kenneth B. Pyle

Professor of Asian Studies at the University of Washington and
President of The National Bureau of Asian Research

House Committee on Ways and Means
Subcommittee on Trade

July 15, 1998

I would like to thank Chairman Crane and the other Members for inviting me to appear before the Subcommittee on Trade to testify on U.S.-Japan trade relations. As I understand the terms of reference for these hearings you would be interested in my views of the political background of our relations with Japan at this time. I will not attempt to discuss specific trade issues *per se* but rather the broader context of Japan-U.S. relations within which our present trade negotiations are set.[1]

For Japan, the Asian financial crisis is the latest in a veritable tide of troubles that has swept over the country in the 1990s. In the face of these troubles Japan has shown a bewildering lack of purpose and direction, a pattern of immobilism in its policymaking, and a deeply dismaying absence of leadership. The problem is not simply the recent Asian financial crisis, nor is it the prolonged economic slump, the uncertain progress of deregulation, and the unresolved banking crisis. Rather, in a succession of crises since the end of the Cold War, Japan has exhibited a peculiar pattern of passivity, indecisiveness, and failure to come to grips with the problems facing the nation. As a consequence Japan has suffered a dramatic diminution of its international stature.

One is struck by the contrast between the confident expectations of the 1980s and the dismal realities of the 1990s. During the previous decade it appeared that the tide of history was with Japan. It was the hallmark of the Nakasone years (1982 to 1987) that Japan must increasingly play the role of leader in the international system and set forth its own objectives and principles. "Having 'caught up' [with the Western nations]," this dynamic and colorful prime minister said, "we must now expect others to try to catch up with us. We must seek out a new path for ourselves and open it up ourselves."[2] The Japanese believed that they were destined to become the world's economic, scientific, and technological leaders in the next century. The belief that Japan would lead a new wave of revolutionary change in the twenty-first century was widely held and Prime Minister Nakasone's circle argued that economic leadership in the world would require political leadership as well.

Nakasone had an impressive grand design to prepare for Japanese global leadership that entailed reforming Japan's institutions, restoring national pride in Japan's modern history, and above all adopting an active role in strategic affairs. He aimed to replace the country's politically passive policies with an activist foreign policy that envisioned a Japan engaged in international strategic issues, participating in its own defense, and possessing its own goals and values. In photo sessions at G-7 meetings, Nakasone pushed to the center and stood tall, chatting affably with Reagan and Thatcher. The Ron-Yasu era was a heady time and the rest of the world was duly impressed. The cover jacket of Paul Kennedy's best selling *The Rise and Fall of the Great Powers* showed a jaunty Japanese carrying the Rising Sun, mounting the stage of world history as

[1] The testimony is excerpted from my forthcoming essay "Japan's Immobilism" to appear later this month in the *NBR Analysis*.

[2] Quoted in Kenneth B. Pyle, *The Japanese Question: Power and Purpose in a New Era,* 2d ed., Washington, D.C.: The American Enterprise Institute, 1996, pp. 89-90.

a tired Uncle Sam followed an aged John Bull off the stage.

In a truly startling reversal of fortune, the post-Cold War period has brought Japan a tsunami of troubles that has utterly frustrated the expectation of an activist Japan as a world leader. Consider this succession of troubles in the 1990s and the peculiar immobilism of Japan's leadership:

(1) At the beginning of the decade the Persian Gulf War revealed a paralysis of policy in which Japan, unable to muster coherent support for the international coalition (despite the fact that 70 percent of its oil came from the Persian Gulf), ended up writing checks for $13 billion for which it got little thanks and much derision.

(2) In 1993 when the Liberal Democratic Party (LDP) was overthrown after 38 years of uninterrupted government, many observers thought that the end of one-party rule and the passage of electoral reform legislation in 1994 would bring to power new faces with new ideas and a new sense of national purpose. Since then, however, politics have been in a rudderless state. Parties have experienced a dizzying display of realignments. In the ensuing three years there were three changes of government, five prime ministers, and the sharing of power by eleven political parties. The opposition parties proved even less able than the LDP to provide decisive leadership. Today the LDP is back in power again, the opposition parties are fragmented, the reformers in disarray, and the electorate so alienated that, in recent polls, fully half the voters respond that they support no party.

(3) In 1994, when the showdown with North Korea over its nuclear weapons program made war appear imminent, the U.S. command in Japan asked the Japanese government to contribute fuel and material for American forces, to provide ships and planes for sweeping mines and gathering intelligence, and to cut off financial flows to North Korea. Japanese officials were unable to respond whether or not they could provide such assistance. If conflict had ensued and American forces had not had access to Japanese bases, Defense Secretary William Perry later said, "it would have been the end of the alliance."

(4) In 1995 an earthquake devastated the major port city of Kobe, and in its aftermath the prime minister and government demonstrated appalling incompetence in crisis management. Self-Defense Forces were slow in being dispatched and got lost in a traffic jam that kept them from efficient rescue operations.

(5) In the same year the Aum Shinrikyo cult released nerve gas into Tokyo subways, killing a dozen people: its biological work was meant to be thousands of times more devastating. We now know that Aum had previously carried out at least nine biological strikes: its targets were the Diet; the Imperial Palace; the surrounding city; and the American naval base at Yokosuka. The attacks failed because Aum never got hold of germs of sufficient virulence. Japanese authorities knew nothing of the attacks until long after they had occurred.

(6) In 1996 the 126-day hostage crisis at the Japanese ambassador's residence in Lima, Peru, revealed a startling lack of resoluteness, crisis management, and determination to take a principled stand. Prime Minister Hashimoto made it clear that his concern was not with resistance to terrorism. Peruvian President Fujimori acted decisively on his own to resolve the crisis knowing that the Japanese government, if informed, would pressure him to try alternative solutions. Japanese commentators subsequently reflected on what they called Japan's "cowardice" in dealing with terrorism.

(7) Throughout the 1990s Japanese leaders have failed to lay to rest the burdens of the nation's militarist past, at great cost to Japan's international standing and its own self-respect. This was particularly evident on the occasion of the fiftieth anniversary of the end of World War II. At that time, the Diet deliberated at great length and without success on a resolution of apology meant to express a commitment to peace based on the lessons of history. Issues of the "comfort women," germ warfare experiments, the Nanjing massacre, etc. continue to fester.

(8) In the Asian financial crisis Japan has displayed policy paralysis once again. The burst bubble and prolonged economic slump have presented the world with a picture of immobilism and disarray and exposed Japan to a chorus of criticism. Coming after several years of economic stagnation, uncertain progress in deregulation, and the unresolved problems of banking debt, Japan's failure to stimulate economic recovery has threatened to exacerbate the regional contagion and has exposed Japan to a chorus of criticism not only from America and Europe but from other Asian countries. President Clinton's effusive praise for China's "great statesmenship and strength...[which serves] the entire region by maintaining the value of its currency" contrasts sharply with Washington's impatience with Japan's policymakers. Isolated, self-absorbed, and resentful of foreign hectoring, Japan is in danger of bearing the blame should the Asian crisis deepen.

Moreover, Japan's continuing economic problems diminish in important ways Japan's capacity for regional political leadership. First of all, Japan is cutting its Overseas Development Assistance (ODA) budget by 10 percent in 1998. It is likely that this year Japan may lose its position as the number one donor of foreign aid, a position it has held for the past seven years. A new study by a blue ribbon committee advising the government calls ODA "Japan's principal foreign policy tool" and recommends that if it is to retain public support it must be deployed in a much more focussed manner to serve Japan's strategic self-interest. Most foreign commentators thought Japan was already doing this, but, as a result of Japan's economic problems, it is likely that Japan's overseas assistance will be more sharply focused in its strategic purposes. Keidanren, the business association of elite corporate leaders, is calling for a return to tied loans.

Second, economic constraints have led Japan to cut its defense budget in 1997 and it is likely to be cut again. There is also increasing talk about the need to cut back on so-called "host nation support" for the U.S. military bases in Japan. Beginning in 1978 the Japanese government, some would say without any legal basis, began paying part of the allowances of Japanese civilian workers at U.S. bases. Officials explained that Japan was offering the contribution as a "sympathy" outlay to show its consideration for the U. S. forces. Over the years it has grown to 44 times the original sum. Today it is close to $6 billion annually and covers 70 percent of the cost of stationing U.S. troops in Japan—including housing and welfare facilities, utilities, land rent, etc. In a 1998 *Foreign Affairs* article, former Prime Minister Hosokawa advocated an end to all host nation support when the present agreement expires in the year 2000. Citing Japan's "serious financial crisis" as well as the diminished threat in the post-Cold War era, he concluded that "the U.S. military presence in Japan should fade with the century's end."[3] To combat such sentiment, former Prime Minister Nakasone, who had always favored a more autonomous Japanese defense system, defended provision of host nation support, but did it in such terms as would make Americans wince, telling a Japanese audience that it was a good thing that Japan "provides money to the United States, allows its troops to be stationed in Japan, and uses them as watchdogs." The reference to "watchdogs" (*banken*), which carries the connotation of mercenaries, was startling because the term has been used before by Japanese politicians in derogatory reference to American troops stationed in Japan.[4]

Third, Japan's financial difficulties will increase the reluctance with which it supports the Korean Energy Development Organization and its lukewarm support for Korean reunification, since the latter will undoubtedly be enormously costly and strategically problematic for Japan. The depreciation of the Korean *won* had made it appear that Japan's share (20 percent) of the cost of light-water reactors for North Korea could be reduced. After initially resisting U.S. entreaties, the Japanese government decided—again reluctantly—to stick to its original commitment, perhaps fearing that in the aftermath of nuclear testing in South Asia North Korea might change its mind about suspending its nuclear program and seek help from Pakistan. It is also possible that the recent nuclear tests in South Asia may have made the Japanese somewhat more receptive to joining theatre missile defense programs with the United States, a decision which they have long delayed, but it is more likely that cost as well as technological and political considerations will cause them to continue to defer a decision.

Fourth, the financial crisis will weaken Japan's "Asianist fever" and take a good bit of the momentum, at least for the time being, out of its fundamental Asian strategy, which has placed great reliance on a combination of trade, investment, and aid to establish Japanese political-economic leadership in the region.

Lastly, the crisis has tarnished the value of the Japanese model of economic development, which the Japanese had regarded as an essential ingredient of their capacity to give leadership to Asia.

(9) There is one more element in the string of troubles which outweighs the others in

[3] Morihiro Hosokawa, "Are U.S. Troops Needed in Japan?" *Foreign Affairs,* vol. 77, no. 4 (July/August 1998), pp. 2-5.

[4] *Asahi shinbun,* October 5, 1997.

many respects and is the most perplexing and problematic for Japan's harried leaders—the rise of China in the 1990s. Nothing has been so psychologically jarring to those Japanese who think about their future strategic role and their aspirations for leadership in Asia. Taken together with all the other troubles enumerated above, the rise of China has greatly diminished the Japanese self-confidence that was so irrepressible in the 1980s. The potential size of China's economy, the uncertainty about its future power and purpose as a nation, the potential magnitude of its problems of environmental degradation, competition for resources, and possible political and social turmoil have all justifiably alarmed the Japanese. Perhaps equally jarring has been the way in which world attention has turned from the Japanese miracle to fascination with China. President Clinton's extended trip to China was closely watched by the Japanese, who are increasingly wary of the potential for change in the triangular relations among China, Japan, and the U.S.

Partly as a result of American dissatisfaction over Japan's response to the Gulf War and to the confrontation with North Korea, and partly as a result of the Taiwan Straits crisis in March of 1996, Japan has reluctantly agreed to U.S. insistence on a revision of the guidelines for the U.S.-Japan security treaty. These revised guidelines provide for an increased but still modest role for Japan in the event of a regional crisis and seek to draw Japan into a tighter, more integrated, more reciprocal, and therefore more effective operational alliance.

Once again, however, one is struck by the slow and limited way in which Japan has dealt with this issue. There is, as many observers point out, a "mountain" of legislation required to initiate these guidelines. The government is moving slowly and deliberately with this legislation and it is likely to be some years before this new, limited role is operational. Above all, Japanese leaders have yet to deal with the unresolved issue of "collective self-defense" and to involve the Japanese people in the solution. The Japanese government continues to maintain the curious position that while all nations under the UN charter possess the right of collective self-defense, Japan cannot exercise this right. So long as this position is maintained, Japan will contribute little leadership in the strategic issues facing Northeast Asia.

How are we to account for the paralysis of Japan's political leadership in this decade? For each of the nine crises cited there are, of course, a number of proximate causes for vacillation. For example, with regard to economic policy there are conflicting concerns among policymakers that tax cuts and stimulative spending would worsen already substantial government deficits and undermine the fiscal discipline required to deal with Japan's rapidly aging population.

If we look, however, for fundamental causes of the overall pattern of immobilism, they are partly to be found in the legacy of the policies and institutions that remain from the catch-up period and the unique role that Japan played in the international system during the Cold War. The century-long campaign to catch up with the Western industrial economies left many deeply entrenched interests and institutional practices, especially the iron triangles among bureaucracy, industry, and ruling party, which are resistant to change and reforms. Moreover, the postwar exclusive concentration on economic growth left many political-strategic institutions undeveloped. The weak prime ministership, the lack of crisis management practice, and the inexperience of deploying armed forces are glaring examples.

Another fundamental cause of immobilism is the nature of Japanese decision making in circumstances of uncertainty. The late Professor Kosaka Masataka, an astute observer of Japanese political behavior, stressed the government's difficulty of reaching consensus in situations of great uncertainty. "Consensus is obtained without great difficulty when the nature of the task is clear. Often, for instance, the Japanese have been good at adapting to strong, decisive pressures from outside. But when the situation is blurred, they are in trouble."[5] From his own experience with Japanese diplomatic method, Henry Kissinger writes of the "painfully—and sometimes maddeningly" slow consensual decision making process. He anticipates therefore that Japan will accommodate to the new post-Cold War circumstances in a cautious and cumulative fashion. "The role of Japan," he writes, "will inevitably be adapted to these changed circumstances, though following their national style, Japanese leaders will make the adjustments by the accumulation of apparently imperceptible nuances." In a closely related additional reason, Kissinger points to the weakness of the Japanese prime ministership: "No single person—not even the prime minister—has the authority to make a decision."[6]

Such consensual decision making is ponderous in times of uncertainty such as the present post-Cold War interregnum in East Asia when the outlines and structure of a new order of things is very unclear. Unlike in Europe, there are a host of issues left unresolved from the Cold War: a divided Korea, the Taiwan issue, the lack of a Russian-Japanese peace treaty, and the persistence of communist governments in several countries. Until these issues are resolved (especially the Korean one) the outlines of a new order will remain very unclear. So long as this interregnum continues, I do not believe that Japan will make fundamental decisions about its future. Why?

If we look at the last 150 years of Japanese foreign policy, a recurrent pattern of behavior stands out. Japan has tended to accommodate to major changes in its international environment. The common approach at periods of fundamental transition in the international system such as we are now in has been to hold back, watch and wait for trends to clarify, and then to adjust to the new international environment when it is clearly established. A good illustration of this approach comes from an interview with Kato Koichi, a likely future prime minister who is better versed on Sino-Japanese relations than any other politician. His attitude toward issues with regard to China is: let's wait and see. China will not be a threat for another generation. He is a master of ambiguity. As Morita Minoru, one of Japan's leading political commentators, says, Kato is a classic LDP

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[5] Masataka Kosaka, "The International Economic Policy of Japan" in Robert A. Scalapino, ed., *The Foreign Policy of Modern Japan*, Berkeley: University of California Press, 1977, p. 222.

[6] Henry Kissinger, *Diplomacy*, New York: Simon & Schuster, 1994, pp. 827-829.

politician in his approach. "Regardless of the issue, he takes a passive stance—he waits for events to develop before making a decision."

Japan has been guided throughout its modern history by pragmatic nationalism rather than by fixed principles. An opportunistic adaptation to international conditions in order to enhance the power of the state has been characteristic of Japanese foreign policy. Some observers of Japan today feel that the Japanese are in the midst of a great debate about their international role and that once they arrive at consensus, Japan will change. Others looking at the quiet influence Japan exercised in the formation of the Asia Pacific Economic Cooperation (APEC) forum and the ASEAN Regional Forum (ARF) argue that Japan is leading from behind—a kind of stealth leadership.

I do not see it either way. My argument, in short, is an outside-in one.[7] The Japanese historically have been shaped by and have adapted to changes in their international environment. Moved by a keen pragmatic sense of national interest, Japan has repeatedly accommodated to fundamental changes in the structure of international politics. It has repeatedly allied itself with the dominant, ascendant power (Great Britain, Germany, the United States). Moreover, it has tended to make fundamental changes in its domestic institutions as part of its process of adjustment to a changed international system.

Today, while uncertainty prevails in so many ways in Japan's external environment, Japan will not make fundamental decisions. It will move very slowly and cautiously. However, once such issues as a divided Korea, China's future, and the nature of the U.S. commitment to the region become clear, Japan will accommodate itself to this new order of things. Moreover, it will accommodate with a speed that will surprise those who look only at the present immobilism.

This historically rooted approach of caution and circumspection to the present interregnum on the part of our principal ally in the region enhances the imperative for American leadership and formulation of a long-term strategic vision for East Asia.

[7] I have developed my argument in the 1997 Edwin O. Reischauer Memorial Lecture reprinted in the *International House of Japan Bulletin*, Summer 1997.

Chairman CRANE. Thank you, Dr. Pyle.

Dr. Hormats, the resignation of Prime Minister Hashimoto has created uncertainty about the future direction of economic policy in Japan, and it's clearly too soon to tell what will happen yet. But do you have any sense of the prospects for continuing reform and deregulation?

Mr. HORMATS. I think, Mr. Chairman, that we know a few things. I'm always hesitant to make judgements about other countries' politics. But there are a couple things we knew.

One is that a large—far larger number of people voted in this election that had been anticipated. The general view was that maybe 35 percent or 40 percent of the electorate would vote. Fifty-nine percent actually voted.

Chairman CRANE. Ten percent more than we.

Mr. HORMATS. That's right.

And in the urban areas, the LDP won virtually no seats—none, if I'm correct. Or a very small number. So there was clearly two things happening: one, a lot of people went out of their way to express frustration and disappointment and annoyance with the LDP. And second, in the urban areas, as opposed to the rural areas, where there is strong LDP constituencies in the urban areas, the LDP was a disaster. So this must convey some signal to the LDP about frustration.

What it portends about future reforms is harder to determine, however. As the testimony that we've heard today, I think, would indicate one should not make the judgment that the frustration with the LDP means that the electorate supports the kind of bold reforms that most here would advocate, which is to say particularly a very dramatic adjustment—reform of the banking and the real estate sectors—or these systemic kinds of reforms that have been discussed here. On the contrary, there are probably a lot of Japanese who regard those as so wrenching and so disruptive of labor markets that they would not support them. So I don't think we can necessarily make the judgment that this election result means that they're going to proceed quickly down the road toward bold stimulus, reform of the banking system, or reform of the property markets. The stock market, I think, began to believe that the day afterwards—certainly, the Japanese stock market did. Ours did as well. But I'm a lot more cautious and circumspect than that.

Chairman CRANE. Mr. Prestowitz, in your book, Trading Places, you advanced some arguments about the Japanese economic success in the 1980's that I didn't agree with you on, but I wonder if you still hold the same view that you expressed in Trading Places.

Mr. PRESTOWITZ. Thank you.

Yes, basically, I do. And I think that—let me pose a question back to you. Mr. Lindsey here made the comment that I, as a revisionist, was wrong about Japan. And both he and you have proceeded on the assumption that I was praising the Japanese system as a superior system. I'm kind of baffled by this because I've been attacked in the press. I've been attacked by Mr. Lindsey's institute as a Japan basher. I mean, I'm one of the well-known Japan bashers. I can't figure out how I can be a Japan basher on the one hand, and an advocate of the Japanese system on the other hand. It's not logical.

Chairman CRANE. Oh, I didn't accuse you of it.

Mr. PRESTOWITZ. So let me try to explain this. I lived in Japan in the 1950's and the 1970's and worked in the government and negotiated with Japan in the 1980's. In those years, the Japanese system was doing very well and was displacing U.S. industry in a number of areas. And I described how the Japanese system worked and how it was doing that. Now, a very interesting point is that I said at that time that Japan's was a mercantilistic, crony capitalist system. And when I said that, I was attacked by Mr. Niskanen, who's the head of Mr. Lindsey's institute, and by other leading economists who said, "no, Japan is just like us." It's a good neoclassical economy. Well, now it turns out that, in fact, it was a mercantilistic, crony capitalist system, and we're now seeing that not only did it imply some damage to the U.S. in the 1980's, but it now, the system now threatens not only the U.S. but itself and the rest of Asia.

Chairman CRANE. Are you arguing that nothing that you said in Trading Places was a recommendation that we might emulate Japan in some areas?

Mr. PRESTOWITZ. No, of course, not. I mean, look. I wasn't 100 percent right. Even I make mistakes. And, you know, there were some things in Trading Places, if I had to write it over again, I'd write it differently. By the same token, the fact that Japan now has problems doesn't mean there's nothing we can learn from Japan. Japan's not all wrong. It has just got some significant structural issues.

Chairman CRANE. Okay, we've got to give Mr. Lindsey equal time.

Mr. LINDSEY. Well, it's good to see that Mr. Prestowitz remains a revisionist. Now he's revising what he used to say.

The debate back in the 1980's was in the context of Japanese economic success, and the question was what's causing that success. The revisionists thought it was due to the hand in glove relationship between industry and government, occasional targeting of specific industries for support, and for the closed financial system that allocated capital on what was thought to be a patient and long-term view.

Those of us on the other side, who were then called naive, free-market ideologues, said, "no, Japan's economic success is due primarily to market factors"—to low taxes and low spending for many decades after the war—low government spending and also to the entrepreneurial ingenuity of Japanese corporations which devised new and superior manufacturing techniques, which did, indeed, in specific industries, though not across the board, knock American companies back on their heels for a number of years, until, American companies learned to mimic and adopt those practices on their own.

So the issue was what caused Japan's success. The free market folks never denied that Japan had interventionist elements. We simply said that Japan was succeeding in spite of those elements and now it is sadly apparent that those interventionist aspects of the Japanese system, which won high praise from the revisionists, have now been Japan's undoing.

Chairman CRANE. Thank you.

And Dr. Paal, you mentioned that the replacement of Hashimoto is not necessarily bad. How long do you think it will be before the newly chosen leaders can take serious steps to correct the problems in the Japanese economy and banking sector?

Mr. PAAL. Well, as I discussed earlier, Mr. Chairman, there's a difference between theory and reality here. In theory, they could begin very soon. They have a due date of getting a new cabinet together by the 26th of July and getting the bridge bank legislation through in a very hurried-up session at that time, and then addressing tax reductions later in the year.

I think the chances of those things happening in lock step are rather small. As an observer of the Japanese scene for quite a long time, I think that the array of Japanese leaders ready to take the bit in the teeth and go with it is so narrow and waiting so long to be senior enough to take the top leadership posts that I would think we'd have to keep our expectations low. It's for that reason that I recommend we adopt as a nation a more activist policy.

Japan has in its history had four occasions when its economy has gotten into real trouble and it has needed help. The first was the 1880's, and they had an internal strong man who led the charge to fix it, Count Matsugata. It happened again in the 1930's, and the Japanese turned their policy over to the military. The military marched on until they lost the war. It happened again in the 1940's when Horace Dodge from the United States was brought in to straighten out Japanese economics. And today, we're witnessing the fourth time.

Given the peculiar circumstances of this versus the previous occasions, I think this is a time when we ought to take a proactive, constructive, all-embracing approach. It may fail. But the alternative of doing nothing is likely to lead to nothing.

Chairman CRANE. And one question that I'd like to put out to all of you folks, and it's a—from a written statement that we received from Richard Fisher, who's Deputy USTR. And it was at the recent APEC ministerial meeting in Malaysia. He stated that Japan, this is a quote, "Japan pursued a course of action that could undermine the entire APEC initiative and cast doubt not only on Asia's recovery, but also on APEC's effectiveness."

And I'd like to throw that out to all of you. Do you basically agree with that assessment? I mean, is that your reading?

Fire when ready, Gridley.

Mr. PRESTOWITZ. I'm not sure we understand. Would you repeat that?

Chairman CRANE. Yes, at the APEC ministerial meeting in Malaysia, he said, "Japan pursued a course of action that could undermine the entire APEC initiative and cast doubt not only on Asia's recovery, but also on APEC's effectiveness."

Mr. PAAL. Mr. Chairman, I know something about what I think is being referred to by Mr. Fisher's statement, and that is that at the APEC ministerial, the Japanese raised reservations about the voluntary sectoral trade liberalization measures that had been promised by the APEC leaders at their previous meeting. Japan, at the previous meeting, had introduced reservations in the areas of agriculture and fisheries, because that's always been a difficult and sensitive area in their ministry. And they raised them again this time in a context when other countries were coming forward with liberalizations that they had promised in the November meeting last year.

In some ways, it should not have been a surprise to the international community that they did this, because it's always been a sensitive issue. It was the wrong note to sound at the wrong time, in an era when everyone is being stricken by closing markets and other kinds of economic difficulties. And that I think goes back to the point many of us were making earlier, which is that Japan today is not in a—its leadership appears not to be a position to be able to override this narrow sectoral interest, such as agriculture and fisheries posed inside Japan.

Chairman CRANE. Anyone else have a comment on that?

Mr. LINDSEY. Just assuming that that was, indeed, what was at issue, and I wasn't able to pick that up from that one comment—however unconstructive Japan has been with respect to voluntary sectoral liberalization within the APEC process, I think those kinds of sectoral issues must be put in context, and they pale in importance next to the huge central issues that face Asia today: Japan dealing with its bad debt crisis; and the rest of Asia dealing with their broken and dysfunctional financial systems. So I think putting too much emphasis and too much heat on Japan with respect to narrow sectoral issues is simply bad prioritization. We ought to keep our eyes on the ball, and the ball is getting the financial system back into operation.

Chairman CRANE. All right. Dr. Pyle, why does Japan continue to play such a reticent stand-on-the-sidelines role in the WTO and in APEC?

Mr. PYLE. Well, Japan, as I said, is not disposed by its nature to be an international leader. Some people, for example, have said that Japan is leading from behind in organizations like APEC. Doug Paal is absolutely right in what he described here as Japan's failure to play a leadership role on this very important issue. It's still really governed by narrow private interests, and those private interests too often collide with the kind of free-trade leadership that is required in WTO and other such international efforts.

Chairman CRANE. Thank you. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Clyde, I might just add with respect to your book and some of the writings I read over the 1980's, I don't—I frankly think you were right. I think what's happening in Japan right now bears out some of the things you were saying about the Japanese economy. You were mainly talking about how to open up the Japanese market because there was a certain amount of controls through the regulatory process and obviously the banking system. And I think, you know, from what happened recently, over the last few years, it bears out your concept of what the Japanese economy was actually like.

I might just want to pose maybe to all of you, particularly Mr. Hormats, each one of you said something that was very important and very interesting. So I'm going to take parts of it. Dr. Pyle talked about the fact that the Japanese government drives the system as the bureaucracy and obviously it requires a consensus. And it's a very slow process. At the same time, I believe the other four of you, talked about the fact that the Japanese need to do something on both the financial institutions, which are in deep trouble at this time. And the fix that they made a few months ago is not sufficient. They need to stimulate its economy. And until there's a permanent tax cut or some direction, probably nothing substantive will, in fact, happen. And obviously, the whole issue of deregulation.

And then, there's also an attitudinal problem in terms of permanent employment and things of that nature. The problem I see is that each one of these three or four requires dislocation and a great deal of turmoil in the Japanese economy, which they're really unwilling to face up to. And that's why, perhaps, the Prime Minister had to resign, and that's why there's some uncertainty and instability going on now—both the political system and in the economy.

Given those elements and given the fact that you're not going to see them solved probably anytime soon, and then you all talked about, and I think it was almost unanimous, that we're seeing something that we hadn't seen since perhaps the 1930's, at least prior to World War II, prior to the war, and during the time of the Depression. What are the prospects? I mean, what can we do? Amo, I wish Amo Houghton was here because when he spoke with Mr. Fisher, he suggested that we need to talk about macroeconomic policy and members of Congress will have to show a little discipline and not speak so much about our specific commodities and specific issues, which I'm sure the next panel is going to do, just as we would probably expect them to do. That's not what we really need to do right now.

But that being the case, what should the United States do, given the limited amount of control? We can hector, as I believe Mr. Rubin is trying to do in a way that is very moderate and at the same time a lot of stability in our market. What can we do? What are the steps that we can take? Obviously, we have to do something with the IMF—probably fully fund that. But beyond that, what can the U.S., in fact, do? Mr. Hormats, and then maybe each of you.

Mr. HORMATS. Okay, let me just try a couple of thoughts. One, I think funding IMF. I very much agree. I think the numbers are getting dangerously low. The Fund has to put money into Russia, and who knows what's coming down the road. And this is a something that really needs to be done, at least to help bolster confidence—not that the Fund is perfect, but that we don't have any substitute for it at this point.

Second, I would make a point about the World Trade Organization. One of the very positive elements in this otherwise terrible carnage in east Asia today is that the countries have avoided wholesale retreat to protectionism, this is something that might not have been possible perhaps 10, 15 years ago. Then you might have had a lot of countries reverting toward protectionist measures. The fact that there are World Trade Organization rules and penalties toward protectionism have helped to provide a counterweight to those in these countries who might have advocated that course. Also the IMF and the Treasury and the USTR have moved in that direction as well. So, keeping the World Trading Organization rules before these countries and avoiding protectionism abroad is important. The same is true here: avoiding a lot of restrictions against these countries. We're going to have a big trade imbalance with the rest of Asia for quite some time to come. And if we succumb to measures to protect our economy, as strong as it is, then these weaker economies are going to use that as a pretext. So that's a second thing.

Third, the point I made in my written testimony, when I mentioned earlier—I think it's very critical now that we—urge Japan to move at a rapid rate to deregulate the real estate sector and improve the banks. I think they've got to determine how to do that, given their own political circumstances. I think they should do it more rapidly, but we don't know how quickly they feel they can tolerate it in terms of their own domestic politics.

I think we can provide a lot of expertise to the Japanese regulators, to the Japanese banking system, to the people who are in charge of these bridge loans. There are a whole new series of institutions that have been set up or are going to be set up to address the bad bank problem, the bad loan problem, and the frozen real estate collateral problem. We have a great many people here—former RTC people, bank people, Fed people, regulatory experts—who can help them do that. That can expedite the process. It's not only true in Japan. It's true all over Asia. And it's not money. Japan doesn't need our money—but our expertise, our experience in this area, I think, could be of vital significance. And that's one of the things I would very much recommend.

Mr. MATSUI. Thanks very much.

Dr. Paal?

Mr. PAAL. Mr. Matsui, the drift in Japan, the lack of focus is just hard to believe for someone who's a frequent visitor there. And that drift has become more conspicuous in recent months. In many ways, Japan is where Great Britain was at the turn of the 20th century. They have a choice. They can have their tea ceremonies and funny hats and live off their savings for the next 80 years, and hope to make it as a nation. Or they can really undertake reforms. I think the best thing we can do as an ally, friend, and sharing the economic universe with them is to let them make that as informed a choice as possible. We need to have this kind of conversation in Japan, where it's not frequently held as a conversation. And I think the teams of experts—and just getting in their face with this issue is the responsible thing to do at this time.

Mr. MATSUI. Thank you.

Mr. PRESTOWITZ. Could I just add two things? I second what Bob Hormats proposed, and I also agree with Doug Paal that one of the striking aspects of this is that in Japan the sense of urgency about this problem is much less than it is outside of Japan. I, therefore, think it's very important for the administration to convey in every way possible, and I think this means the President ought to go as soon as the new prime minister is named, go meet him. And say, "hey, you know, things are really getting out of hand here." I also think the U.S. can orchestrate APEC and the G–7 and the WTO and the OECD—all of the international organizations—all to convey a sense of urgency to Japan so that in a way, you kind of push the Japanese leadership to rise to the occasion.

The second thing I think is that I don't really think the Japanese know what to do. And here Bob's idea of sending experts is good. And I would just extend that and say I think it's important for the U.S., in conjunction with the Europeans and the other international organizations, to put together a pretty explicit road map. We gave a road map to the Chinese telling them what they had to do to get into the WTO. You know, a road map here that everybody, not just us, but everybody gives to the Japanese and says, "Hey, you know, guys, this is how to do it." I think would be very useful.

Mr. LINDSEY. I think that technical advice could be useful, and we certainly have expertise in some of the areas that are of greatest challenge to Japan right now. But I think really the most important thing that the United States can do over the coming months and years is to avoid taking actions that will make matters worse. In particular, we need to avoid bilateral confrontations and showdowns, which could end up actually being very perversely self-defeating, triggering a market panic that ends up sending Japan over the edge. So we definitely want to stay away from that.

Furthermore, though, on the more positive kind of engagement, I think there is a chance that that also can end up being self-defeating. I don't see any way that Japan is going to change until it absolutely has to. And when market forces give them no alternatives, governments make sweeping reforms that upset vested interests and important constituencies when there's no choice at all. And these days very surly and impatient markets are starting to box in Japanese policymakers. If we go in and launch some kind of bilateral initiative to sort out Japan and give it a road map for the future, it's going to be terribly tempting to declare success, even if the result is really just temporizing and papering over problems, which could end up delaying ultimate accountability of Japanese policymakers for the problems in that country. We need to avoid taking steps that take market pressure off the Japanese policy makers—in particular the reforms this April that all but eliminate foreign exchange restrictions and allow Japanese to move their money overseas or to move it into foreign-managed hands. I think will be a marvelously positive lever of pressure because as that money starts escaping from the country, it's going to put downward pressure on the yen and put political pressure on the Japanese government to do something to make Japan be an attractive place to invest money.

Mr. MATSUI. Dr. Pyle, would you.

Mr. PYLE. Congressman, I've just come back from Japan. I've been going there regularly for 35 or more years. I came back with several impressions. One was Japan today is feeling very isolated and self-absorbed, resentful of foreign hectoring, not really feeling deeply a sense of crisis yet. The kind of sense we have. At the same time, there's also something that struck me really strongly on this visit is a renewed respect for the United States and for the value of the alliance, which in the 1980's was diminished and even in the early 1990's there was a lot of brave talk about Japan joining with Asia. That's pretty much gone now. Japan really has a great deal of renewed respect for this country's leadership. And I think, therefore, that we have considerable leverage. And that we should use it in the way that the other panelists have suggested.

I was there when President Clinton was in China, and there was a great deal of sensitivity in Japan to the kind of things that the President and Jiang Zemin were saying and intimating about China's great stature in resisting devaluation. And the implication was that Japan was not showing this kind of stature. So I would agree with Clyde that we have an obligation to the leadership, and we can orchestrate through multilateral channels considerable pressure on Japan to face up to the responsibilities that it has.

Mr. MATSUI. I'd like to thank all five of you. I appreciate it. Thank you.

Mr. HERGER [presiding]. Anyone else wish to inquire?

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

I was interested in Mr. Lindsey's comments, having been on the Banking Committee here ten years ago in the middle of the S&L crisis. I'm struck by the unreason that often prevails in this institution. When we spoke to the issue at that time of the S&L crisis, the S&L bailout was much larger than it turned out to be with a $500 billion price tag. There are even some bestsellers that were written about the banking situation that was going to occur after the presidential election. I think the suggestion was that all the big banks were going to go belly-up shortly after the election. Recall how popular that notion was?

What was equally popular at the time was the time was the prevailing suggestion that if we could just restructure our economy along the lines of what the Japanese had done so skillfully. In fact, they lectured us a number of times, if you recall, about the things that we could do. They lectured us hard about the size of the Federal deficit, and I'd be interested if you would like to go on a bit more with your comments. I thought they were right on target.

Mr. LINDSEY. Sure, first on the S&L crisis in the United States. There are many parallels between that situation in the United States and the situation that currently afflicts Japan, although the Japanese problems do seem to be both substantially larger in magnitude and in national scope than those of the S&L crisis. But nonetheless, at the time, there was a lot of talk about not just the S&L crisis, but a general crisis in the banking industry and that we could face a kind of systemic financial meltdown. That makes me somewhat hopeful that some of the more apocalyptic talk that we're back at the verge of the 1930's that we're hearing today with respect to the east Asian crisis may be similarly overdrawn; that it may be that some particular prudent reforms in the financial sector may be enough to stave off what could be a real catastrophe.

As to the talk back in the late 1980's and early 1990's that our financial system ought to mimic the Japanese, there was very widespread—I don't mean to just single out Clyde Prestowitz—there was very widespread feeling at the time that the United States' main problem, its main competitiveness problem was a short-term focus; that we had impatient equity markets and we had to report to stockholders every quarter; and that, boy, wouldn't things be better if we had a system like the Japanese where all the money goes through banks and everybody knows everybody, and no one is pressing anyone to make short-term returns, and therefore, everyone can concentrate on strategic objectives and building market share and making investments in new technology and so forth.

Well, as it turned out, our short-termism really now looks like accountability. And the long-term focus that we were praising or that some were praising in the Japanese system turned out to be a lack of accountability; that saying you have a long-term strategic vision is very convenient when you're not earning return. You can say, "Well, just wait until the long-term. Everything is going to work out okay." Well, the long-term has arrived now in Japan, and it's very ugly.

So, I think there's a lesson for many people that the market-oriented system of the United States in which banks are not the central intermediary for allocating capital, but rather we rely much more heavily on arms-length equity markets, I think that model—the western model—is going to be ultimately adopted by east Asia rather than the reverse which was predicted five, ten years ago.

Mr. NEAL. Anybody else wish to comment?

Mr. HORMATS. Let me just add one point because I think that point about equity is an interesting issue. One of the real problems all over Asia, except for one economy which I'll mention at the end it's gotten itself into trouble by relying too little on equity and too much on debt. Japan that's certainly true. It's really not an equity culture. It's not a risk-taking culture. The average Japanese puts a huge amount of their savings into super-secure assets like bank deposits, which are still secure, and short-term money market funds, but not equities. Now the opening of opportunities to invest through mutual funds and foreign companies is making them a little bit more equity-oriented. But all over Asia, enormous amount of leveraging took place—huge amounts of debts and that's why this problem is so difficult. It's true in Japan. It's true in Korea. It's true in most parts of Asia.

It's very interesting to contrast Taiwan with Korea in the sense that Taiwan and Korea have the same kinds of industries generally. But Taiwan's industries were financed largely through equity—much less debt, much more equity than most other parts of that region. And I think that to the extent you can improve the efficiency of equity markets in the area, you can help to avoid these big buildups of debt, which were big problems. And equity, when you make an equity investment, as long as it's based on the kind of rules we understand, there's a lot of accountability based on it. You have to do quarterly reports and things like that. So, management is much more accountable in that kind of environment. So it brings with it not only less leverage, but also more accountability.

Mr. HERGER. Thanks. Would anyone else? Yes, Mr. Jefferson.

Mr. JEFFERSON. I'm afraid there have been so many responses I can't recall who said what with respect to my question, but I'll ask it anyhow and maybe you can remember.

I think two panelists said that we should avoid making matters worse. I know Mr. Lindsey said it over here on this side. And someone said that we should avoid making decisions that would limit access to our market for Japanese products and so on. Is that a recipe for our responding to the Japanese with regard to their importing to us as usual? Won't this result in higher deficits? And, if it does, when do you say that's a problem? How high is—I mean, how high should they go? Do we talk about deficits any more? Is it too ruinous?

I know these are separate questions, but how we handle the trade issues and how we handle the issue of soundness of the Japanese economy, but they are, in the one sense, separate, another sense, when you get back to your issue of making matters worse, they're connected. So if you don't want to make matters worse, what do we do about the deficit issue? Do we talk about it? How do we handle that?

Mr. LINDSEY. Well, I'll take the first crack at this. You raise a number of different questions. First on the trade deficit, I don't think bilateral trade deficits are economically meaningful. The global trade deficit that we run with the rest of the world is also not a function of trade policy differences around the world, but rather a function of macroeconomics, the difference between domestic savings and domestic investment. My colleague Dan Grizwald wrote a very good paper recently on the trade deficit and going through those kinds of issues. I might recommend that.

Right now, the combination of our strong economic performance and the weak economic performance in Japan is widening our trade deficit with Japan. That's reflected mostly by a decrease in Japanese imports from the U.S. rather than an increase in Japanese exports to the United States. The Japanese economy is stagnant, therefore imports are going down.

I don't think that fact, in and of itself, should be a bone of contention. It simply reflects the fact that the Japanese economy is weak. Everyone recognizes that and we've been talking about the kinds of things Japan ought to do to fix that situation.

As far as trade disputes are concerned, certainly Japan and other countries and the United States have policies that discriminate against goods and services of foreign origin. With respect to the Japanese policies that do so, I think we have the option of taking those kinds of disputes to the World Trade Organization. We did that, for example, with respect to a discriminatory tax system Japan had on spirits, alcoholic spirits. We took it to the WTO; we won. So if we have discrete commercial disputes regarding Japanese policies that discriminate against foreign goods and services, I think we have recourse and we have options. But in general, the trade deficit, I don't think, should be the focus of our concern.

Mr. JEFFERSON. What do you mean when you say, And don't make matters worse by taking actions against the Japanese economic system?

Mr. LINDSEY. Well, if, for example, we said, Japan, you must reform your economy by date X or we're going to slap 100 percent duties on products X, Y, and Z, first, that could very well precipitate a financial panic that would be the exact catalyst to push Japan over the cliff. That is a possible outcome and, therefore, it's playing with fire to engage in that kind of confrontation.

At the very least, all it accomplishes is harming American businesses and consumers that use and benefit from Japanese products and harming the Japanese companies that earn revenues from selling abroad. So it doesn't do anything to make the situation better.

Mr. JEFFERSON. Let me ask you one other thing, if I might. There's been some discussion about what the Japanese electorate doesn't support. Does anybody have a feel for what it does support with respect to reforming the system or changing the way the Japanese economy's performing? What does the electorate support? Does anyone know? The Japanese electorate, not ours.

Mr. PYLE. Well, I think the Japanese electorate is desirous of changes in many aspects of its political economic system. The problem has been to find political leadership that will be responsive to this kind of generalized sentiment that the Japanese have, which is a recognition that they do have to make fundamental changes, that they do have to do more to respond to needs for international leadership.

But the Japanese electorate—for example, there are now four or five major candidates to take Hashimoto's place. It's going to be decided in the back room. It's going to be decided in jockeying among factional leaders and there will be a new face there in a couple of weeks. But the likelihood that this will be a leader who has a reform agenda is very, very slim in my judgment. So the political system is not really responsive to a kind of generalized recognition on the part of the electorate that change and reform is necessary.

Mr. PAAL. Mr. Jefferson, I think it's fair to say too that, while the Japanese electorate has signaled a desire for change, they've repeatedly also signaled a desire to avoid pain and there's no change without pain in the current circumstances. And so politicians there are in a situation in which some of you in this Congress may recognize, which the voters want something at the lowest possible cost. When it comes to bankruptcies, for example, you have to declare winners and losers. If you call in bad loans and you put people out of business, you put people out of work and that's very hard to do in a Japanese context. That reinforces, I think, the view of most of the panelists here, if not all of them, that it's going to be very, very hard to get the Japanese to bring about this kind of change on their own; about the situation getting much worse.

Mr. LINDSEY. Let me just add that certainly that voter turnout and the results indicate a high degree of voter frustration with the ruling Liberal Democratic Party. But we don't know whether people are frustrated because the LDP has done too little or whether they're frustrated because they've done too much. Or whether they're simply frustrated because the LDP has been vacillating and inconsistent. I'm sure different parts of the electorate had different motivations. So, while I would like to be optimistic and read these election results as a mandate for change, and perhaps it is possible that they will used as such, it's not necessarily so.

Also, even if frustration with one party is incoherent, in other systems it nonetheless does have clear policy ramifications because there's an opposition party that takes advantage. In the Japanese system, unfortunately, there isn't a strong, cohesive opposition party that will be able to take advantage of these particular election results.

Mr. HERGER. I thank you, Mr. Jefferson. I thank our panelists. We do have about three minutes left for this vote. Thank you very much for appearing and your very good and helpful testimony.

We will recess now, subject to the call of the Chair. And when we return, we'll conclude with our third panel. Again, thank you very much.

[Recess.]

Mr. HERGER. We will now reconvene the Ways and Means Subcommittee on Trade.

And if we could have our last panel—it looks like it's gathering. Mr. Brad Smith, director of international relations, American Council of Life Insurance; Shannon S. Herzfeld, senior vice president, international affairs, Pharmaceutical Research and Manufacturers of America; and Mr. Wendell Willkie II, senior vice president, general counsel, of Westvaco Corporation, New York, New York.

Mr. Smith.

STATEMENT OF BRAD SMITH, DIRECTOR, INTERNATIONAL RELATIONS, AMERICAN COUNCIL OF LIFE INSURANCE

Mr. SMITH. Thank you. Mr. Chairman and members of the subcommittee, we'd like to thank you on behalf of our 532 member companies for the opportunity to raise this important issue. In addition to my written comments, with your permission, I'd also like to submit for the record a further explanation of the violations that we believe are currently underway with the 1994 and 1996 U.S.-Japan Bilateral Insurance Agreements, along with a concurrent document produced by our sister association, the American Chamber of Commerce in Japan Insurance Committee.

Mr. HERGER. Without objection.

Mr. SMITH. Thank you.

At the beginning of 1998, our international committee authorized the creation of a new task force to review current and future insurance trade agreements with regard to compliance and implementation. Its first project was to answer a request from the United States Trade Representatives' office for industry input on the Japanese government's implementation of the 1994 and 1996 U.S.-Japan Insurance Agreements.

The U.S. ensures the Japanese insurance market remains highly restrictive and extremely difficult to penetrate. At $407 billion a year in annual premium volume, it is the largest life insurance market in the world, yet the foreign share of Japan's market is a mere 3.9 percent. By contrast, the foreign market share of every other G–7 country is at least 10 percent and, in some cases, it exceeds 30 percent.

In 1994 and 1996, our respective governments undertook two agreements designed to promote transparency and deregulation of the Japanese insurance market and to open it to meaningful foreign participation. However, the overall goals of these agreements are far from being achieved until such time as Japan fully implements the commitments it has made to substantially deregulate the primary sector areas of its insurance market in a transparent manner. It is obliged to maintain existing protections for foreign firms that have created significant market niches within the so-called third sector, which I'll explain in a moment.

In terms of liberalizing the primary insurance sector, which represents 95 percent of the Japanese market, I have listed the many specific items of non-compliance in my written testimony, although I'll be pleased to answer any questions you might have. In sum, this not only means that the Japanese insurance market remains effectively closed to U.S. insurers, but that Japanese consumers continue to be denied the benefits of a competitive marketplace.

Similarly, we are extremely concerned with the diminution of the third-sector safeguards caused by increased activity of Japanese insurance firms and subsidiaries in this segment of the market. The desire of Japanese business to participate here provides our negotiators with significant leverage to encourage liberalization of the first sector, which is life, and the second sector, which is property and casualty.

Until the 1994 agreement, the government of Japan pledged to continue longstanding limitations on entry by Japanese large insurance companies into the life portion of the third sector, as well as specific restrictions on third-sector activities by Japanese life and non-life subsidiaries. These limitations must continue until primary sector liberalization has been achieved and a transition period of two-and-a-half years has expired. The purpose being to enable foreign firms to establish some toehold in the primary sectors which, as I said, represents 95 percent of the market, before they are faced with onslaught in the third sector from large Japanese insurance companies. Without enforcement of this provision, the foreign market share in Japan's insurance market may actually fall.

ACLI member companies report that the Ministry of Finance has failed to live up to this key provision in several critical ways. First, it has allowed the second-largest Japanese non-life insurance company, Yasuda, to create, by agreement, a de facto subsidiary through its partial ownership of INA Himowary, thus creating radical change in the agreement, which is specifically prohibited. This circumvention has created pressure on the Ministry of Finance to also allow other Japanese companies into third sector, specifically by approving a cancer insurance rider product for Tokio-Anshin, which is owned by Japan's largest insurance company, Tokio Fire and Marine. Even as we speak, companies are reporting potential new problems in Japan's third sector. The specific concern is that protected products, like group personal accident and cancer insurance, are being marketed through new sales channels, creating radical change in the insurance sector which is a serious violation of the agreement.

With all this in mind, we firmly agree with USTR's July 1 conclusion that, as things stand today, the two-and-a-half-year countdown to the opening of the third sector should not begin. The countdown should not begin until, as the bilateral agreements require, there is substantial deregulation of the overall Japanese insurance market. The objective of the bilateral agreements was to increase American insurance companies' opportunities in the Japanese market by improving market access for foreign companies, improving market competitiveness, and promoting consumer choice. When Japan lives up to its commitments, the real beneficiaries will be Japanese consumers who, for the first time, will be able to buy innovative and competitively priced insurance products.

I'd be pleased to answer any questions you might have.

[The prepared statement and attachments follow. Attachments are being retained in the committee files.]

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURANCE

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TRADE

ON

IMPLEMENTATION

OF

1994 AND 1996 US/JAPAN INSURANCE AGREEMENTS

JULY 15, 1998

Statement Made By:
Brad Smith
Director, International Relations
ACLI

Mr. Chairman and members of the Subcommittee, my name is Brad Smith, and I am Director of International Relations of the American Council of Life Insurance. ACLI's International Life Insurance Committee has active participation of over fifty member companies, both those with existing international operations and many currently planning or developing international activities. The committees mandate is to advance the interests of ACLI member companies on international life insurance, pension, disability and long term care matters, including formulating policy recommendations, providing a unified industry forum, assuring effective lines of communication between pertinent federal and state government agencies, foreign governments and trade associations, and other financial service organizations, and providing support for ACLI member companies through educational and informational assistance programs.

As the ACLI's Director of International Relations, I help members with research and coordinate the development and advocacy of industry consensus positions on trade policy and industry relations matters that affect our industry. In this capacity, I work closely with the trade negotiation and facilitation offices of the U.S. executive branch, most regularly the Executive Office of the United States Trade Representative and the Commerce, State and Treasury Departments.

The ACLI has long been a supporter of free and fair trade in global life insurance and pension markets in the belief that increased competition improves efficiency and professionalism in local insurance markets, and provides consumers with the best choice of insurance products at the lowest cost, and with the best possible service.

At the beginning of 1998 our international committee authorized the creation of a new task force to monitor compliance and implementation of current and future insurance trade agreements. This was done following the just concluded World Trade Organization's Financial Services Negotiations. Our Insurance Trade Agreement Compliance Monitoring Task Force, continues to review these commitments along with other bilateral and multilateral agreements which the U.S. is a party to, but its first project was to answer USTR's request for industry input on the Japanese Government's implementation of the 1994 and 1996 US/Japan Insurance Agreements.

The agreements call for a status review between the two governments every six months, and USTR was seeking any specific problems U.S. companies were having in Japan which they felt to be inconsistent with the agreements, so USTR could raise these issues with their Japanese counterparts. We surveyed all members of our International Life Insurance Committee and reported the results in writing to USTR. Since then we have requested regular meetings with USTR to provide updates on the status of Japanese implementation of the measures committed to in the agreements, as well as providing any specific technical assistance our negotiators may need.

For U.S. insurers, the Japanese insurance market remains highly restrictive and extremely difficult to penetrate. At US$407 billion dollars a year in annual premium volume, it is the largest life insurance market in the world. Yet the foreign share of Japan's market is a mere 3.9%. By contrast, the foreign market share of every other G7 country is at least 10% and in some cases exceeds 30%.

In 1994 and 1996 our respective governments undertook two agreements designed to promote transparency and deregulation of the Japanese insurance market and to open it to meaningful foreign participation.

We recognize that some limited progress has occurred since 1996. However, the overall goals of these agreements are far from being achieved. Until such time as Japan fully implements the commitments it has made to substantially deregulate the primary sector areas of its insurance market in a transparent manner, it is obligated to maintain existing protections for foreign firms that have created significant market niches within the so-called third sector.

In terms of liberalizing the primary insurance sectors which represent 95% of the Japanese market, specific items of non-compliance include:

- Lack of transparency and failure to make meaningful reform of the rating bureaus;
- Slowing the entry of new products and rates into the marketplace by regularly failing to approve them within 90 days;
- Continuing failure of operational transparency in the notification system so that the regulatory system and related rules are often vague and open to unpredictable interpretation;
- Failure to include prudential recommendations of foreign insurers in the reform of the payment guarantee system resulting in a system that fails to equitably distribute the cost of future insolvencies and minimizes foreign participation in the organization's management, and importantly;
- A consistent failure to adequately staff the relevant regulatory offices to be able to fully implement all of the preceding commitments.

In sum, this not only means that the Japanese market remains effectively closed to U.S.

insurers, but that Japanese consumers continue to be denied the benefits of a competitive marketplace.

Similarly, we are extremely concerned with the diminution of the third sector safeguards caused by increased activity of Japanese insurance firms and subsidiaries in this segment of the market. The "third sector" is comprised of specialty insurance products such as personal accident, medical and cancer insurance, and is the only sector in which foreign insurers have gained a significant share. The desire of Japanese business to participate here provides significant leverage to encourage liberalization of the first sector (life) and the second sector (property and casualty). In the 1994 and 1996 agreements, the USTR successfully linked future domestic Japanese industry access to the third sector (representing some 5% of the overall market) to substantial deregulation of the primary areas of life and non-life insurance (95% of the market).

Under the 1994 Agreement, the Government of Japan pledged to continue long-standing limitations on entry by Japan's large insurance companies into the life portion of the third sector, as well as specific restrictions on third sector activities by Japanese life and non-life companies and their subsidiaries. These limitations must continue until primary sector liberalization has been achieved, and a transition period of two-and-a-half years has expired. Its purpose is to enable foreign firms to establish some toehold in the primary sectors before they face an onslaught in the third sector from large Japanese insurers. Without enforcement of this provision, the foreign share of Japan's market may actually fall.

ACLI member companies report that the Ministry of Finance has failed to live up to this key provision in several critical ways. First it has allowed the second largest Japanese non-life company (Yasuda) to circumvent the agreement by allowing Yasuda to establish a *de* *facto* subsidiary through its partial ownership of INA/Himawari, thus creating a "radical change" in the third sector -- a clear violation of the 1994 and 1996 agreements. This circumvention has created pressure on the Ministry of Finance to allow other large Japanese companies to enter the third sector, specifically by approving a cancer insurance rider product for Tokio-Anshin, the new life subsidiary of the Tokio Fire and Marine, Japan's largest non-life company.

Even as we speak, companies are reporting potential new problems in Japan's third sector. The specific concern is that protected products are being marketed through new sales channels creating "radical change" in this important sector.

Failure to achieve liberalization of its insurance market is not the only area where Japan has failed to act. For years Japan's leaders have said they intend to fundamentally reform their economy, making it more transparent and open to foreign competition. Today Asia is facing its most acute economic crisis in decades. Japan - by far the largest economy in the region and the natural engine to lead economic recovery - continues to resist change. Prime Minister Hashimoto recently told a meeting of South East Asian leaders that Japan would simply not be able to absorb higher imports from Korea, Thailand, Indonesia, the Philippines or others. Japan's failure to accept higher levels of imports means the US will become the likely export target for these countries as they attempt to export their way to renewed economic growth. It is therefore crucial for the United States to ensure that Japan live up to all its trade obligations, including insurance.

With all this in mind, we firmly agree with the USTR's conclusion that, as things stand today, the two-and-a-half-year countdown to the opening of the third sector should not begin. The countdown should not begin until, as the bilateral agreements require, there is substantial deregulation of the overall Japanese insurance market. The objective of the bilateral agreements was to increase American insurance companies' opportunities in the Japanese market by improving market access for foreign companies, improving market competitiveness and promoting consumer choice. When Japan lives up to its commitments, the real beneficiaries will be Japanese consumers, who for the first time will be able to buy innovative and competitively priced insurance products.

We stand ready to lend every assistance and support to our government negotiators and commend this Subcommittee and other interested members for their strong support for our efforts to insure that Japan lives up to its trade commitments.

I would be pleased to answer any questions.

Mr. HERGER. Thank you, Mr. Smith.

Ms. Herzfeld.

STATEMENT OF SHANNON S.S. HERZFELD, SENIOR VICE PRESIDENT, INTERNATIONAL AFFAIRS, PHARMACEUTICAL RESEARCH AND MANUFACTURERS OF AMERICA

Ms. HERZFELD. Thank you very much, Mr. Chairman. Thank you for the opportunity to present our industry's views.

As you know, I represent PhRMA, the Pharmaceutical Research and Manufacturers of America. We are America's leading research-based pharmaceutical and biotechnology companies. Many of the members of this committee are quite familiar with PhRMA's members. Companies like Searle have their headquarters in Illinois. Pfizer and Bristol-Myers Squibb are headquartered in New York. Warner Lambert has a state-of-the-art research facility in Michigan. And, of course, California and Massachusetts have clusters of high-tech biotech companies such as Amgen and Genzyme, Genentech, and Biogen.

The lifeblood of our industry is research, taking America's best ideas and turning them into innovative medicines. PhRMA companies alone will invest more than $20 billion in research and development in 1998. That is one-fifth of our total world sales. This ensures that the American pharmaceutical industry remains the leader in the development of innovative medicines and, indeed, half of all new medicines now are discovered here in the United States.

This not an easy task. On average, it takes 12 to 15 years and approximately $500 million to go from the discovery of a new drug to your medicine cabinet. For every 15,000 compounds that are investigated, only 3 ever make it to your medicine cabinet and of those 3, only 1 will turn a profit. So that's 1 profitable compound out of every 15,000. This is a risky and challenging business.

The Japanese market is very, very important to our members. It is a $64 billion market and Japan is the second-largest pharmaceutical market in the world. American companies, however, have managed to capture only 15 percent of this market. In contrast, for example, we have about twice that market share in Europe. Since America is undeniably the leader in innovative medicines, this relatively small market share percentage is a disappointment.

Professor Lacey Glenn Thomas of the Emory University Business School recently studied the Japanese pharmaceutical market. He found that, since 1991, for every 10 new medicines that were launched in the United States and Europe, only 3 have become available in Japan. That means that 7 out of 10 new medicines launched in this decade remain unavailable in Japan.

For example, none of the three leading medicines available here to treat depression are available in Japan. Nor are major medicines for epilepsy, migraine headaches, prostate disease, or leukemia. We in America have begun to expect new medicines and new therapies to be available to us but, in contrast, the Japanese patient and their doctors wait as the gap increases between what is therapeutically possible and what is administratively available.

Like everything in Japan, the underlying reasons are complicated, but the entrenched bureaucracy remains at the core. Foreign clinical data is still not generally accepted by Japanese regulators. In order to launch your drug in Japan, Phase III clinical trials—that's when you use thousands of volunteers—must be repeated on ethnic Japanese persons residing in Japan. This requirement, which we hope to see modified in the relatively near future, is time consuming, costly, and extremely redundant. And there is no analogous requirement here in the United States. When you finish your trials, it now takes approximately 40 months from the time you file your new drug application until its approval. In the United States, it takes 15 months and that time is dropping.

And, finally, the Japanese bureaucracy sets a reimbursement price for drugs. Let me state this again: There is no free market price for our pharmaceuticals in Japan. The Japanese bureaucracy sets the reimbursement price. And they do so in an antiquated fashion that ends up propping up older, less-effective medicines and holding down the price available for new and innovative medicines. And this robs innovators of their economic incentive.

Last May, President Clinton and Prime Minister Hashimoto agreed to deregulate pharmaceuticals within the context of the Enhanced Initiative on Deregulation and Competition Policy. This was very important. The Japanese finally recognized that innovative medicines need to be a part of a modern health care system and they agreed they needed more transparency in their health care reform. And, indeed, they agreed to allow the foreign pharmaceutical companies to finally participate in their reform discussions. We are optimistic and we realize we would not have even gotten very far—not this far—without steadfast support from this committee, from your colleagues in the Senate, and the Clinton administration, and the U.S. Embassy in Tokyo.

We are cautiously optimistic, but we know far too well that agreements that look terrific on paper are sometimes a disappointment when implemented. Japan continues to experience difficult economic times and we are quite concerned that the entrenched bureaucracies will respond by circling the wagons, holding off reform, and postponing deregulation and this is precisely why we need your support in order to combat.

We hope that we will continue to have your support in this endeavor as we look to see last May's agreement turn into a reality. We will be coming back for your continued support and I wish to thank you very much, Mr. Chairman, for your kindness and opportunity to appear today. Thank you.

[The prepared statement follows:]

Statement PhRMA

SHANNON S.S. HERZFELD
SENIOR VICE PRESIDENT
INTERNATIONAL AFFAIRS

PHARMACEUTICAL RESEARCH AND
MANUFACTURERS OF AMERICA

BEFORE THE

SUBCOMMITTEE ON TRADE
COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 15, 1998

Mr. Chairman, I'm pleased to have the opportunity to testify before the Subcommittee on Trade regarding PhRMA's priorities in the Japanese market.

PhRMA represents America's leading research-based pharmaceutical and biotechnology companies. Our companies are dedicated to developing innovative new medicines that will enable patients in the United States and around the world to live longer, healthier, happier and more productive lives. America is the world's leader in research pharmaceuticals. But our leadership is fragile. More than any other sector, the global pharmaceutical business demands relentless innovation. On average, it takes 12 to 15 years, and $500 million, to bring a new drug to market. Last year, the PhRMA companies spent over $20 billion -- one-fifth of total sales -- on research and development. A research-based pharmaceutical company that fails to restock its pipeline by developing new products to replace those whose patents are about to expire, has no future. Accordingly, America's leading pharmaceutical companies must continuously reinvent themselves by spending vast sums of money on risky, challenging, cutting-edge R&D in hopes of finding new cures and treatments that will succeed in a highly competitive global marketplace.

At $64 billion, Japan is the world's second-largest pharmaceutical market. It is by far the largest and most important market in Asia. American research pharmaceutical companies have been doing business in Japan for many years. Today, the PhRMA member companies have about $9.6 billion in annual sales in Japan, which is equivalent to a 15 percent market share. We have a major stake in the Japanese market, but we face significant and daunting challenges.

Japan is in the midst of a major reform of its health care system. These reforms fundamentally will reshape our future in Japan. The Japanese Government is striving to preserve quality medical care for a rapidly aging population, while controlling escalating health care costs. These are challenges that all industrialized nations, including the United States, will face in the next century.

Today, I want to commend the United States and Japanese Governments for a path-breaking agreement on pharmaceuticals in the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. The agreement was announced on May 15 by President Clinton and Prime Minister Hashimoto on the eve of the Birmingham Economic Summit. The highlights of the Agreement include commitments by Japan to:

- Recognize the value of innovative medicines, and not impede the introduction of innovative products, that bring better and more effective cost-effective treatments to patients;
- Ensure transparency during the formulation of health care policies by allowing U.S. pharmaceutical manufacturers meaningful opportunities to state their opinions and exchange views with the relevant Japanese Ministries and advisory groups;
- Shorten the approval process for new drugs to 12 months by April 2000 with steady and continuous improvement in the interim; and
- Expand acceptance of foreign clinical trial data for pharmaceuticals in compliance with guidelines adopted by the International Conference on Harmonization.

The recent agreement with Japan is an example of a win-win trade agreement. Deregulation will help American pharmaceutical companies compete successfully in Japan, but even more importantly it will give Japanese patients increased access to world-class treatments for cancer, heart disease, diabetes, Alzheimer's, depression, and other life-threatening diseases. By streamlining and speeding up its regulatory approval process for new medicines, Japan will save lives, while also achieving cost savings.

We also recognize, Mr. Chairman, that the Government of Japan today is facing a significant economic recession, and that Government is looking for various ways to reduce government expenditures, while providing incentives for the economy to grow and instilling confidence in the Japanese consumer. We believe that the commitments made by the Japanese Government in Birmingham to de-regulate the health care sector as it governs the use of medicines, and to create greater incentives for medical innovation, can create cost savings in health care in the future, and thus assist Japan in moving out of its current recession.

We are pleased that the Japanese Government has agreed that the PhRMA member companies should have a meaningful opportunity in the Japanese health care reform process to contribute views and ideas -- just like other stakeholders. But we also realize that this is only a first step. We look forward to being a constructive partner in developing comprehensive health care reforms aimed at providing better and more affordable health care for Japanese patients. Having a seat at the table will enable us to contribute the best ideas drawn from our years of doing business around the globe. Specifically, the U.S. experience shows that market-based health care reforms can achieve effective cost savings, while maintaining quality medical services, preserving the physician's decision-making autonomy, and rewarding medical innovation. A dynamic and competitive health care marketplace is the best guarantee that in the next century science and innovation will continue to produce life-saving cures that support effective cost-containment by allowing less expensive and less invasive therapies.

We are deeply concerned, however, about the re-emergence of proposals for a reference pricing system, that would impose disproportionate burdens on U.S. pharmaceutical companies in Japan. "Reference pricing" would group innovative U.S. patented products and older "me-too" products, which are predominantly of Japanese origin, in broad "therapeutic categories," which would be subject to the same reimbursement rate. The proposal is based on the German reference pricing model, which the Germans now recognize was a total failure for patented medicines. Government micro-management through reference pricing all but snuffed out innovation in Germany, and denied the German people the medicines they need. The German Minister of Health has stated publicly that the recent abolition of the old reference pricing system for patented products already has begun to pay off with new investment and research, which means new hope for the people and patients of his country. The reference pricing system didn't work in Germany, and it won't work in Japan, either.

Such a system penalizes medical innovation. If such a system were to be imposed in Japan, it would burden and restrict the ability of U.S. companies to succeed in that country, since our industry's lifeblood is innovation and innovative products. But it also would create disincentives for U.S., European and Japanese companies looking for opportunities to bring innovative medicines to Japanese patients. There already exists a strong foundation of scientific knowledge in Japan, and Japanese industry is committed to quality manufacturing. However, because of burdensome regulatory requirements, the

Japanese system provides little encouragement to innovation and denies Japanese patients access to the most innovative therapies in the world.

In our view, successful health care reform requires adoption of a systemic approach to change in the entire health care system, not the singling out of one sector, such as the pharmaceutical sector, to bear a disproportionate share of the cost-savings.

The United States, as the world leader in pharmaceutical innovation, has a stake in a fair and non-discriminatory reimbursement system in Japan and markets around the world. Accordingly, PhRMA welcomes Japan's path-breaking commitment in the Enhanced Initiative to "recognize the value of innovative medicines" in formulating health care reforms. We hope this principle can be used to guide the reform process in the right direction.

PhRMA also applauds the initiatives taken by the Japanese Government to get products to the market more quickly. Shortening the product approval process to 12 months by April 2000, as the Japanese Government has promised to do, has the potential to dramatically expand access by Japanese patients to world-class medicines.

A recent study by Professor L.G. Thomas of Emory University's School of Business confirmed that Japan lags behind the rest of the world in approving innovative new medicines. The Thomas study also indicates that, since 1991, seven out of 10 new medicines launched in Europe and the United States remain unavailable in Japan. None of the three leading medicines to treat depression is available in Japan, nor are major medicines for epilepsy, migraine headaches, prostate disease or leukemia.

This is particularly striking in a wonderful country like Japan, which prides itself on being modern. For those of you who have visited Japan, you know that, if you want top quality audio equipment, you go to the Akihabara section of Tokyo. If you want a powerful supercomputer, you can go to Kawasaki. If you want the newest liquid plasma display screen, you go to Osaka, and, for the most part, if you want state-of-the art pharmaceuticals, you go to Narita Airport to get on a plane bound for Europe or America.

Our member companies also are experiencing a general time lag in the introduction of all new drug products in Japan. For example, a recent industry survey in Japan showed that new drugs approved in 1997 had taken an average of nearly 40 months (not including "fast track" approvals for three treatments for HIV and AIDs), compared to 15 months in the U.S.

Under the Enhanced Initiative, Japan will expand the acceptance of foreign clinical data in its approval of new pharmaceuticals. If these commitments are fully implemented, it will significantly reduce the time and expense that U.S. firms must devote to new product testing and approvals in Japan. This step will benefit Japanese patients by accelerating the introduction of innovative, cost-effective medicines by U.S. firms, which are leaders in developing world-class drugs. It will speed reform of an archaic clinical trial system, which currently has the unintended effect of restricting access by Japanese patients to potentially life-saving medicines developed abroad.

While we laud the commitments made by the Japanese leadership in Birmingham to de-regulate the pharmaceutical sector in several important ways, we also are not naïve about the process of implementation of these commitments. Our experience over the past several years has shown us that there has always been a long and arduous road to travel in U.S.-Japan trade agreements between commitment and implementation --- between what the Japanese Government says it is going to do and what it actually does. We look forward to working with you, Mr. Chairman, and other members of this Committee, as well as with our key trade negotiators, to ensure that the Government of Japan does what it committed to do in Birmingham on May 15.

Mr. Chairman, we are on the verge of a golden age in health care. In the next century, the potential for discovery and innovation in biomedical sciences, biotechnology and genomics is almost limitless. America is a world leader in medical research and innovation, and in developing new medicines. PhRMA applauds the efforts by the U.S. Department of Commerce, Office of the United States Trade Representative, U.S. Embassy, and Japanese Ministry of Health and Welfare to accelerate reforms that will reduce the burden of regulation, reward innovation, encourage investment in cutting-edge research and development, and promote effective cost-containment. We appreciate the support we have received from this Committee in conveying our concerns about reference pricing to the Japanese Government. We look forward to working with you to ensure that the PhRMA companies continue to have an opportunity to contribute to the discovery and development of new medicines that will improve the well-being of Japanese patients, as well as patients throughout the world.

Mr. HERGER. Thank you. Thank you very much, Ms. Herzfeld.

Ms. HERZFELD. Thank you.

Mr. HERGER. Mr. Willkie.

STATEMENT OF WENDELL L. WILLKIE II, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, WESTVACO CORPORATION

Mr. WILLKIE. Yes, thank you, Mr. Chairman. We appreciate the opportunity to appear before you today. I appear on behalf of not only Westvaco corporation, but also the American Forest and Paper Association.

Westvaco is a major manufacturer of paper packaging and specialty chemicals. During the last decade, our international sales have nearly tripled. International business is the fastest-growing segment of our company and last year our business outside of the United States accounted for 25 percent of our total sales.

The American Forest and Paper Association represents an industry that accounts for 8 percent of U.S. manufacturing output. The U.S. is the largest producer of paper and wood products in the world and Japan is the second-largest market for paper products. Simply put, Mr. Chairman, export sales are critical to the future growth and well-being of our industry and access to the Japanese market is an essential part of this equation.

Unfortunately, however, Japan's continuing refusal to open its markets adversely affects trade and economic growth in the Asia Pacific region and now threatens to stall an important trade liberalization initiative in the APEC forum, as Mr. Fisher's testimony before the committee earlier today indicated.

In Vancouver last November, APEC leaders, including President Clinton and then-Prime Minister Hashimoto, endorsed a proposal to eliminate tariff and non-tariff barriers in nine priority sectors, including wood and paper products accounting for over $1.5 trillion in regional trade. With some of its members already deeply in crisis, the APEC leaders opted for a bold trade liberalization plan to stimulate regional trade and boost the confidence of world financial markets.

The APEC initiative is of vital importance if we are to open Japan and other Asian markets to U.S. forest products. In 1997, the Far East region attracted 40 percent of U.S. paper and wood product exports at a dollar value of about $8.5 billion. Statistics from the first quarter of 1998, however, as compared to the first quarter of 1997, illustrate what our industry, Mr. Chairman, is now up against. For the first quarter of 1998, wood product exports are down 44 percent. Paper and paper board exports are off 77 percent. Newsprint exports are down 25 percent and printing and writing papers are down 36 percent. And in the same time frame, wood product imports have increased 18 percent; paper and paper board by 44 percent; printing and writing imports have increased 138 percent; and newsprint imports are up an alarming 700 percent.

In other words, the Asian economic crisis is having a significant and very negative impact on the forest products industry. In this context, trade liberalization through the APEC initiative is urgently needed if we are to preserve American jobs in our industry and establish a level playing field which will enable us to compete in Japan and other Asian markets over the long term.

Last month, APEC trade ministers met in Kuching, Malaysia. Country after country agreed that the crisis was not an excuse to stall further trade liberalization, but on the contrary, a compelling reason to move forward. These ministers agreed that eliminating trade barriers must be a part of any long term solution to the region's economic problems. All countries agreed, that is, except for Japan. Citing the fact that its industries cannot stand up to international competition, Japan is seeking to exclude as many as six of the nine sectors from its market opening commitment, with forest products topping the list.

The irony in the Japanese position is striking. By continuing to protect non-competitive industries, Japan is refusing prescriptions being taken by weaker economies, smaller economies in the region. What message is Japan now sending by its actions to other important APEC countries? The CEOs of our industry, members of Congress, numerous governors, and the leaders of our unions have written to the President, urging him to hold Japan to its APEC commitment.

If the past is any guide, we can expect Japan's leaders to argue that politicians cannot challenge the powerful economic interests arguing for continued protection, especially in the country's current turbulent political climate. But there is no reason for the United States to concede this and very large reasons to press even harder for an immediate and firm commitment by Japan to open its market, including a commitment to eliminate tariffs and reduce non-tariff barriers in all sectors being negotiated in APEC. Internal politics notwithstanding, Japan can no longer duck its obligations to its partners in the region and to the global trading community. As with other leaders throughout the region, it is hoped that Mr. Hashimoto's successor will make market reform the first order of business.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF
WENDELL L. WILLKIE II
SENIOR VICE PRESIDENT & GENERAL COUNSEL
WESTVACO CORPORATION

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE ON
UNITED STATES-JAPAN TRADE RELATIONS

JULY 15, 1998

Mr. Chairman and Members of the Committee, thank you for this opportunity to present testimony. My name is Wendell Willkie, and I am Senior Vice President and General Counsel of the Westvaco Corporation. Westvaco is a major manufacturer of paper, packaging and specialty chemicals. During the last decade, Westvaco's international sales have nearly tripled, making international business the fastest growing segment of our company. Last year, business outside of the United States accounted for 25 percent of our company's total sales. We are also one of the largest producers of envelopes in the world.

I am here today on behalf of my company and the American Forest & Paper Association. The United States is the largest producer of paper and wood products in the world. Our industry accounts for 8% of U.S. manufacturing output. We employ 1.6 million Americans and rank among the top 10 manufacturing employers in 46 states. With U.S. and foreign sales in excess of $200 billion annually, we have been ranked as among the most globally competitive of all U.S. manufacturing industries.

Export sales are critical to the future growth and, ultimately, the survival of our industry. Access to the Japanese market is a critical part of this equation. After the U.S., Japan ranks as the second largest market for paper products and the number one export destination for solid wood products. Japan is a high cost producer of both paper and wood products. The competitive price and high quality of U.S. forest products should command for our companies a strong position in the Japanese market.

But this is not the case:

JAPAN MARKET ACCESS

The primary hurdle that excludes U.S. paper products from the $50 billion Japanese market is a pervasive web of anti-competitive business practices which ensure that the bulk of Japanese sales go to domestic suppliers. Anticompetitive behavior at all levels of the production and distribution chain have kept imports from all sources to just 4.2 percent of Japanese paper consumption--the lowest import penetration ratio in the world. (Background information on the form and extent of anti-competitive practices in the Japanese paper market is attached to this statement.)

From 1992 to 1997, the U.S. and Japan had a government-to-government agreement to improve U.S. access to the Japanese paper market. This agreement failed to increase the U.S. market share--it actually declined by one tenth of one percent: our share was 1.9 percent when the agreement started and it declined to 1.8 percent in 1997 when Japan unilaterally decided it would not be renewed. During the five year "truce" purchased by the agreement, however, the Japanese paper industry scrapped many of it most outdated machines, (receiving government supports for displaced workers), consolidated its largest firms, added new, more efficient capacity and, under the guidance of a MITI Plan, transformed itself into a potential export industry. This new capability rests on the foundation of a sanctuary home market.

Today, it is fair to say that the results are in: for 1997, the first year without an agreement, Japanese paper production is up by 3.3%, imports from all sources have declined by 15%; and exports have increased by 35%--with the higher value-added printing and writing papers increasing by 50% and containerboard up by almost 60%.

In the wood products market, Japan has traditionally relied on discriminatory technical standards and a sharply escalated tariff structure to exclude value-added wood products imports. In recent years, due in large measure to the Japanese government's desire to lower the cost of housing construction through deregulation, the U.S. has been able to make substantial progress in mitigating the more discriminatory aspects of Japanese building codes and other technical standards. But tariffs remain a major obstacle. We support USTR's efforts to further liberalize standards in the deregulation forum, but the Japanese market will not be open--and U.S. producers will not earn key export dollars-- until tariffs on wood products are eliminated.

JAPAN'S ROLE

There is little in my testimony that is unique or surprising: the broad outlines will be familiar to the other industry representatives you hear from today. Because successive governments have given priority to Japanese industry demands for protection from import competition, Japan has never realized its appropriate role in the international trading system--that of a high income, developed market, particularly for emerging manufacturing and resource-based industries in the region. The U.S. has exhorted a succession of Japanese Prime Ministers to step up to Japan's full measure of responsibility for the functioning of the open world trading system--without much success.

The recent financial crisis in Asia lends new urgency to our effort to open the Japanese market. The threat that continuing Japanese protectionism may drag the larger region deeper into recession means that tolerance of further stalling and equivocation may well be costly to our own economy as well as those Asian countries already deeply involved.

On June 20 G-7 deputy finance ministers and their regional counterparts held an emergency meeting in Tokyo and declared: "it is of vital importance to Japan, to the recovery of Asia, particularly those countries affected by financial market turbulence, and to the entire world economy, that Japan restore its banking system to health, achieve domestic demand-led growth, open and deregulate its markets."

These three elements also made up Prime Minister Hashimoto's pledge to President Clinton in the wake of U.S. intervention to support the yen.

So far, Japan has not taken credible action on any of these:

- the bridge banking plan has been found seriously deficient by world financial markets; and

- reliance on outdated public spending techniques, and conflicting signals on possible tax cuts, has failed to stimulate domestic spending.

But the most glaring deficit between Japan's commitment and its performance is in the area of market opening.

APEC

The immediate vehicle for Japan to take on an appropriate and responsible role in boosting Asian economic recovery is the trade liberalization initiative being negotiated in the Asia Pacific Economic Cooperation forum (APEC). Last November, President Clinton and other heads of state, including Japanese Prime Minister Hashimoto, endorsed a proposal by their trade ministers to liberalize trade within the APEC region in nine priority sectors--forest products, fish and fish products, toys, gems and jewelry, chemicals, medical equipment, environmental goods and services, energy, and telecommunications. Trade in the nine sectors already generates $1.5 trillion in sales for the APEC economies; liberalization should boost those numbers significantly higher.

Negotiators were instructed to reach agreement on early trade liberalization in the nine sectors by mid-June 1998, and to begin talks on trade liberalization in six additional sectors--oilseeds, food, fertilizer, autos, natural and synthetic rubber, and civil aircraft.

The APEC initiative is critical to fully opening Japan and other Asian markets to U.S. forest products. In 1997, about $8.5 billions in U.S. export of paper and wood products, representing 40 percent of total industry exports, were shipped to the Far East region. The results this year will be much worse for our industry. Already, our companies are under significant pressure as a result of the Asian financial crisis--U.S. paper, pulp and wood exports to Asia are down sharply, and we are beginning to see rising imports from the region. The competitive boost associated with the devaluation of regional currencies far exceeds the margin of protection provided by most tariffs: the APEC initiative therefore represents our best, and perhaps only, opportunity in the foreseeable future to preserve American jobs in this industry and establish the kind of level playing field which will enable us to compete in Japan and other Asian markets once the current financial crisis is over.

Participation in all the APEC sectors, and forest products in particular, is very much in Japan's own interest. Removing tariff and non-tariff barriers to trade will give an immediate boost to the Japanese economy and spur demand by reducing costs to Japanese consumers. Over the long run, greater competition will force Japanese industry to become more efficient and stop the drain of money used to prop up inefficient enterprises. In the wood products sector alone, studies show that elimination of wood tariffs will lower the cost of housing in Japan.

Even more important, the liberalization of the Japanese market in these sectors, at this time, is critical to the recovery of the region. APEC leaders are looking to the success of the APEC negotiations as a way to send a credible signal to world markets that they will continue to be competitive. At the same time, the elimination of Japanese tariffs on forest products in particular would have the immediate effect of increasing the export earnings potential of regional suppliers--such as Indonesia, Malaysia, Thailand and South Korea--which have been hardest hit by the crisis. Without Japanese participation, the long term economic benefit of APEC trade liberalization is sharply diminished and the credibility of the regional liberalization process as a whole is undermined.

At the June 22-23 APEC Ministerial in Kuching, Malaysia, APEC trade ministers resoundingly endorsed trade liberalization. In the forest products sector, we are pleased that Ambassador Barshefsky succeeded in keeping the trade liberalization process moving forward, and that Ministers reconfirmed their commitment to essential elements of the forest products proposal which AF&PA has been promoting: coverage of all products (both paper and wood), zero tariff rates, and specific end dates ranging from 2000-2004.

In the face of the region's deepening economic turmoil, country after country agreed that the crisis was not an excuse to stall further trade liberalization but, on the contrary, a compelling reasons to move forward. They agreed that eliminating trade barriers must be a central component of any long term solution to the region's economic revitalization.

All, except Japan. Citing the fact that these industries cannot stand up to international competition, Japan is seeking to exclude as many as six of the nine sectors from its market opening commitment--with forest products (and fish) at the top of the list.

The irony in this position is clear--and potentially tragic. By continuing to protect non-competitive industries, Japan is refusing the IMF prescription being taken by weaker economies in the region. Continued adherence to the old protectionist Japan model will certainly extend the longevity of its current recession, and virtually ensure that the Japanese economy will not be capable of acting as a regional locomotive any time soon. On the contrary, given its relative size, it could increasingly become a drag on a region which is already over stressed.

NEXT STEPS

The now-canceled meeting between President Clinton and Prime Minister Hashimoto would have been the best opportunity for the U.S. to collect on the Japanese commitment to deregulate and open its markets as part of the joint effort to support the yen. The CEO's of AF&PA member companies, several members of Congress--including members of this Committee--the Governors of fourteen states and the leaders of the forest products industry unions have written to the President urging him to raise APEC sectoral liberalization to the top of the U.S.-Japan bilateral agenda. (These letters are attached to this statement.)

If the past is any guide, we can expect Mr. Hashimoto's successor to argue that, in his party's weakened political state, they cannot challenge the powerful economic interests arguing for continued protection. There is no reason for the President to concede this point--and very large reasons for him to press even harder for an immediate and firm commitment by Japan to open its market, including a commitment to eliminate tariffs in all sectors being negotiated in APEC.

To ensure that this opportunity does not pass--and that the traditional Japanese practice of waiting until the last to make concessions does not cast a pall over the November meeting of APEC leaders, further undermining market confidence, the President should make it clear to Mr. Hashimoto and his colleagues in the LDP that--internal politics notwithstanding--Japan can no long duck its obligations to its partners in the regions, and to the global trading system. Like new leaders throughout the region, Mr. Hashimoto's successor must make market reform the first order of business. Committing Japan to eliminate its tariffs on all sectors covered by the APEC initiative would be a clear signal that the new leadership has both the vision and the fortitude to lead Japan--and the region--out of its current difficulties.

Mr. HERGER. Thank you very much, Mr. Willkie.

Mr. Smith, the administration has emphasized the implementation of existing trade agreements. In your written statement, it shows that the 1992–1997 paper agreement—and, excuse me, I want to address this to Mr. Willkie——

Mr. WILLKIE. Sure.

Mr. HERGER [continuing]. Paper agreement with Japan failed to increase the market access. Do you feel this was a problem with implementation?

Mr. WILLKIE. Well, I think that the last administration's U.S. Trade Representative Ambassador Hills did a terrific job in negotiating that agreement. And I think that our industry, as with others, have also been well-represented. Our interests have been well-advocated by Ambassador Barshevsky and her predecessor, Ambassador Kantor.

But the political intransigence and the resistance in Japan has simply, to date, precluded our making the progress that we think it's reasonable to anticipate. We have—foreign firms have a 4 percent market share in forest products in Japan and the U.S. industry has a 2 percent market share. In every other market in the world, we have a much more substantial market share than that. The agreement has not yielded the results we had anticipated and now we see that Japan is refusing to participate in this APEC trade liberalization process.

So we think it's important that we keep up the pressure. This is the right way to go. It's the way the whole rest of the world is going and, Mr. Chairman, we appreciate the leadership that you and other members of Congress have taken in articulating the interests of our industry. We know you've been a good friend to our industry. And we just think we need to keep the pressure on.

Mr. HERGER. Thank you, Mr. Willkie. Ms. Herzfeld, you described the U.S.-Japan Enhanced Initiative on Deregulation and Competition as a constructive step in this area. As we have learned over the years, agreements are only as good as their implementation. What steps do you believe will lead to adequate implementation?

Ms. HERZFELD. Thank you very much, Mr. Chairman. We think it was a breakthrough agreement in that it got the Japanese to recognize formally that there is a role for innovative medicines in health care reform. We, though, are very uneasy that during this time of economic difficulty, the bureaucracy, which is really responsible for the slow change in Japan, is going to entrench; is going to be obstructive.

The bureaucracy needs to be led from the top. We are looking for continued pressure, like we have received from this committee, from your colleagues in the Senate, from the administration, at every step. Japan is going through a major health care reform, quite independently of their financial crisis. They have pledged to have a massive new health care system in place by April, 2000. And that will either be a health care system which is inward-looking and bureaucracy-driven or a health care system which is modern.

We will get to a modern health care system if we keep the pressure on, day-in and day-out, from the Embassy to the Department of Commerce to the U.S. Trade Representative, through members such as yourself and your committee and through the Senate. Without it, the progress will stop in its tracks.

Mr. HERGER. Thank you, Ms. Herzfeld. Now, Mr. Smith, does the extreme weakness of the yen affect your members' ability to sell insurance in Japan?

Mr. SMITH. No, not at all. The U.S. insurance companies, because of the very competitive nature of the United States market, have been very successful in markets around the world. The purpose of these agreements is to create the opportunity for U.S. companies to be able to compete in Japan on price. The historical regulation of the Japanese market is everybody has to sell the same product at exactly the same price. Actually, in times of economic difficulty, price competition would add to increased sales by U.S. companies, so this should actually be an advantage to us, if we're truly allowed to compete in the market, as the agreements are intended to achieve.

Mr. HERGER. Thank you very much. I do thank our panelists and your participation. These are concerns for not only your companies, but many other companies that are in our districts throughout our nation and I agree with you that we have to continue to keep the pressure on, to continue to work on this issue together. I believe only by doing so will we see the progress that we deserve and which has to come about.

I thank you. With that, this Subcommittee will stand adjourned. Thank you.

[Whereupon, at 5:05 p.m., the hearing was adjourned subject to the call of the Chair.]

[Submissions for the record follow:]

Testimony of Ambassador Richard Fisher
Deputy United States Trade Representative

U.S. Trade Relations with Japan

House Ways & Means Trade Subcommittee
Executive Session
July 15, 1998

Mr. Chairman and Members of the Committee, thank you for holding this hearing on our trade relationship with Japan and for inviting USTR's testimony.

U.S.-JAPAN TRADE AGENDA

Our trade policy with respect to Japan begins with three simple facts. One, Japan is the world's second largest economy; two, Japan is our second largest trade partner; and three, we expect Japan to play the responsible role it can and should play in world trade and economics.

Our trade relationship with Japan is thus highly complex, and enormously important to American firms, workers and investors, as well as to Japan, Japan's neighbors, and the entire world. And our negotiating agenda with Japan reflects the importance and breadth of this relationship. We are engaged in discussions of the Asian financial crisis and Japan's domestic growth; deregulation of Japan's economy; monitoring and enforcement of our existing bilateral trade agreements; dispute settlement proceedings at the World Trade Organization; regional trade liberalization through Asia Pacific Economic Cooperation (APEC); working to strengthen the operation of the WTO and developing the agenda for WTO negotiations on agriculture, services, transparency, and other issues.

These discussions aim at the following goals: immediate and decisive action to strengthen Japan's financial system; rapid and effective implementation of fiscal stimulus in Japan to restore robust, domestic demand-led growth, and comprehensive deregulation and market opening.

These are issues on which we, and Japan's neighbors, and Japan's people, urgently need meaningful action. My testimony today will address our trade relationship with Japan.

U.S.-JAPAN TRADE

Japan can do more for its own citizens and for our economic relationship by ensuring long-term demand-led growth and openness to the world through comprehensive deregulation and market-opening.

Over the years, Japan has reduced tariff barriers to very low levels in most sectors. However, it has created and maintained a panoply of formal and informal measures, such as closed distribution systems; exclusionary business practices; over-regulation; discriminatory and nontransparent procurement procedures; inappropriately close relations between government and industry; and a business environment that protects domestic companies and restricts the free flow of competitive foreign goods into the Japanese market. These practices are inappropriate in today's world economy. Their impact on U.S. and other foreign firms have made them a key focus of our market-opening efforts in Japan.

1. Enhanced Deregulation Initiative

We believe that meaningful deregulation in Japan goes hand in glove with fiscal stimulus in contributing to Japan's economic revival. Deregulation, if done properly, should reduce non-tariff barriers to trade and increase market access opportunities for U.S. firms and workers, while increasing economic efficiencies and permitting market forces to determine market outcomes. We intend to work constructively with Japan to ensure that this political commitment is translated into genuine market opening deregulatory actions.

At the G-8 Summit in Birmingham on May 18, 1998, we culminated a year of talks under the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy with a broad agreement on deregulation measures Japan agreed to take in key sectors. This agreement includes deregulation actions by Japan in the telecommunications, housing, medical devices and pharmaceuticals, and financial services sectors, as well as the overarching structural issues of competition policy, distribution and transparency of government practices.

Let me briefly highlight some of the accomplishments of that agreement.

Telecommunications. Japan agreed to set market-based interconnection rates, (i.e., the price new entrants pay for access to the dominant carrier's network, in Japan's case to NTT's network), thus addressing the key competitive issue for local competition, where several U.S. providers have major investments. Japan also agreed to liberalize its international services market by permitting innovative arrangements [e.g. international simple resale] for terminating international calls in Japan; and has begun liberalizing its satellite services market.

Housing. Japan recognized U.S. grade marks for lumber; committed to lowering barriers to the construction of three story wooden structures; and agreed to eliminate the use of unique Japanese performance-based standards with respect to building materials.

Medical Devices and Pharmaceuticals. Japan committed to reduce its approval time for new drugs from 18 to 12 months over the next two years; increase acceptance of foreign clinical test data; and will ensure that foreign firms play a meaningful role in Japan's ongoing debate over health care reforms.

Distribution. Japan agreed to abolish the Large Scale Retail Store Law, long recognized by the U.S. as a significant impediment to foreign access to Japan's retail distribution sector.

Competition Policy. Japan pledged to promote competition by increasing the budget and staffing of the Japan Fair Trade Commission, abolishing numerous exemptions to the Antimonopoly Law, and examining the Antimonopoly Law compliance programs of Japan's top 2000 firms.

Transparency. Japan agreed to begin opening bureaucratic regulatory decisions to public scrutiny which will provide U.S. companies with greater access to information and ease some of the heavy administrative burdens imposed by the Japanese system.

2. Next Steps on Deregulation

We are encouraged by the results of the first year under the Enhanced Initiative. However, there is a long way to go. We look forward to working with Japan in the months ahead to build on our accomplishments so far. Deregulation is a continual process, and we are committed to an aggressive deregulation agenda aimed at additional, meaningful market-opening measures from Japan. Our agenda for the coming year is comprised of three elements:

1) Implementation of deregulation measures under the Enhanced Initiative

In telecommunications, we will work closely with the Ministry of Posts and Telecommunications and U.S. industry to ensure that Japan's commitment to reform its interconnection regime is fully enacted. We will also work to improve access to rights-of-way to build infrastructure; and to assure that rules ensuring that the burdens of funding universal service are fairly distributed and are not a barrier to competition.

In housing, we are pressing Japan to eliminate its tariffs for value-added wood building materials, which protect an inefficient processing industry and raise costs. We are working closely with experts in U.S. industry to ensure that Japan fulfills its commitment to revise its building standards in a way that is consistent with international practice and ensures improved market access. We have put Japan on notice that we are extremely concerned about what appears to be a backing away from its Birmingham agreement to revise 2x4 construction regulations in line with international practice.

With respect to medical devices and pharmaceuticals, we are working with our Japanese counterparts to ensure that U.S. devices and pharmaceutical manufacturers have the opportunity to provide input into the serious health care reform process in Japan, which will start shortly. We look for tangible indications that Japan is moving toward a more expedited approval process that rewards and does not discourage innovation.

In retail distribution, having passed legislation to abolish the Large Scale Retail Store Law, MITI is drafting guidelines to implement a new law governing the establishment of large retail stores. We will work closely with U.S. industry to ensure that these guidelines are transparent, non-discriminatory and provide sufficient safeguards for U.S. firms should they encounter arbitrary interference from local entities.

2) Pressing for additional deregulation measures in these sectors and structural areas.

We plan to submit a new list of deregulation requests to Japan early next Fall. We are now putting this list together which will include additional measures we will be seeking Japan's agreement to enact. For example:

In telecommunications we will seek procompetitive rules which ensure consumers can switch carriers with no inconvenience. This will make it easier for U.S. service providers to enter and compete with NTT, the telecommunications monopoly in Japan. In housing, we plan to expand our agenda to include non-wood related building materials. On competition policy we will press for the Japan Fair Trade Commission (JFTC) to take a more active role in deregulation and to amend the Antimonopoly Law to allow private parties to sue for injunctions and damages.

3) Developing specific deregulation requests in new areas, such as energy.

We are developing an agenda for our new initiative on energy sector deregulation in Japan, including electric power, oil, and gas equipment and services. Under this initiative, we plan to address concerns raised by U.S. industry regarding such regulatory issues as burdensome testing and inspection requirements; the use of narrow, technical standards rather than performance-based standards; and other burdensome laws and regulations that impede foreign access to this market. We also will use these discussions to advance our mutual efforts on energy sector liberalization within the Asia Pacific Economic Cooperation forum. Finally, we hope to use these discussions to support the Japanese Government's efforts to deregulate this sector, which would create new opportunities for U.S. and other foreign firms.

3. Monitoring and Enforcing Agreements

At the same time, we will continue vigorously to monitor and ensure compliance with our existing trade agreements with Japan.

Since the Clinton Administration came into office, beginning with the Framework Agreement in 1993 we have concluded 35 results-oriented trade agreements with Japan. These cover a broad range of sectors, including autos and auto parts, insurance, medical technology, financial services, telecommunications, wood products, civil aviation, sound recordings, distilled spirits, and maritime and port practices. They address impediments to trade such as distribution, procurement, competition, and other market access issues. To ensure that these agreements yield the anticipated results, the Administration is committed to vigorous and continuous monitoring and enforcement efforts.

As the number of agreements with Japan has grown, the Administration has devoted additional attention and resources to monitoring and enforcement efforts. Last year, Congress approved funding for additional staff in our Japan office, and for an expanded Office of Monitoring and Enforcement at USTR. These offices work with one another as well as with other USTR offices responsible for handling various issues with Japan. USTR also coordinates and works closely with (1) the Commerce Department's Trade Compliance Center; (2) the U.S. Embassy, (3) other agencies responsible for Japan trade issues. These offices consult frequently with U.S. industry to identify concerns and most effective ways to address them. The result has been a qualitative improvement in our ability to monitor and enforce our Japan trade agreements.

Let me offer just a couple of specific examples of recent successes:

- We successfully intervened on behalf of U.S. industry after discovering that the National Police Agency was using discriminatory procedures to procure a wireless communications system from domestic suppliers as a result of U.S. Government pressure, the agency terminated the discriminatory procurement and initiated a new, open procurement process. We are closely monitoring developments with respect to the new procurement.

- Earlier this year, we expressed our serious concerns to Japan's Minister of Health and Welfare to adopt a reference pricing system for reimbursement pharmaceuticals in the administration of its health care system. Specifically, a reference pricing system would group generic drugs together with new, more effective pharmaceuticals -- pharmaceuticals in which firms have invested very considerable capital in developing -- in calculating the price the government reimburses pharmaceutical companies under the national health care system. This reference pricing system would have had a extremely negative impact on U.S. pharmaceutical manufacturers, clearly world leaders in the development of innovative life saving drugs. Japan agreed to shelve its plans for now and provide meaningful opportunities for our companies to input into the reform process. We will continue to watch this process closely in the coming months in close coordination with U.S. industry.

- After learning earlier this year that the Ministry of Posts and Telecommunications was preparing guidelines for the implementation of new interconnection rules -- which could potentially severely disadvantage U.S. suppliers -- we pushed hard for an opportunity to comment on those guidelines and succeeded in having U.S. views incorporated into the final product.

Let me now turn to our current monitoring efforts and highlight a few of the agreements on which we focus intense attention.

-- Flat Glass -- Market access has been a longstanding problem in the Japanese flat glass sector. In 1995, we concluded an agreement in which Japanese glass manufacturers and distributors committed to diversify their sources of supply to include foreign glass suppliers and to avoid discrimination based on capital affiliation. There has been some progress under the Agreement. For example, Japan has agreed to revise its residential energy standards in Japan to increase the use of insulated glass -- a product area in which our companies are particularly competitive.

We are still very concerned, however, with the continuing problems U.S. companies face in trying to gain meaningful access to the Japanese glass distribution system. In an attempt to address these problems, we submitted to Japan a detailed Antimonopoly Law "Compliance Initiative" to ensure that Japanese glass manufacturers and distributors vigorously comply with Japanese antitrust law. We are extremely disappointed that the Japanese Government has rejected this initiative and intend to continue to press Japan on this issue. In the meantime, we plan to continue to provide input into the comprehensive antitrust survey of the glass sector, which the Japan Fair Trade Commission (JFTC) has recently initiated.

-- U.S.-Japan Automotive Agreement -- We have achieved some progress under the 1995 U.S.-Japan Automotive Agreement in increasing access for vehicle manufacturers and eliminating burdensome regulations in the auto parts sector. We also have improved opportunities for auto parts manufacturers in the United States and Japan. Indeed, the Japanese automakers have increased production in the United States, providing more than one and a quarter million additional direct and indirect jobs to U.S. workers and increasing parts purchases from U.S. suppliers for use in these facilities by 10 percent last year, according to the University of Michigan.

Under the Automotive Agreement, we use the objective criteria specified in the Agreement to evaluate progress and include this evaluation in our semi-annual auto monitoring report. The report highlights key areas of outstanding concern, including practices that continue to inhibit foreign access to the Japanese auto distribution networks, regulatory barriers in the auto parts market, and to encourage Japan to take concrete actions to address these concerns.

We have been working closely with the auto and autos parts industries over the past several months to prepare the next auto monitoring report, which we plan to release shortly, and to develop our auto strategy for the coming year. At the moment, the concerns of our auto industry are focused as much on the macroeconomic environment in Japan as they are on specific market access concerns. With Japanese auto sales down for 15 straight months and the sector contracting 18 percent during the first four months of this year, their concerns are certainly warranted.

Absent a pick up in domestic economic activity in Japan, or reversal in the exchange rate for yen, and more vigorous efforts by the Japanese Government to fully implement both the letter and the spirit of the Agreement, the efforts of the U.S. auto industry to compete in the Japanese market through the development of high-quality, competitively-priced products for the Japanese market continue to be frustrated. The economic difficulties of the Japanese economy notwithstanding, we fully expect the Japanese Government to take concrete actions to further open and significantly deregulate this sector. Such actions would serve not only to achieve continued progress under the Agreement, as Japan committed to do, but to help spur economic growth in the Japanese economy.

-- Insurance -- We continue to have serious problems with Japan's implementation of its commitments under the Insurance Agreement. On July 1, we formally expressed our extreme disappointment in Japan's failure to fully implement all of its insurance deregulation obligations on the time line envisioned by both governments. The 1994 and 1996 agreements established a framework for Japan to deregulate its insurance market first by opening to competition its primary insurance market, roughly 95 percent of Japan's $335 billion total insurance market.

Our concerns regarding Japan's primary sector deregulation center on two issues: 1) inadequate steps to prevent continuation of activities of non-life insurance cartels called "rating organizations," which have been used to impose industry-wide compulsory premiums on insurers; and 2) continued delays and arbitrary practices by the Ministry of Finances in approving applications from foreign insurance providers. Given Japan's failure to implement significant aspects of its deregulation commitments, we have put Japan on notice that the United States opposes the starting on July 1 of the 2-1/2 year "clock" for terminating measures relating to the activities of Japanese insurance firms in the third sector. The United States will not agree to begin the clock until Japan comes into full compliance with its commitments to properly and effectively deregulate the primary insurance sector. We are seeking to work with Japan in this regard.

With respect to the third sector, the United States is deeply disturbed that the Ministry of Finance approved a cancer rider to a Japanese company, which was clearly designed to undermine key provisions in the insurance agreement.

Of course, this list of agreements is not exhaustive. Our efforts are also devoted to monitoring bilateral agreements on computers, telecommunications, construction and many other sectors.

4. Other Market Access Issues

An important element of our trade agenda on Japan this year is our market-opening initiative on film. As you may be aware, in February, the U.S. Government announced a new initiative to monitor Japanese Government representations to a World Trade Organization (WTO) panel on the openness of its photographic film and paper market. We have thus established a monitoring and enforcement committee to collect information and data on foreign access to the Japanese distribution system and retail market. We intend to report on areas where progress has been achieved and to highlight outstanding areas of concern that the Japanese Government needs to address. Our first report will be issued in the next several weeks, using data and information provided by Kodak, other photographic film manufacturers, the Japan Fair Trade Commission, and our own survey of Japan's film sector.

We are also actively considering new areas for negotiation with Japan in an effort to address outstanding market access concerns. In particular, distribution and standards issues are areas that may merit future bilateral negotiations.

We also will not hesitate to challenge Japanese trade practices at the WTO, as appropriate, to further open the Japanese market. Although we were extremely disappointed with the panel decision on the film case, we have successfully resolved disputes regarding copyright protection for sound recordings and discriminatory taxation for distilled spirits under the WTO. We are now challenging Japan's practices on varietal testing for fruits in the WTO, as Japan's non-scientifically-based requirements on quarantine treatment has unfairly impeded market access for U.S. apples, cherries, and nectarines.

THE INTERNATIONAL TRADE SYSTEM

We also expect Japan to take a leadership role in the further opening of the global trading system through regional and multilateral trade negotiations. In particular, Japan's full and constructive participation will be critical to the work of APEC and to the WTO negotiations on agriculture, services and other issues set to begin next year.

1. APEC

Last year in Vancouver, APEC agreed to finalize arrangements to liberalize trade in nine sectors in 1998, accounting for $1.5 trillion in trade: energy; environmental goods and service; medical equipment; forest products; fish; chemicals; gems and jewelry; toys; and telecommunications. Officials were also directed to further develop proposals in another six sectors: food, oilseeds, civil aircraft, automotive, rubber and fertilizer.

This carefully balanced package offers significant concrete benefits to both APEC's developed and developing economies, and can offer renewed psychological confidence during the Asian financial crisis that market opening will be an integral part of economic reform. Work on the nine sectors is scheduled to be completed by the next Leaders' meeting in Kuala Lumpur this fall.

We have been deeply concerned by the positions Japan has taken on the work to implement this objective. Japan has pursued a course of action that could undermine the entire APEC initiative, and cast doubt not only on Asia's recovery but also APEC's role in the trading system. At the recent APEC Ministerial meeting in Kuching, Malaysia, Japan sought explicit acceptance by the other APEC members that participants in the various sectoral initiatives did not need to pursue tariff cuts or other market opening actions, and argued that its fishery and forest products industries are too sensitive to allow it to make any tariff cuts.

Japan was completely isolated on this score. All other members recognized the need for participation in all elements of the proposals -- tariff and non-tariff barriers as well as trade facilitation and economic and technological cooperation. China, Korea, and ASEAN economies are participating, even as they are struggling with financial turmoil. And neither we nor other APEC economies can allow Japan to evade the concessions others are prepared to make, especially in these troubled economic times.

We, and other APEC economies, are prepared to work with Japan to provide reasonable flexibility for especially sensitive products, even in the fish and forest products sectors. But neither we nor other APEC economies could accept a formulation that would result in Japan's dereliction of its role in Asia's recovery and its central responsibility for continued trade liberalization in APEC. We hope that, in the aftermath of Kuching, Japan will revise its current position and work with the rest of APEC to come up with a reasonable approach to flexibility, which does not unbalance and undermine the initiative that Japan's and other APEC Leaders worked so hard to launch last year.

2. WTO

As the world's two largest economies, the United States and Japan bear special responsibilities in the World Trade Organization, to adhere to the spirit and letter of current multilateral rules and obligations, and to be at the forefront of further trade liberalization.

Clearly, we have managed to do this in the past. It may be recalled that at the end of the Uruguay Round, the decisions on many of the sectoral initiatives or zero-for-zero agreements were actually agreed upon at a meeting of the United States, Japan, the EU, and Canada hosted by Japan. We expect similar vision and leadership from Japan as we move forward in preparing for the Ministerial meeting in 1999, where agriculture and services are featured prominently in the work program and further negotiations. We welcome Japan's understanding of the need for greater transparency and openness in the WTO's operations. This is significant and signals a welcome change in Japan's approach. Similarly, Japan is among those countries that takes seriously the work that must be done to ensure that each and every accession is completed on a commercially viable basis.

CONCLUSION: JAPAN'S ECONOMIC STRENGTH

In conclusion, our trade agenda with Japan is broad and complex. We have learned over the years that the most effective way to address our trade problems with Japan is to work through them sector by sector, barrier by barrier. The process is painstaking and time-consuming. But it is the only effective way to address our market access problems and create a fair, open and competitive market. And the results of this policy, combined with short-term fiscal stimulus and reform of the financial sector, will be a more vital Japanese economy which is better equipped to assist in Asia's recovery, and a better partner in a more international, more open, 21st century trading system.

Thank you, Mr. Chairman. I welcome your questions and those of the Committee.

THE AMERICAN CHAMBER OF COMMERCE IN JAPAN

ACCJ VIEWPOINT

REFORM OF RATING ORGANIZATIONS

BACKGROUND

The 1996 Supplementary Measures ("Measures") to the 1994 US-Japan Insurance Framework Agreement include statements that the Ministry of Finance ("MOF") *"has decided to take actions to undertake fundamental reform of the rating organization system, with a view toward achieving maximum liberalization through elimination of obligations for members of a rating organization to use rates calculated by the rating organization"* and further that the Government of Japan *"intends to submit to the Diet as early as possible in 1998 legislation which will achieve these objectives"*.

Amendments to the Law Concerning Non-Life Insurance Rating Organization ("RO Law") as well as of the Insurance Business Law to reform the rating organization system were submitted to the Diet on March 10, 1998, and are slated for approval by June 18, 1998, the end of the current Diet session. When adopted, the revised RO Law will go into effect on July 1, 1998.

Under the proposed revisions to the RO Law, the obligation of members of the Non-Life Rating Organization and the Automobile Insurance Rating Organizations (the "ROs") to adhere to standard, total premium rates calculated by the ROs will be substantially reduced. With two exceptions, the ROs will calculate only pure premium rates[1] for referential use by the ROs' members for all the fire, personal accident and automobile insurance lines covered by the two ROs. The two exceptions are compulsory automobile liability insurance ("CALI") and household earthquake insurance, which are government-mandated programs.

The Anti-Monopoly Law exemption for the ROs' activities will be abolished for all but the standard, total premium rates applicable to CALI and household earthquake insurance. Member companies will be expected to calculate their own premium rates for all other lines based on the pure premium rates calculated by the ROs and their own calculation of their expenses and profit margin. These changes, if fully implemented, are a substantial step in the direction of deregulation.

Cabinet orders and ministerial ordinances to supplement the RO Law are now being finalized by MOF. Revisions to the current articles of incorporation and internal regulations also must be drafted to reflect the proposed reform. The ROs started discussions with member companies in October 1997 on the new organizational structure and the scope and mode of operation for the reformed RO. Those discussions are on-going.

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[1] Pure premium rates are the actual cost of claims, and are only one element of the total premium rate. Other elements include expenses (administrative and acquisition costs) and a profit margin.

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ISSUES

Ministerial Ordinances
JNLIA has recommended, and MOF has included in its Ministerial Ordinances, an expansion of classes of business for which the RO will calculate pure premium rates. In addition to fire, personal accident and automobile insurance, the draft Ordinances include medical expense and nursing care insurance. Both of these lines of insurance cross into life insurance. Furthermore, until such time as it is clear that the reforms envisioned in the RO Law will in fact be reflected in the articles of incorporation and internal regulations, the classes of insurance should remain unchanged.

Lack of transparency
Although the bill pending before the Diet will eliminate the obligation for members of an RO to use the standard tariff rates calculated by the RO in most instances, the law itself contains only a general outline and is short on details. Until such time as the cabinet orders and ministerial ordinances under the RO Law are promulgated and the content of the articles of incorporation and internal regulations of the RO are determined, it cannot be known whether restrictions and practices established in those documents will nullify or dilute to the point of irrelevance the reforms contained in the revised RO Law.

Expense data
The stated role of the RO is to calculate referential pure premium rates for various property, personal accident and automobile lines of insurance, other than CALI and household earthquake insurance. Nevertheless, the two ROs propose to collect expense data from their members, perform statistical analyses of that data and provide the resulting information to the members. Providing members with information on their competitors' costs of doing business will restrain, rather than promote, competition and create uniformity. This is contrary to the stated goal of introducing competition and dismantling premium uniformity.

Directors
Both ROs propose the same configuration of directors: six directors from the member companies and 15 outside directors. The directors from non-members are said to represent the public interest and will likely be selected from candidates proposed by the ROs. The need for directors that represent the public interest no longer exists because the duty to abide by the standard, total premium rates was eliminated, except for CALI and household earthquake insurance. The Compulsory Automobile Liability Insurance Council and the Insurance Council (which will be integrated into the Financial Business Council) are in a better position to represent the public interest in this regard. The presence of a considerable majority of directors not from insurance companies will have the effect of making the ROs less responsive to the needs of the industry. The ROs should be operated to advance the interests of the companies that they serve and not be a means of controlling the industry in the manner determined by the ROs through directors selected by the ROs.

(Insurance Subcommittee; For use from 6/98 to 6/99)

Quasi-Government Organization
In discussions with member companies regarding the ROs proposed new organizational structure and scope and mode of operation, it is clear that the ROs still consider themselves quasi-government organizations with little accountability to their member companies. Recommendations from foreign members to combine the ROs into one organization and streamline its operations have been ignored. As long as the ROs are not market-driven service providers, they will continue to hamper industry efforts to innovate and differentiate themselves in the market.

RECOMMENDATIONS

- The draft Ministerial Ordinances should be revised and medical expense insurance and nursing care insurance deleted as lines of business for which the ROs will calculate pure premium rates.

- Certification that the RO Law has been fundamentally reformed should be delayed until such time as the current debate about the functions and the scope of the activities of the ROs is concluded. Until then it cannot be confirmed that fundamental reform has been carried through in the cabinet orders and ministerial ordinances and the RO's articles of incorporation and internal regulations.

- The collection of expense data intended by the ROs is included in their proposed new articles of incorporation. As the articles of incorporation of the ROs are subject to the prior approval of the Financial Supervisory Agency ("Agency"), the ACCJ recommends that the Agency not allow collection of expense data as this is likely to restrain competition.

- The number of directors is also included in the provisions of the ROs' articles of incorporation. The ACCJ recommends restructuring the configuration of the directors by the Agency. The non-member directors should be eliminated or their numbers substantially reduced.

- The ACCJ recommends that the two ROs be combined into one and duplicate administrative functions eliminated. Additionally, the RO should charge member companies only for basic services (calculation of pure premium rates) with all other services charged on a usage basis.

TESTIMONY OF
THE AMERICAN ELECTRONICS ASSOCIATION

SUBMITTED TO THE
U.S. HOUSE OF REPRESETATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE

IN CONJUNCTION WITH THE SUBCOMMITTEE'S
JULY 15, 1998 HEARING ON
UNITED STATES-JAPAN TRADE RELATIONS

AEA POSITION ON JAPAN MARKET ACCESS IN TELECOMMUNICATIONS AND COMPUTERS

The American Electronics Association expresses its appreciation to Chairman Crane, Ranking Member Matsui and the entire Trade Subcommittee membership for the opportunity to present our concerns regarding the immensely important topic of United States-Japan trade relations. The AEA's 3,200 members represent all sectors of the high tech industry spectrum. As such, our nation's trade—as well as general economic and political—relations with Japan are immensely important to us.

The AEA would like to take this opportunity to call upon the U.S. government to continue to closely monitor past agreements it has reached with the Japanese government to open up sectors of their high tech markets. The AEA believes the data, to date, are conclusive that the Japanese government is not living up to the expectations embodied in past commitments with regard to the telecommunications and public sector computer markets.

Maintaining U.S. government vigilance in enforcing and expanding these agreements is essential not only to the integrity of diplomatic trade initiatives and the continued competitiveness of our high tech industry, but also to the economic health and stability of the entire region. In the wake of the Asian currency crisis, Japan (which accounts for nearly three fourths of the region's aggregate gross domestic product) is undoubtedly the key to recovery. The continued failure of the Japanese government to live up to the spirit and intention of its agreements hurts not only the Japanese economy, but also the recovery prospects of an increasingly integrated and interdependent region.

The AEA wishes to voice industry concern with the disappointing lack of expected increase in market share in the Japanese telecommunications and public sector computer markets, despite Japanese commitments in the past to open these markets.

ACCESSING THE JAPANESE TELECOMMUNICATIONS MARKET:
The two major problems for telecommunications in Japan have been procurement by government agencies, including Nippon Telegraph and Telephone (NTT) Corporation—which is majority owned by the Government of Japan—and equal access to the Japanese telecommunications network infrastructure, again controlled almost entirely by NTT. The framework agreements on procurement, signed in 1994, established a set of expectations for the United States that Japan would ensure significant increases in market access and sales as measured annually by foreign-capital affiliated sales and share.

Despite Japanese government commitments to further open up this sector of their economy to competition—both domestic and foreign—the non-government share has risen only slightly. This is especially troubling in light of the fact that this sector of the Japanese economy has been outperforming other sectors. According to the Japanese government's most recently published statistics, telecommunications services grew to a value of $107.5 billion, an increase of 21 percent from 1995 to 1996. At the same time, market share for the facility-based services of the so-called "new common carriers" (NCCs), the non-government competitors' share grew only slightly from 7.4 percent to 7.9 percent of domestic revenues.

Precipitous Drop in Foreign Market Share
The harshest news has been reserved for foreign market share in this sector. Despite the 1994 Framework Agreement on Government Procurement of Telecommunications between the United States and Japan, Japanese government procurement of products from non-Japanese sources has actually taken a precipitous drop. Japanese statistics, recently confirmed by the U.S. Embassy in Tokyo, show that the foreign portion of Japanese government procurement in telecommunications equipment and services dropped from 12.0 percent in 1995 to 3.5 percent in 1996.

Barriers to Entry
A number of factors can be said to account for these disturbing trends. A direct contributing factor to the lack of market access has to do with standards and specifications. NTT does not use internationally accepted standards throughout its network. The use of Japan-specific or even NTT-specific standards is a major barrier to market access, as are other procurement guidelines. Some of the attendant problems caused by this are highlighted by the results of a June 1998 survey of firms conducted by a Japanese semi-governmental organization.

According to the survey:

- "Japan has two regulations relating to technical standards of telecommunications equipment: the 'Telecommunications Business Law' and the 'Radio Law.' For mobile telephones and wireless equipment, there are two inspection authorities for these two technical standards. Therefore, manufacturers wishing to newly enter the Japanese market are subject to these two examining authorities. On the other hand, there is only one regulation relating to technical standards in each of the U.S. and European countries. Thus, manufacturers only have to undergo examinations of one certification authority. Examination fees are higher in Japan than in the U.S. and European countries. As for acquisition of test data necessary for inspection, it is more difficult to utilize private testing organizations in Japan than in western countries";
- "regulations relating to the classification of businesses, rates, network interconnections and telecommunications infrastructure in Japan, are factors which make new entry into the Japanese telecommunications service sector more difficult than in the U.S. and European countries or make establishment of competitive prices more difficult." It is pointed out that these, as a result, are factors reducing the opportunities for access of competitively priced imports into the Japanese market;
- and, regarding government procurement, foreign manufacturers face unnecessary and burdensome hurdles "since the content of the product specifications presented by the major carriers in Japan are complicated and not sufficiently documented."

NTT also exerts control over the market due to its monopoly position as the sole network provider. New service providers attempting to enter this important market must use the NTT network to complete their service offerings, unless they want to build an entirely new national network. This is obviously prohibitively expensive. NTT consequently capitalizes on its position by charging exorbitant access charges for traffic from new entrants, as well as prohibitively high fees for programming and installation of equipment needed to physically interconnect to NTT's network. NTT does not base these rates and fees on what the U.S. would call incremental costs, that is, costs incurred due to the increased traffic from the new operators, but on a non-transparent process which seems to allow NTT to estimate its operating results, and then pass on a share of this burden to the company wanting to interconnect to NTT's network. Access charges amount to approximately 50 percent of the cost of a call. This is true for all types of calls, except for those calls that stay within an NCC network (a very small portion of the traffic in the case of Personal Handiphone System). Promises have been made to rectify these problems, but they have been vague in nature, are not due to be implemented until some time after the year 2000, and contain no guarantees or timetables for nationwide implementation.

In fairness, it must be acknowledged that a few foreign companies have announced plans to build their own networks to serve localized markets, but beyond the granting of initial licenses by the Ministry of Post and Telecommunications (MPT), they have found their progress hampered by a raft of regional and local licensing requirements which make the regulatory aspects of their task a nightmare. This is a situation that must be firmly and speedily addressed by the regulator in Japan.

New entrants are also hampered by a lack of clear and equal access to rights-of-way, conduits and poles necessary to make building any sort of network a reality. Again in this area, vague promises only serve to highlight the lack of willingness to open its network to competition on the part of NTT, and a failure of resolve to address the problem on the part of the MPT.

Finally, a series of one-on-one interviews by AEA with companies doing business in Japan have revealed a persistent pattern of a "buy Japanese" attitude and practice within the Japanese government. Accordingly, extra efforts are required by American and other non-Japanese companies in order to gain access to the same information at the same time as it is released to the companies that have enjoyed long term relationships with NTT and other government officials. The existence of this favored group of suppliers is attested to by the fact that they are referred to as the "NTT Family" in the Japanese trade press.

Anecdotal complaints point the finger at many factors including the temporary transfer system between government and industry, and the continuation of "keiretsu" groupings as contributing to the almost impenetrable barrier to American and other foreign goods. Indeed, American companies have expressed the sentiment that when information on procurement bids has been made public in an unbiased manner, the result has been a fair lead-time for every group involved including American companies.

We strongly urge the United States government to remain vigilant in enforcing the 1994 Framework Agreement on Government Procurement of Telecommunications between the United States and Japan and in seeking renewed commitments from Japan on market access during the up-coming review of the agreement.

ACCESSING THE JAPANESE PUBLIC SECTOR MARKET FOR COMPUTERS:
Japanese government procurement practices have resulted in a similar story for foreign computer manufacturers trying to crack the public sector market. Despite the current Japanese economic downturn, the public procurement market has grown, particularly for computers and computer-related equipment. Nonetheless, the data reveal that, for the third straight year, there has been a steady decline in the percentage of Japanese government procurements of foreign computers and computer-related services.

The 1992 Bilateral Agreement on Computer Procurement was established with the intention of increasing market share and penetration by Foreign Computer Manufacturers (FCM) in Japan. In this sense, it is safe to say that the Japanese Government's compliance with the Agreement borders on failing. Figures from Fiscal Year 1995-96 show a year-on-year decline in the foreign share of computer hardware procurement. Unfortunately, that trend is expected to have continued through Fiscal Year 1997.

Precipitous Drop in Foreign Market Share
A study recently completed for the Computer Systems Policy Project (CSPP) in Washington, D.C. has revealed the following:

- The FMC share of the public sector market for midrange and mainframe computers in Japan declined from 10.2 percent of the market in 1995 to 9.3 percent in 1996.
- Similarly, the FMC share of the public sector market for personal computers declined from 15 percent in 1992 to 11.6 percent in 1994. In 1996, FMC market share in this sector was only 7.7 percent. Putting this in sharper contrast, the CSPP study points out that the Japanese government actually increased its share of the over-all PC market in Japan at roughly the same time. In 1990, the public sector accounted for only 3.7 percent of PC sales in Japan. By 1996, this share had reached 7.7 percent.
- Finally, the CSPP study has revealed that the foreign market share for all types of computers is significantly higher in the Japanese private sector than it is in the public sector, indicating that U.S. and other foreign products are clearly competitive in Japan. In 1996, the FMC share of sales of midrange and mainframe computers to the Japanese private sector was 35 percent, as opposed to 9 percent in the public sector. For PCs, the FMC share of private sector sales was 29.3 percent, whereas it was 7.7 percent in the public sector.

The Need to Revise the "Action Program"
AEA believes there is no alternative but to revise the Government of Japan's "Action Program" regarding this Bilateral Agreement in order to correct the situation. The AEA has formally requested that the U.S. government press the government of Japan during the upcoming Computer Agreement review (scheduled for August 24th and 25th, 1998) to revise its "Action Program." USG should also receive a commitment from the GOJ that the situation will be rectified as soon as possible.

<u>Areas Where the GOJ Action Plan Should be Revised</u>
In order to rectify the current situation regarding public procurement vis-à-vis the Bilateral Agreements on Computers, the AEA suggests the following two approaches. Further, in order to guarantee a favorable position for foreign computers in the Japanese market, AEA suggests that provisions in both A and B be enacted at the same time:

A) LOWERING THRESHOLD ON AMOUNTS FOR PUBLIC NOTIFICATION BIDDING
<u>Point of Revision</u>: The AEA requests to have the Standard Drawing Rights (SDR) limit (In computer products/services) lowered from 800,000 SDR to 385,000 SDR.
<u>Reasons for Revision</u>:
- The SDR level has been set at 800,000 since the agreement came into effect in 1992; but severe "price erosion" has occurred rendering this current amount inappropriate.
- Due to price erosion, projects that would have been openly bid a certain amount when the 1992 Agreement initially went into effect, would now fall outside the scope of 800,000 SDRs and, therefore, would not be subjected to public notification.
- There has been a decline in published notices for bids for projects. They have tended to be for large-scale bidding. Therefore a decline is observed in lower and mid-priced amount contracts. This reduces the tendering opportunities for foreign manufacturers.
- The decline in these projects increase non-transparency concerns, and translates into fewer market opportunities for American computer manufacturers active in the public sector.

B) ADJUSTMENTS TO THE "OVERALL GREATEST VALUE EVALUATION METHOD"
<u>Point of Revision</u>: The AEA finds that there are no great differences between the current greatest overall valuing tendering system and the former system of lowest price value. The tendering

method, which weighs performance factors, is largely ignored. AEA recommends the tendering system be one where the factors of cost, technological merit and service/support are combined and weighted in a balanced fashion (the way most procurement regimes operate), resulting in a truly cost performance-based tendering system.

Reason for Revision:

- It can be said that the "Overall Greatest Value Evaluation Method" is the preferable tendering method for high technology products such as computers. However, the current "Overall Greatest Value Evaluation Method" bears little resemblance to the evaluation method widely utilized in the Japanese private market.
- An Overall Best Value system does not exist, per se, as a classification (type) of tendering system in private procurements in Japan. What does exist is a system based more on a combination of technology/technical merit, service and price. More emphasis is placed on the balance of all of these factors. It is arranged so that Cost Performance is paramount, not just simple price only. The "system" has variations but generally speaking as a whole, private tendering approaches are preferable for our firms when compared to the current "Overall Greatest Value" approach seen in public procurement.
- Under the current public procurement system, there seems to be a lack of rules regarding weighting and rating, so that in effect the method seems to evolve into one where lowest price is the paramount factor.
- There are also fundamental problems in the application of the "Overall Best and Greatest Value" Tendering system. Unreasonable amounts of documents (documentation) often are requested in these government tenders. Based on these over-regulated aspects, foreign manufacturers' enthusiasm to attempt projects is dampened. Furthermore there are considerable differences between the "Overall Best and Greatest Value" System for public procurement and the "Greatest Value System" (*hyoka hoshiki*), used in private procurement in Japan.
- As long as a public procurement system not based on a strong weighting of performance issues is in place, there is really no outlet for competitive foreign computer manufacturers.

CONCLUSION:

With much of Asia in economic turmoil and with the Japanese economy in a self-recognized recession, the American Electronics Association calls upon the U.S. government to maintain its vigilance in assuring the complete implementation of market-opening agreements it has reached with the government of Japan. It is as important that the Japanese government meet the expectations embodied in the agreements as it is that they meet the letter of the agreements themselves. The AEA holds that this is of the utmost importance at this time, not only for the continued prosperity of the U.S. telecommunications and computer industries, but also for the future economic vitality of the Japanese economy and the economy of the entire region. Japan is widely recognized as the lynchpin to Asia's economic recovery. Japan is, by far, the largest and most dynamic engine for growth in the region. Maintaining efforts at prying their markets open will assure that this engine is ignited and fully functional.

Testimony of Peter S. Walters
Group Vice President
Guardian Industries Corp.
before the
House Ways and Means Trade Subcommittee
July 15, 1998

Market Access in Japan: The Case of Flat Glass

Introduction

Mr. Chairman and other distinguished committee members. Thank you for the opportunity to appear before you today to discuss Japan trade issues.

My name is Peter Walters. I am Group Vice President at Guardian Industries Corp. of Auburn Hills, Michigan. Guardian is a major worldwide manufacturer of flat glass products used in the construction, automotive, furniture and appliance industries. We are also a leading manufacturer of injection molded plastic exterior trim systems for the automotive industry.

I would like to tell you of our experiences in attempting to establish a significant presence in Japan's flat glass market.

Background

Guardian Industries has worked extremely hard for the past decade to achieve access to the Japanese market for our products. Another American competitor, PPG Industries Inc., of Pittsburgh, has been active in Japan for over 30 years. Together, despite our efforts, we account for little more than 1 percent of the Japanese flat glass market. Japanese assertions to the effect that imports account for about 14 percent of the market do not reflect the full story. In fact, 70 percent of that share is accounted for by imports of foreign affiliates owned by Japanese producers. Another 28 percent consists of automotive and specialty glass products sold directly to Japanese producers and do not go through the Japanese distribution system. The lack of any real success in Japan by Guardian and PPG is astonishing in light of our substantial market shares in every other market in which they compete around the world. For example, in most major markets, Guardian typically enjoys a market share of 10 to 20 percent.

Guardian's initial market-entry strategy in Japan was one that had been successful for our company throughout North America, Latin America, Europe, and the rest of Asia. We set out to win customers by providing high-quality glass products at very competitive prices. We have been able to offer attractive prices in part by shortening and simplifying the distribution chain.

From the outset, we met a stone wall in Japan. With minor exceptions, neither glass distributors nor glass fabricators would handle our products, even though we were able to provide prices at least 30 to 50 percent below domestic prices. It soon became clear that the problem centered on Japan's distribution system. Each of the three Japanese flat glass companies -- Asahi Glass Company, Nippon Sheet Glass Company, and Central Glass Company -- maintained an exclusive network of distributors. Moreover, the three operate as a cartel, maintaining steady market shares of 50, 30 and 20 percent respectively since the early 1950's. In order to avoid what the Japanese call "confusion", no salesman for one Japanese flat glass manufacturer calls on another manufacturer's customer. Foreign suppliers clearly are not part of the club. Any distributors tempted to purchase imported glass are pressured in a variety of ways, including threats that their domestic sources of supply would be cut off.

In an effort to combat these tactics, Guardian created a sales subsidiary in Japan and opened a network of warehouses to minimize delivery time. PPG went a slightly different route: It entered into a joint venture with a Japanese trading company to handle marketing and sales in Japan. Despite these time-consuming and expensive efforts, Guardian has not yet made significant headway and PPG's results apparently have been well below normal expectations.

In June of 1993, the Japan Fair Trade Commission released a study of the flat glass market that confirmed the extent of anticompetitive behavior that we had found to exist. When it came to action, however, the JFTC pulled its punch. It decided not to impose penalties because the glass companies had already agreed to take reform measures. These industry measures proved to be weak and accomplished little.

Efforts to Open the Market

In recent years, the U.S. Government has worked hard to break down the obstacles to market access in Japan. The Bush Administration was the first to take up the issue. In the 1992 Bush-Miyazawa Action Plan, the Japanese government acknowledged the problem in the flat glass sector and undertook to "substantially increase market access for competitive foreign firms." Unfortunately, the election period intervened and there was little consistent attention to the Action Plan. Thus, the Japanese were emboldened to ignore key elements of the agreement.

In January 1995, after long and complex negotiations, then-U.S. Trade Representative Mickey Kantor concluded a bilateral flat glass agreement with then-MITI Minister Ryutaro Hashimoto. The five-year agreement spelled out the responsibilities for all parties to create an open flat glass market.

- Japanese flat glass manufacturers and distributors released public statements that the market was open on a non-discriminatory basis for competition by all suppliers, foreign and domestic alike.

- The Government of Japan endorsed these statements and agreed to survey the industry annually to ensure that the goal is being met. The data required to be collected in the annual survey is spelled out in great detail in the agreement.

- The Japanese Government also agreed to strengthen building standards to require greater use of energy-efficient glass products and safety glass.

- U.S. suppliers agreed to continue to work hard, with the support of the U.S. government, to take advantage of new market opportunities.

The governments agreed to meet at least annually to review progress under the agreement. We believed at the time that this agreement, if properly implemented, would be helpful.

The Current Situation

We are now more than halfway through the five-year life of the flat glass agreement, and I must report that results have been disappointing. As reported in the 1998 National Trade Estimate Report on Foreign Trade Barriers, released by USTR last month, "The Japanese glass distribution system remains closed to foreign glass producers...(page 237)." Things looked promising for about six months after the agreement took effect. Sales initially increased about 50 percent for Guardian. Then there was a very pronounced turnabout. Sales rapidly eroded to pre-agreement levels, where they remain today. It is as if a cap had been imposed. Among those distributors that handle foreign glass, very few allow foreign glass to exceed 5 percent of total purchases.

And there are no signs that this pattern is likely to change. In fact, according to the survey by the Ministry of International Trade and Industry released earlier this year, foreign suppliers still account for only 2.8% of the market. Even worse, fully 80% of Japanese distributors say that they are not going to buy more foreign glass.

We are at a frustrating point in the implementation of the agreement. The Japanese -- both government and industry -- insist that the market is open because they have declared it open. Meanwhile, our salesmen report continuing anticompetitive behavior in the marketplace. At the third annual meeting in May, in an effort to ensure that Japanese flat glass companies fully implement their commitments to open the market, the U.S. Trade Representative and the U.S. Department of Justice proposed that anti-monopoly compliance plans be adopted. These plans, patterned after those maintained by larger corporations here in the U.S., would ensure that all corporate officials are fully briefed on appropriate behavior in the marketplace. The proposal put forward by USTR and Justice was only a procedural one, aimed at ensuring full implementation of the bilateral flat glass agreement.

The Japanese government flatly rejected this proposal, apparently arguing that Japanese companies must be found guilty of anticompetitive behavior before they can be required to adopt compliance plans. As an alternative, the Japanese side announced that the JFTC would be taking another look at the flat glass market, but had no specifics on when this study will begin or what its scope will be. From our point of view, the JFTC study is another delay tactic. We only have 18 more months to run on the agreement. The JFTC study will easily chew up a year, and while we wait the Japanese will argue that nothing can be done.

It is difficult for us at Guardian to understand Japan's intransigence. They say they want to de-regulate and open their markets. But when push comes to shove, they circle the wagons and do as little as possible. When it comes to fulfilling an agreement, they spend time designing and making arguments why the narrow letter has been met and entirely ignore the goals of the agreement.

Comprehensive de-regulation is in Japan's interest. The Japanese people are embracing de-regulation and change, despite resistance from politicians and bureaucrats. Industrial policies orchestrated by "enlightened" bureaucrats arguably assisted Japan's post-war recovery. But today excessive regulation, closed markets, prohibitively high taxes, and ineffective antitrust laws represent a crippling drag on Japan's international competitiveness. Moreover, this period of a relatively weak yen is precisely the time Japan should be opening its markets since pressure from imports would not adversely affect domestic industry.

Japanese consumers, not Guardian or PPG, would be the main beneficiaries of an open and competitive flat glass market that expands access to new energy-saving glass technologies, provides incentives for innovation, and provides more choice at competitive prices. But, as long as the Japanese distribution system is locked up by vertical restraints, the Japanese glass cartel has no incentive to innovate and no reason to listen to consumer demands.

The U.S. Trade Representative's office, our Embassy in Tokyo, and the Departments of Commerce, Justice, and State have worked hard to keep the pressure on Japan to fully implement the agreement. The Administration has had the clear and strong support of the Congress. In July of last year, Mr. Chairman, 53 Members of the House of Representatives sent a letter to the President asking for a redoubling of efforts to achieve compliance with the flat glass agreement. A similar letter was sent by 26 Senators.

Despite the Administration's efforts and the clear backing of the Congress, we are extremely disappointed with the lack of progress. In my view, it would be a mistake for Japan to be intransigent at a time when trade frictions with the United States are beginning to increase. It should be in Japan's interest to resolve as many outstanding trade issues as possible -- and flat glass is certainly resolvable. Japan should not want to become perceived as a country that does not live up to its agreements or responsibilities.

Mr. Chairman, market access must be a central issue -- along with reform of the financial system and macro-economic policy -- that should be immediately addressed when Japan's new government is formed. It is especially important that existing market access agreements -- such as flat glass -- be faithfully implemented.

Thank you for the opportunity to testify before you today.