

A REVIEW OF U.S.-JAPAN RELATIONS

HEARING

BEFORE THE
SUBCOMMITTEE ON EAST ASIAN
AND PACIFIC AFFAIRS
OF THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE
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A REVIEW OF U.S.-JAPAN RELATIONS

THURSDAY, SEPTEMBER 29, 2005

U.S. SENATE,
SUBCOMMITTEE ON EAST ASIAN AND PACIFIC AFFAIRS,
COMMITTEE ON FOREIGN RELATIONS,
Washington DC.

The committee met, pursuant to notice, at 2:30 p.m. in room SD-419 Dirksen Senate Office Building, Hon. Lisa Murkowski (chairman of the subcommittee) presiding.

Present: Senators Murkowski and Kerry.

OPENING STATEMENT OF HON. LISA MURKOWSKI, U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Good afternoon and welcome to the Foreign Relations Subcommittee on East Asian and Pacific Affairs. Today we will be taking an overall look at U.S.-Japan relations and what policies we may need to pursue in the future.

We are honored to have Assistant Secretary of State Chris Hill, and also Deputy Under Secretary of Defense Richard Lawless. I want to thank both of you gentlemen for your time in appearing before the subcommittee this afternoon.

With all of the talk and attention on China these days, it is easy to perhaps overlook the fact that Japan remains the world's second largest economy—an economy three times larger than China's. Combined, the United States and Japan account for 40 percent of the world's GDP. So it is a fair assessment to say that what impacts U.S.-Japan relations and our trade can also have a significant impact on the world's economy.

I come from a State that is actually closer to Tokyo than it is to Washington, DC and I can verify it by looking at my flight miles. In fact, Japan has been Alaska's No. 1 trading partner for decades. It was back in 1965, Alaska became the first State to open a tradeoffice in Japan.

It may surprise some of my colleagues to know that Alaska is the site of the United States' only LNG export terminal—we have been shipping liquefied natural gas to Japan since 1969, which accounts for 2 percent of Japan's natural gas consumption. In addition, Japan participated in the building of the Trans-Alaska Pipeline, supplying 500,000 tons of steel pipe when material was not available here at home. And of course, our seafood trade with Japan remains strong.

We are proud to have a strong and vibrant Japanese-American population in our State playing an active role in State activities. Alaska-Japan ties are strong. On a personal note, and I've men-

tioned this before, it was with great sadness that I learned earlier this year that Japan is downgrading its consulate general in Alaska and reassigning Consul General Akihiro Aoki.

But of course, no matter how much I might try to persuade you otherwise, U.S.-Japan relations are not all about Alaska. In my opinion, Japan is the United States' most important ally in the Asia region. They have been a steadfast partner in the war on terrorism, including the first-ever deployments of Japanese Self Defense Forces after the Japanese Diet gave unprecedented authority to provide "rear area" support to U.S. forces.

Their support of our efforts in Afghanistan and Iraq is not just about personnel, but extends to financial assistance as well. They play a key role in the Six-Party Talks. I would also like to thank the Japanese people and Government for their generous offers of assistance to those impacted by Hurricanes Katrina and Rita.

I want to also comment on the various proposals that have been submitted to expand permanent membership of the United Nations Security Council. With the second largest economy in the world, and contributing nearly 20 percent of the U.N.'s regular budget, in my opinion, if there is any nation that deserves a permanent seat on the Security Council, should it expand, it is Japan.

Of course, as in any relationship between two nations with strong economies, there are differences that need to be resolved—I know we have interested parties here today who would like to see an end to the ban on beef imports and those who are concerned about regulations on medical technology.

From Japan's perspective, the WTO's ruling on the Byrd Law resulted in Japan imposing a 15 percent tariff on U.S. steel products. But like any mature relationship, we also know that these are issues we can work out as friends and allies.

Now I would be remiss in my role if I failed to mention energy issues. Japan has minimal domestic oil and natural gas reserves. As energy efficient as Japan is, they are still 80 percent dependent on fossil fuel imports for their primary energy needs.

And China and India's global search to secure energy supplies is making waves throughout Asia. In an August interview, Japan's Economic and Trade Minister Shoichi Nakagawa stated that while high oil prices are a concern, the real issue for 2010 is the matter of oil supply; "Given the situation we are now in, we must now formulate a new energy strategy."

While Japan has a 170-day stockpile of oil reserves, 87 percent of Japan's oil imports come from the Middle East. Recent action by China to access natural gas reserves in the disputed area of the East China Sea has added to tensions between Japan and China.

When you think about China's engagement with states that are not necessarily considered to be responsible actors in the international scene, at what point does Japan follow suit? Japan is already looking to invest in Iran, but faces heavy pressure from the United States not to. If we insist Japan not go after this potential source of energy, at what point does Japan's energy needs override our security alliance?

These are all issues that confront the U.S.-Japan relationship as we move forward. I look forward to hearing from our witnesses on what policies we as a Nation should pursue and what actions Con-

gress can take—or perhaps shouldn't take, to foster a continued strong relationship and greater understanding between our peoples.

[The prepared statement of Senator Murkowski follows:]

PREPARED STATEMENT OF HON. LISA MURKOWSKI U.S. SENATOR FROM ALASKA

Good afternoon and welcome to the Foreign Relations Subcommittee on East Asian and Pacific Affairs. Today we will be taking an overall look at U.S.-Japan relations and what policies we need to pursue in the future.

We are honored to have Assistant Secretary of State Chris Hill, and Deputy Under Secretary of Defense Richard Lawless with us today. Thank you gentlemen for appearing before the Subcommittee.

With all of the talk and attention on China these days, it is easy to overlook the fact that Japan remains the world's second largest economy—an economy three times larger than China's. Combined, the U.S. and Japan account for 40 percent of the world's GDP. So it is a fair assessment to say that what impacts U.S.-Japan relations and our trade can also have a significant impact on the world's economy.

I come from a state that is actually closer to Tokyo than it is to Washington, D.C. In fact, Japan has been Alaska's No. 1 trading partner for decades. In 1965, Alaska became the first state to open a trade office in Japan.

It may surprise some of my colleagues to know that Alaska is the site of the United States' only LNG export terminal—we have been shipping liquefied natural gas to Japan since 1969, accounting for 2 percent of Japan's natural gas consumption. In addition, Japan participated in the building of the Trans-Alaska Pipeline, supplying 500,000 tons of steel pipe when material was not available here at home. And of course our seafood exports to Japan remain strong.

We are proud to have a strong and vibrant Japanese-American population in our state playing an active role in state activities. So Alaska-Japan ties are strong. On a personal note, it was with great sadness that I learned earlier this year Japan is downgrading its consulate general in Alaska and reassigning Consul General Akihiro Aoki.

But of course, no matter how much I might try to persuade you otherwise, U.S.-Japan relations are not all about Alaska.

Japan is the United States' most important ally in the Asia region. They have been a steadfast partner in the war on terrorism, including the first-ever deployments of Japanese Self Defense Forces after the Japanese Diet gave unprecedented authority to provide "rear area" support to U.S. forces.

Their support of our efforts in Afghanistan and Iraq is not just about personnel, but extends to financial assistance as well. They play a key role in the Six-Party Talks. And I would also like to thank the Japanese people and Government for their generous offers of assistance to those impacted by Hurricanes Katrina and Rita.

I want to also comment on the various proposals that have been submitted to expand permanent membership of the United Nations Security Council. With the second largest economy in the world, and contributing nearly 20 percent of the U.N.'s regular budget, in my opinion, if there is any nation that deserves a permanent seat on the Security Council should it expand, it is Japan.

The timing of this hearing is somewhat fortuitous with the recent election giving Prime Minister Koizumi a strong mandate to move forward with his reform measures. I look forward to hearing from our witnesses on how this development impacts Japan's policies, and its potential impact on our relations.

Of course, as in any relationship between two nations with strong economies, there are differences that need to be resolved—I know we have interested parties here today would like to see an end to the ban on beef imports and are concerned about regulations on medical technology.

From Japan's perspective, the WTO's ruling on the Byrd Law resulted in Japan imposing a 15 percent tariff on U.S. steel products. But like any mature relationship, we also know that these are issues we can work out as friends and allies.

Of course, in this day and time, I would be remiss if I didn't also mention energy issues. Japan has minimal domestic oil and natural gas reserves. As energy efficient as Japan is, they are still 80 percent dependent on fossil fuel imports for their primary energy needs.

And China and India's global search to secure energy supplies is making waves throughout Asia. In an August interview, Japan's Economic and Trade Minister Shoichi Nakagawa stated that while high oil prices are a concern, the real issue for 2010 is the matter of oil supply. "Given the situation we are now in, we must now formulate a new energy strategy."

He argued that Japan is too dependent on oil relative to natural gas and too dependent on the Middle East, making it vulnerable to problems in the Hormuz Strait, the Straits of Malacca, and the Taiwan Straits. He noted that the ratio of energy conveyed by pipeline is very low in Japan's case.

While Japan has a 170-day stockpile of oil reserves, 87 percent of Japan's oil imports come from the Middle East. Recent action by China to access natural gas reserves in the disputed area of the East China Sea has added to tensions between Japan and China.

When you think about China's engagement with states that are not necessarily considered to be responsible actors in the international scene, at what point does Japan follow suit? Japan is already looking to invest in Iran, but faces heavy pressure from the United States not to. If we insist Japan not go after this potential source of energy, at what point does Japan's energy needs override our security alliance?

These are all issues that confront the U.S.-Japan relationship as we move forward. I look forward to hearing from our witnesses on what policies we as a nation should pursue and what actions Congress can take—or shouldn't take—to foster a continued strong relationship and greater understanding between our peoples.

Senator MURKOWSKI. So with that I would ask that we begin the panel by hearing from the Honorable Christopher Hill, Assistant Secretary for East Asian and Pacific Affairs. Again welcome to the subcommittee, we appreciate the generosity of your time in being with us today.

STATEMENT OF THE HON. CHRISTOPHER R. HILL, ASSISTANT SECRETARY FOR EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Secretary. HILL. Thank you very much, Madam Chairman I have a statement to be entered into the record, with your permission I'll read excerpts of that statement.

Senator MURKOWSKI. Your statement will be entered into the record.

Secretary HILL. Madam Chairman, members of the Subcommittee on East Asia and Pacific Affairs, I am pleased to be with you today to discuss United States relations with Japan, our close friend and key ally which shares with us a commitment to democracy, universal principle of human rights, and promotion of free markets.

I welcome the opportunity to outline our efforts to ensure that this most vital Asian economic and security partnership remains robust and durable.

Our alliance with Japan has been a force for progress, and the key to promoting security and stability in East Asia. Naturally we must adapt the alliance to meet the challenges of the 21st century. Working in close concert with the Defense Department we are looking toward a fundamental transformation of our alliance, as Mr. Lawless will explain in greater detail.

We want to forge a long-term commitment from both countries, and both peoples to allow our alliance to adapt, grow, and meet the challenges facing us now, and in the years ahead.

We recognize that Japan faces certain constraints in its military cooperation, such as its policy on collective self-defense and Article 9 of the Constitution which are matters for the Japanese people. But as Secretary Rice noted this year in Tokyo, we welcome Japan's clear decision to step up to wider global responsibilities.

Japanese leadership in advancing freedom is good for the Pacific community and it is good for the world. Japan stands with us from

East Asia to Afghanistan. A vital partner in the Six-Party Talks, Japan played a key role in the negotiations in Beijing earlier this month of a joint statement, in which North Korea committed to abandoning all nuclear weapons and existing nuclear programs. I will give the committee on October 4, a full read out of the discussions in Beijing.

Elsewhere, Japan is helping us to do the hard work that will enable the expansion of markets, for the development of democracy, and the promotion of human rights.

Japan worked side-by-side with us and others to respond to last December's horrific earthquake and tsunami. In Iraq, in addition to the nearly \$5 billion dollars in aid pledged by Japan, the Japanese self defense force engineering battalion deployed in Samawah is helping rebuild that city.

In Afghanistan, Japan has contributed \$1 billion in aid and is working with us to complete the Kandahar-Herat Ring Road and to rebuild infrastructure.

Japan has also been a significant contributor to the War on Terror, providing refueling to coalition vessels performing maritime interdiction operations in the Indian Ocean. In addition, the new U.S.-Japan Strategic Development Alliance initiated by Secretary Rice earlier this year, will allow us to discuss and better coordinate our assistance priorities and programs, in the geo-political context.

Yesterday, Under Secretary Shiner and Deputy Foreign Minister Yabunaka held the first formal meeting under the SDA. Japan's growing global role, its significant contributions to U.N. operations, warrant a permanent seat for it on the Security Council.

However, that must happen in the context of other fundamental reforms that will make the United Nations more accountable to its members, more suited to new challenges, and more faithful to its founding purposes.

Healthy relations among Japan and its neighbors, particularly China, are essential to stability and prosperity in East Asia, and thus in the interests of all countries in the region and of the United States. Japan and China are more economically dependent on each other than ever. China is now Japan's largest trading partner; trade between the two countries was over \$170 billion in 2004.

Frictions remain however, including great sensitivities arising from World War II and other historical issues.

Given the growing common interests of the nations of Northeast Asia, these differences constitute unfortunate obstacles in taking full advantage of the tremendous opportunities that exist in the region. As Deputy Secretary Zoellick suggested last week, part of the solution is greater dialog, and for our part, we will continue to stress to our allies and partners in the region the importance of finding mutually satisfactory and amicable solutions to these issues.

On September 11, 2005, Prime Minister Koizumi won a landslide victory. He has stressed his determination to pursue further reforms. We will continue to support reforms in key sectors, we strongly urge Japan to resume beef imports from the United States without further delay. Despite repeated interventions at the highest-levels, it has not happened yet. And this should change.

It was the defeat of Prime Minister Koizumi's top priority, the privatization of Japan Post, that prompted him to call the election. We will watch privatization closely, we want to ensure a fair and level playing field for private competitors of Japan Post massive insurance, banking, and express mail operations.

Japan is a strong partner for the United States in APEC and other regional fora. We share much the same view on many issues in the World Trade Organization, but remain apart on some key topics, such as market access for agriculture goods. The United States and Japan are also the world's two most technologically advanced societies, and we are cooperating in this area as well.

For example in climate change, in the effort to address the threat posed by Avian Influenza, we can say with satisfaction and pride that the U.S.-Japan relation has truly never been better. We look forward to continued to even closer cooperation with Japan, because together we can accomplish so much more for the people of both countries. From the hundreds of thousands of visitors from Japan each year, to the success of exchanges that bring Americans to live and work in Japan, we have a relationship that goes well beyond the meetings of our leaders and government officials. And we will build on this human dimension as we work together to promote peace, civility, democracy, and prosperity in Asia and around the world.

Thank you very much.

[The prepared statement of Secretary Hill follows:]

PREPARED STATEMENT OF HON. CHRISTOPHER R. HILL, ASSISTANT SECRETARY FOR EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Madam Chairman, members of the Subcommittee on East Asia and Pacific Affairs, I am pleased to be with you today to discuss U.S. relations with Japan, our close friend and key ally in Asia and the world.

Japan is remarkable for its transformation and development in the 60 years since the end of World War II. We share with Japan a commitment to democracy at home, to the universal principle of human rights and to the promotion of free markets abroad. Through the tremendous efforts of its people, Japan is now the world's second-largest economy, the world's second-largest provider of international assistance and the second-largest contributor to the United Nations. Japan is, in many ways, a model for what we hope many countries around the world can and will achieve.

Japan is a key ally of the United States in Asia and around the world. Like us, Japan is dedicated to maintaining regional security and to promoting peace and stability around the globe. But our alliance represents more than a defensive balance of power. It is also a positive force for progress. We now have a historic opportunity to transform our alliance to meet the challenges of the 21st century—including both traditional and new security, economic, and transnational challenges. We are working very closely with the Department of Defense, led by my colleague Richard Lawrence, to use this opportunity to transform our alliance to meet those challenges.

Our alliance was founded in response to the threat from the Soviet Union. Today, we view our alliance as an opportunity to pool our capabilities in the face of new challenges and opportunities, from terrorism to the tsunami relief efforts to HIV/AIDS to our new Asia Asia-Pacific Partnership on Clean Development and Climate. We are working hard to restructure our forces and forge a long-term commitment from both countries and both peoples to allow our alliance to adapt, grow, and meet these and other challenges for the years ahead.

Japan faces certain constraints, such as its policy on collective self-defense and Article 9 of the Constitution. These are issues for the Japanese people to work out for themselves, through ongoing public and Diet debate. With continued close consultations and further refinement of shared goals, we intend to do everything we can to keep this alliance as vital and effective over the course of the next 50 years as it has been over the previous 50.

Today, Japan stands with us from East Asia to Afghanistan. For example, Japan is a vital partner in the Six-Party Talks and played a key role in the negotiation in Beijing earlier this month of a Joint Statement, in which the Democratic People's Republic of Korea (DPRK) committed to abandoning all nuclear weapons and existing nuclear programs, and returning, at an early date, to the Nuclear Nonproliferation Treaty (NPT) and International Atomic Energy Agency (IAEA) safeguards. Japan joined the United States and other parties in making clear that discussion with the DPRK about peaceful nuclear energy could take place only after the DPRK came into full compliance with relevant international agreements, including returning to the NPT and full implementation of IAEA safeguards. The Japanese had direct discussions with their DPRK counterparts on issues of concern such as abductions and human rights. I will give the Committee a full read-out of the discussions in Beijing on October 4.

Elsewhere in the world, Japan is helping us to do the hard work that will create the necessary environment for the expansion of markets, the development of democracy, and the protection of human rights. As it works with us, Japan is changing its own role in the international system. It has made essential contributions to Iraq, Afghanistan and the War on Terror. Japan worked side-by-side with us and others to respond to last December's horrific earthquake and tsunami; Japan is working with us today to implement an early warning system for the Indian Ocean. Secretary Rice and Foreign Minister Machimura just launched our new Strategic Development Alliance (SDA), which will further strengthen our coordination in the crucial area of international aid and development.

In Iraq, in addition to the nearly \$5 billion pledged by Japan and the \$1.5 billion it has spent so far on reconstruction, the Japanese Self Defense Force engineering battalion deployed in Samawah has built or rebuilt several water treatments facilities and power stations, repaired hospitals, and provided ambulances, medical equipment and emergency medical supplies. The Iraqi government has made clear its appreciation; we, too, greatly appreciate Japan's steadfast commitment. Japan has also taken a higher profile role in the Middle East Peace Process, aiding the Palestinian people with humanitarian assistance, and helping to reform the Palestinian Authority and implement confidence-building measures.

In Afghanistan, Japan has contributed nearly \$1 billion in aid and its Overseas Development Assistance (ODA) personnel are working with us and Afghans to rebuild the Kandahar-Herat Ring Road and revitalize infrastructure that has been virtually non-existent for years. Japan has been a significant contributor to the War on Terror, providing at-sea refueling to Coalition vessels from twelve countries performing maritime interdiction operations in the Indian Ocean. Without the 103 million gallons Japan has provided to date—worth about \$150 million—some Coalition members would not have been able to participate at all. We applaud the Government of Japan's recently announced intention to seek legislative branch approval to extend that operation for another year. This is the most significant military mission that Japan now undertakes in the war on terror.

The new U.S.-Japan Strategic Development Alliance (SDA) will allow us to discuss and better coordinate our assistance priorities and programs in the context of the geopolitical situation, and in accordance with our common views on development. Secretary Rice and Foreign Minister Machimura released a set of shared principles for results-oriented development assistance during the U.N. General Assembly meetings in New York earlier this month. Yesterday, Under Secretary Shiner and Deputy Foreign Minister Yabunaka held the first meeting under the SDA, discussing job creation and business climate reform in Indonesia and education and work force development in Pakistan, activities which have the common goal of creating sustainable jobs for the people of these key Asian countries to give their people greater opportunity.

Japan's growing global role is evident in many ways. Japan was a core member of the tsunami relief effort and has been at the forefront of nations working to establish an early warning tsunami system in Asia. Japan's global role is also evident at the U.N. We believe Japan's role in the world, not to mention its significant contributions to U.N. operations, warrant a permanent seat on the Council, and we have long supported a permanent seat for Japan. However, as the Secretary said at the General Assembly on September 17, our challenge now is to enact the vital reforms that will make the United Nations more accountable to its members, more suited to new challenges and more faithful to its founding purposes. Real progress on fundamental reforms will prove that the United Nations can tackle even bigger and more complex changes—in particular, the reform of the Security Council, including a seat for Japan and greater representation for developing countries.

Closer to home, healthy relations among Japan and its neighbors, particularly China, are essential to stability and prosperity in East Asia, and thus in the inter-

ests of all countries in the region and of the U.S. as well. Japan and China are more economically dependent on each other than ever—particularly on the trade front—with China now Japan’s largest trading partner; two-way trade between the two countries was over \$170 billion in 2004.

However, frictions remain, fed by territorial disagreements, including East China Sea energy exploration; historical disputes; and other issues of concern. For its part, Beijing shares with some of its neighbors, including the Republic of Korea, a lingering distrust of Japan’s view of its past. Tokyo, in return, is concerned about inaccuracies in and the anti-Japanese tone of textbooks in China and Korea. Given the growing common interests of the nations of Northeast Asia, these differences constitute unfortunate obstacles to taking full advantage of the tremendous opportunities that exist in the region. As Deputy Secretary Zoellick suggested last week, part of the solution is greater dialog. For our part, we will continue to stress to our allies and partners in the region the importance of finding mutually satisfactory and amicable solutions to these issues.

On September 11, 2005, Prime Minister Koizumi won a landslide victory. He has stressed his determination to pursue further reforms, which we hope will include redoubled efforts for economic reform. Much progress has been made, but there are still areas within the Japanese economy that remain heavily regulated. We will continue to support the Japanese effort to make further reforms in sectors such as pharmaceuticals and medical devices, telecommunications and health care, and, of course, we strongly urge Japan to resume beef imports from the United States without further delay. It has been a year since we reached agreement on a framework intended to accomplish that.

Despite repeated interventions at the highest-level by the U.S. Government, it has not happened yet. This should change.

As you know, it was the defeat of Prime Minister Koizumi’s top reform priority, the privatization of Japan Post, that prompted him to call an election; with the large majority now enjoyed by the ruling coalition in the Lower House of the Diet and political momentum behind the Prime Minister, most Japanese observers believe it likely this legislation will pass quickly. Beyond mail services, Japan Post also includes huge banking and insurance operations. We will monitor developments closely; we want to ensure that Japan Post’s insurance arm, which is subject to a set of laws and regulations that differ from those governing the private sector, will not be allowed to issue its own new products until a fair and level playing field has been established between it and its private sector competitors, which include a number of large American insurers. We have similar concerns in the express mail and banking sectors.

The United States and Japan are also perhaps the world’s two most technologically advanced societies—and we are cooperating in this area as well. One example is climate change. The United States and Japan are founding members of the Asia-Pacific Partnership on Clean Development and Climate, announced by Deputy Secretary Zoellick in July. In this Partnership, the United States and Japan, with fellow members China, India, Korea and Australia, will use our scientific and technological expertise to encourage accelerated deployment of cleaner, more efficient energy technologies to meet national pollution reduction, energy security and climate change concerns.

In another scientific area, Japan and the United States are at the forefront of the effort to monitor avian influenza. We are working together in both APEC and the International Partnership on Avian and Pandemic Influenza, announced by the President earlier this month, to try to prevent an epidemic among humans from occurring—and to be ready to combat the disease should an epidemic nevertheless occur.

We look forward to continued close cooperation with Japan, as both nations realize that we can accomplish so much more when working together and complementing each other’s efforts. This relationship is strong, broad and deep, and we seek to make it even more so while adapting it to the new challenges of a new era. From the hundreds of thousands of visitors from Japan each year, to the success of exchanges that bring Americans to live and work in Japan, we have a relationship that goes well beyond the meetings of our leaders and government officials. We will build on this human dimension as we work together to secure peace, stability and prosperity in Asia and around the world.

Senator MURKOWSKI. Thank you, I appreciate the testimony, and next we will go to the Honorable Richard Lawless, Deputy Under Secretary for Asia-Pacific Affairs. Welcome.

Secretary LAWLESS. Thank you very much. I also have a statement to read for the record. And I'd like to do so.

Senator MURKOWSKI. It will be included in the record.

Secretary LAWLESS. Thank you.

STATEMENT OF THE HON. RICHARD P. LAWLESS, DEPUTY UNDER SECRETARY FOR ASIAN-PACIFIC AFFAIRS, DEPARTMENT OF STATE WASHINGTON, DC

Secretary LAWLESS. Thank you Chairman Murkowski and members of the subcommittee for this opportunity to appear before you to discuss the United States' alliance relationship with Japan. It's truly an honor to be here today.

It goes without saying that the security relationship between the United States and Japan remains a vital interest for both of our countries and for the Asia-Pacific region. That relationship has provided the foundation for the peace and stability that have enabled the prosperity we see today throughout the Asia-Pacific region. It will continue to serve that role for the foreseeable future.

Yet amidst all the crises that grab the headlines on a daily basis and that place many demands on the time of members of your committee and the time of those of us in government appearing before you today, it is so easy to lose sight of our nation's critical need to nurture such a key relationship on a continuing basis.

That nurturing process requires us to ensure that relationships like the one between the United States and Japan stay ahead of the ever-increasing pace of change in the world around us. So with that in mind, I am appreciative that your committee has set aside time here today to take a look at the security relationship between the United States and Japan and to consider the course we are on with Japan.

The United States and Japan set that course nearly 3 years ago, at the December 2002 "2 + 2" Ministerial meeting between the U.S. Secretary of State and Secretary of Defense and their Japanese counterparts. At that 2 + 2 meeting, the United States and Japan launched a bilateral review of our respective defense and national security policies in light of the change, and changing security environment. This review would include, we agreed, an examination of bilateral roles and missions, forces and force structures, cooperation in regional and global challenges, participation in international peacekeeping and other multinational efforts, cooperation in missile defense, and resolution of issues related to U.S. basing in Japan.

More specifically, we set out to do five distinct things on the basis of that meeting: First, we wanted to conduct a bilateral assessment of strategy and threats. In that process, we would consider the international environment, the interests the United States and Japan each have, the challenges we each face, and our strategies for dealing with those challenges.

This work was reflected in the Common Strategic Objectives that the two countries issued as part of their joint statement at the 2 + 2 Ministerial meeting in February 2005.

In that document, the United State and Japan clearly articulated key bilateral, regional and global interests that we share, as well

as the common objectives we hope to achieve relative to those interests.

The second task that we set for ourselves 3 years ago was to conduct an assessment of the different roles and missions the United States and Japan should each undertake to achieve our common strategic objectives.

Third, we launched an assessment of our respective force structures to help us determine what changes in force structure might be required to support our respective roles and missions.

Fourth, we began an examination of the basing structure of both U.S. and Japanese forces in and around Japan. This includes the changes that the U.S. is considering in its basing in Japan in connection with DOD's Global Posture Review.

It also includes consideration of related realignments in the posture of Japan's Self-Defense Forces and an assessment of U.S. and Japanese abilities to conduct the training and exercises both U.S. and Japanese forces need in order to maintain their preparedness for their respective roles and missions.

Fifth and finally, we began an examination of force presence issues and the things that could be done to ensure continuing support for stationing of U.S. forces in Japan.

This would necessarily focus on measures to ensure that both U.S. and Japanese citizens see the continuing benefit in the U.S. forward presence in Japan.

From our perspective in the Department of Defense, this five-part process is larger than mere posture realignment. In short, we are working with Japan to transform our alliance, taking into account both the changes in the international security environment and the changes taking place in Japanese attitudes toward security issues.

I think this committee is quite aware of the evolution taking place in Japanese security policy, but let me cite a few examples. Since 1999, Japan has: Initiated research cooperation with the U.S. in missile defense; Sent forces to the U.N. reconstruction mission in East Timor; Enacted legislation enabling the dispatch of forces in support of Operation Enduring Freedom and provided at-sea refueling support, at no cost, to ten nations' fleets under that law; Passed legislation enabling the dispatch of forces in support of Operation Iraqi Freedom and maintained forces in Iraq and Kuwait on reconstruction missions under that law; Passed legislation strengthening its central government's authorities in emergency situations, including the authorities related to support of U.S. forces in contingencies; Launched a program to acquire ballistic missile defenses; Announced a relaxation of arms export policies to enable collaboration with the U.S. in development and production of missile defenses; and Issued a new National Defense Program Guidelines document that recognizes the link between international stability and Japan's national security, and from that perspective the important role of the Self-Defense Forces' participation in international missions.

Now, I would agree that, measured against the yardstick of Japanese security policy for the past sixty years, these developments are very significant. The United States welcomes these changes as do most countries around the world.

But measured against Japan's capabilities to contribute to international security, and measured against Japan's global interests and the benefits Japan derives from peace and stability around the world, these changes remain quite modest.

So it is in this context that the U.S. and Japan must consider how to realign U.S. forces and Japanese forces. We can both see the trend in Japanese security policy toward a more active role in international security affairs. This is a welcomed trend.

But we can also see that this trend will take considerable time to reach fruition. As a result, the United States posture realignments must address immediate needs as we see them today, that is immediate alliance needs, and simultaneously anticipate changes taking place within Japan that will make it possible for the Self-Defense Forces to do more tomorrow.

If we under-anticipate those changes, we may end up with more U.S. capability left in Japan than we need, causing unnecessary irritants in local relations. If we over-anticipate those changes, we may eliminate critical alliance capabilities.

That is why realignment of U.S. forces in Japan, more than in any other country, is fundamentally dependent on decisions the host country is making about its own security future. For realignment is not simply about reducing the size of our U.S. force presence there, or figuring out a workable solution for a replacement facility for the Marine Corps Air Station at Futenma, or realigning command and control functions, or expanding operational cooperation in mission areas like missile defense or intelligence, surveillance and reconnaissance.

It's about all these things and more. It is fundamentally about transforming the alliance to ensure that it remains capable of achieving the Common Strategic Objectives the United States and Japan have together established and agreed upon. And it is about ensuring that the alliance remains capable in the 21st century of continuing to fulfill its historic role as the foundation of peace and security in the Asia-Pacific region.

I believe that both the United States and Japan recognize this opportunity and want to seize it. But we nonetheless face all the usual obstacles that keep governments and bureaucracies from transforming, even when everyone knows it is absolutely the right thing to do.

So the question both our countries face is whether we can overcome those obstacles and do the right thing. I am optimistic that we can, and I am hopeful that we can do it this year.

Thank you again for this opportunity to discuss the U.S. alliance relationship with Japan before this committee. I would be happy to answer your questions. Thank you.

[The prepared statement of Secretary Lawless follows:]

PREPARED STATEMENT OF HON. RICHARD P. LAWLESS, DEPUTY UNDER SECRETARY
FOR ASIAN-PACIFIC AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Thank you Chairman Murkowski and members of the committee for the opportunity to appear before you to discuss the United States' alliance relationship with Japan. It is an honor to be here today.

It goes without saying that the security relationship between the U.S. and Japan remains a vital interest for both of our countries and for the Asia-Pacific region. That relationship has provided the foundation for the peace and stability that have

enabled the prosperity we see throughout the Asia-Pacific region today. It will continue to serve that role for the foreseeable future.

Yet amidst all the crises that grab the headlines on a daily basis and that place many demands on the time of members of your committee and the time of those of us in government appearing before you today, it is so easy to lose sight of our nation's critical need to nurture such a key relationship continuously.

That nurturing process requires us to ensure that relationships like the one between the U.S. and Japan stay ahead of the ever-increasing pace of change in the world around us. So I am especially appreciative that your committee has set aside time here today to take a look at the security relationship between the U.S. and Japan and to consider the course we are on.

The U.S. and Japan set that course nearly 3 years ago, at the December 2002 "2 + 2" meeting between the U.S. Secretary of State and Secretary of Defense and their Japanese counterparts.

At that 2 + 2 meeting, the U.S. and Japan launched a bilateral review of our respective defense and national security policies in light of the changing security environment. This review would include examination of bilateral roles and missions, forces and force structures, cooperation in regional and global challenges, participation in international peacekeeping and other multinational efforts, cooperation in missile defense, and resolution of issues related to U.S. basing in Japan.

More specifically, we set out to do five distinct things on the basis of that meeting:

First, we wanted to conduct a bilateral assessment of strategy and threats. In that process, we would consider the international environment, the interests the U.S. and Japan each have, the challenges we each face, and our strategies for dealing with those challenges.

- This work was reflected in the Common Strategic Objectives that the two countries issued at the 2 + 2 meeting in February 2005.
- In that document, the U.S. and Japan clearly articulated key bilateral, regional and global interests that we share, as well as the common objectives we hope to achieve relative to those interests.

The second task we set for ourselves 3 years ago was to conduct an assessment of the different roles and missions the U.S. and Japan should each undertake to achieve our common strategic objectives.

Third, we launched an assessment of our respective force structures to help us determine what changes in force structure might be required to support our respective roles and missions.

Fourth, we began an examination of the basing structure of both U.S. and Japanese forces in and around Japan.

- This includes the changes that the U.S. is considering in its basing in Japan in connection with DOD's Global Posture Review.
- It also includes consideration of related realignments in the posture of Japan's Self-Defense Forces and an assessment of U.S. and Japanese abilities to conduct the training and exercises both U.S. and Japanese forces need in order to maintain their preparedness for their respective roles and missions.

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It's about all these things and more.

In short, it is fundamentally about transforming the alliance to ensure that it remains capable of achieving the Common Strategic Objectives the U.S. and Japan have established. And it is about ensuring that the alliance remains capable in the 21st century of continuing to fulfill its historic role as the foundation of peace and security in the Asia-Pacific region.

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So the question both our countries face is whether we can overcome those obstacles and do the right thing. I am optimistic that we can, and I am hopeful that we can do it this year.

Thank you again for this opportunity to discuss the U.S. alliance relationship with Japan before this committee. I would be happy to answer your questions.

Senator MURKOWSKI. Thank you Secretary Lawless. I appreciate the direction of your remarks and the discussion about the realignment. But I even more appreciate your initial comments, where you reminded us how important it is to nurture and sustain those relationships that we have had, for a long time those alliances that quite often we tend to take for granted. And so often when we have trouble spots, or hot spots, or an emerging area that we just don't know what's going on, all the focus, and all the attention seems to be there and those that have been cooperative and that we have managed to work with for years, decades, seem to get put off to the

side, and in fact as you note there is some very serious work that we need to do jointly, with our friend and our ally Japan. So we shouldn't be taking anything for granted; we should be, as to use your terms, "nurturing this relationship and sustaining these key relationships."

So I appreciate your highlighting that in your remarks. I want to start off my questioning with you Secretary Hill.

First of all I want to thank you for all the work that you are doing in the Six-Party Talks and the accomplishments that you have been able to achieve; we look forward to hearing your further expanded remarks, next week I guess it is.

But in relation to the Six-Party Talks, we recognize that Japan has been insistent that the issue of the Japanese abductions that took place in the 1970's, and the 1980's be part of this deal. I guess my question to you is, how this instance has impacted the talks, whether it has at all, whether it is an impediment, is it something that could be detrimental to the goal of dismantling North Korea's nuclear weapons program if, in fact, Japan and North Korea are unable to resolve these issues?

Secretary HILL. Well first of all, we are very pleased that the Japanese delegation and the North Korean delegations were able to have several bilateral meetings in the course of the Six-Party Talks, and to discuss their outstanding issues, including this issue of abduction. It is an issue that is of great concern to the Japanese public, a great concern to the Japanese government. And as such it is an issue that needs to be addressed now, we are not saying where it needs to be addressed, but it has to be addressed. And if you look at the Six-Party process, in its totality, we are dealing with denuclearization of the Korean Peninsula, but we're also dealing with the eventual reintegration of North Korea into the world, starting with its neighbors. The Six-Party process is really about North Korea and its neighbors. I think it's very important that North Korea have a good relationship with Japan. Japan as we've described in our testimony, this is a very important player in the world, number 2 economy in the world.

Frankly, it's vitally important that North Korea have a good relationship with Japan, so it is entirely appropriate that North Korea and Japan try to resolve this, or identify a track for resolving this as we go forward.

From the point of view of negotiating the denuclearization provisions, I'm not concerned about this, I believe we can deal with this issue. There are other issues as well, but we have to, I think, understand that we are dealing with a very broad subject that is denuclearization followed by North Korea's reintegration into the world.

Senator MURKOWSKI. But it sounds as though this is one of those issues that in order to have that relationship with their neighbors is going to have to be resolved, whether it's resolved at these Six-Party Talks, or as you suggest, perhaps some other venue.

Secretary HILL. Yeah, it does not have to be solved within the Six-Party process, it can be solved bilaterally and be—it's appropriate to solve this bilaterally. But it has to be solved. I mean this is an important issue for the Japanese public. The Japanese public is very aware of this. And the Japanese Government is obviously

very aware of this as would be any government on who's watch its citizens were abducted to another country. So this is simply a fact, and it has to be dealt with. And I was encouraged by the fact that they had these meetings, and I hope they'll have more, and I hope they'll deal with this, and deal with this and other issues because North Korea needs a good relationship with Japan.

Senator MURKOWSKI. In speaking about their neighbors that they all need good relationships with, you're talking about the issue that we have—the small islands in the China Sea, the growing tensions between Japan and both China and South Korea, over these conflicting claims to the islands. What are the stakes, if any, to the United States, and should from a policy perspective the United States be involved in this—the conflict there?

Secretary HILL. Fortunately we don't have a conflict there, we have a disagreement there, and it is fundamentally in the interest of the United States that these countries have good relations with one another. It is fundamentally in our interest that China and Japan have a good relationship. Fundamentally in our interests that our two great allies in the region, the Republic of Korea and Japan have a good relationship. So we encourage their meeting on these issues; we encourage dialog and we have made it very clear to all parties concerned that we want to see them reach a solution on this. So it is very much in our interest to do this and we obviously watch these issues very closely. I don't think that there is a cause for U.S. intervention in these questions. These are countries that should be able to sit down and work these issues out.

Senator MURKOWSKI. You mentioned the relationship with China and the importance as a trading partner. We recognize that China has replaced the United States as Japan's most important trading partner. I think you—I think you said \$170 billion, what does this very growing importance of China suggest about the future of U.S.-Japan relationships? How do we fit into this very profitable and prosperous relationship between Japan and China?

Secretary HILL. Well, China is indeed a player in the region that is going to be with us for a long time; going to be a major player, not only in the region, but in the world. But I think one has to be careful to keep in mind that China is by no means to surpass the GDP of Japan or the United States. China has a long, long way to go to reach those kinds of levels. So I would say that the U.S.-Japan economic relationship is really second to none and unlikely to be encroached on anytime soon by a relationship with China. To be sure, China is now the—Japan's leading economic trading partner. As it is with the Republic of Korea, but that's a little deceiving, those statistics are deceiving, because when you look carefully, you'll see a lot of those statistics, that is a lot of the trade that is, now going to China is actually coming to the United States, so to some extent we've seen a shift in U.S. deficits with Japan, through U.S. deficits with China. So it is very much tied up with the economic relationship with the United States.

Senator MURKOWSKI. You mentioned the ban on beef imports. And your statement that we must resume our trade with Japan on this issue without further delay. I think were your words. How much impact has the beef issue, the beef import issue had on our economic ties with Japan?

Secretary HILL. Madam Chairman, I think this issue not only should be resolved without further delay, it should have been resolved a long, long time ago. The delay in resolving this issue frankly is inexplicable. U.S. beef herds have had a total of some 2 cases of BSE, and we're talking about enormous herds, the largest in the world. Japan's very small beef industry, has had some 20 cases of BSE, in short there is nothing unsafe about U.S. beef, it is truly the safest in the world. I understand that Japan has its procedures, procedures that are even outside the regular governmental structures, that is having to do with various commissions. They have to solve this, and I, as a diplomat, find it a little difficult to be diplomatic over this issue. When you look at the U.S. farmers who are working hard, U.S. cattlemen trying to sell their products abroad, we had a market in Japan of \$1.7 billion dollars. That's a lot of—that's a big market, and they've lost it over a case that frankly should have been solved a long time ago.

So if you're asking whether this has had an impact on the way people think about the Japanese market, you bet it has. It's had an impact over the feelings of U.S. exporters toward the Japanese market; it's had an impact in a lot of different ways. I truly believe the Japanese, for their own benefit, ought to get this issue solved.

Senator MURKOWSKI. I think we would all agree with you on that one. I have to ask you, as my final question to you, you probably know it's coming. It's sea urchins. You probably don't get too many questions about sea urchins, so I have to go there for you. I raised this issue with you at your confirmation hearing regarding the illegal sea urchin harvest in the Russian waters and how these were suppressing the market. This is one area again where Alaska is providing to the Japanese, through our exports, a very positive benefit. Do you have any new information, any updates you can give me on what's going on with the sea urchins?

Secretary HILL. Madam Chairman, you've raised that issue before during my confirmation and I confess, I don't have new information.

Senator MURKOWSKI. I didn't mean to put you on the spot.

Secretary HILL. I'm going to do something—I'm going to promise you I will get some new information on this. I have—

Senator MURKOWSKI. I'm not going to relax until I know about the sea urchins.

Secretary HILL. Well fair enough. You know you have a lot of fishermen in Alaska who depend on the Japanese market for this, and to see these Russian ships, where as I understand it they harvest, and it goes right into Japan, it doesn't go back for any registration through Russia, and it's comprising some unfair competition to your fishermen. So I'm very sympathetic to them. If you'll allow me to work a little on this issue, one of the arguments is one has to deal with it not in Japan, but in Russia, and let me run that down as well. In fact, I'll be seeing my Russian counterpart in the Six-Party Talks, I can surprise him and ask him about that. But I can also check some other channels.

Senator MURKOWSKI. I appreciate that, and I know that Alaska's fishermen will appreciate the efforts. We do appreciate the smaller details that you tend to, but as you point out, these are big; this is an important market for a small group, so we appreciate that.

[The requested information concerning sea urchins submitted by Secretary Hill follows:]

By Japanese law, foreign fishing boats must first enter their home country's ports (i.e., Russia) and receive export certificates before exporting to Japan. However, Russian fishermen often sell sea urchins to Japanese fishing boats at sea, and they are subsequently sold in Japan as Japanese-caught urchins. This also violates Japanese quarantine rules on fresh marine products, and illegal imports are also hurting Japan's domestic sea urchin fishing industry.

The Government of Japan recognizes there is a problem, but has been reluctant to tackle it. The Fisheries Agency of Japan has said that each country should regulate its own caught marine products, so Japan has no authority over Russia's fisheries enforcement. Over-fishing in Russia is rampant, but it is not clear whether the Russians are violating any laws on sea urchin quotas.

The National Marine Fisheries Service believes we cannot act unilaterally against Russia without violating our WTO commitments. We also suspect that the price of sea urchins is depressed more due to oversupply than to Russian sea urchins flooding the market.

Senator MURKOWSKI. Secretary Lawless, let's turn to you, and I appreciate the detail that you went into in terms of some of the history on the background on the "2 + 2." Japan's 2005 to 2009 defense plan, for the first time, mentions China as a security problem. What steps is Japan taking to address this concern?

Secretary LAWLESS. I think, first of all, if you refer back to our February 19, 2005 joint statement of common strategic objectives, where we actually mention China, the two countries. We both say a lot of very positive things about how we would anticipate the integration of China into the greater international community and things such as this. At the same time, in a way this was recognition that Japan, as you say, had addressed in its defense white paper, Japan—excuse me, China—and it had also addressed China in its review, defense review, its guideline review that it issued in December of that year, as well as in an earlier publication called the Araki Report, which I believe was issued by the Prime Minister's office in an October 2004 timeframe.

In each case I think it is simply an awareness on the part of Japan.

A year later, in their budget was a \$1.3 billion dollar line item for ballistic missile defense. That impressed us. So we think that the leadership that's in place now, and I'm speaking from Department of Defense, but I believe my colleagues in the State Department share this with me, share this thought, it's a very impressive leadership and we're very proud to have them working with us on this realignment process.

Senator MURKOWSKI. We've been joined by the ranking member, Senator Kerry. Senator would you have any comments that you would care to make, or would want to jump right into questions.

Senator KERRY. Thank you. Thank you Madam Chairman.

Thank you very much, Mr. Secretary welcome. And I apologize for being a little bit late. But I am going to try not to go over all the territory obviously that you just covered, and if I do just remind me.

Let me begin by picking up on this Iraq stream. I've seen the newspaper reports about a contemplated withdrawal sometime next year. There's some uncertainty about what the longevity is going to be here. There's already been one extension under their law. Are we anticipating a second extension? What is the situation on that?

Secretary LAWLESS. Yes we are, excuse me sir. We are anticipating another extension. But again, we stress that that's a decision that their government has to make but, yes, we're anticipating another extension.

Senator KERRY. And is there more, in your judgment, that Japan could do. I gather that there's about \$5 billion of assistance that has been promised, is that correct?

Secretary LAWLESS. That is correct. Yes I believe that's a combination of direct aid and—

Senator KERRY. How much of that has actually been drawn down, do you know?

Secretary LAWLESS. I do not have that information.

Senator KERRY. Do you know when this promise was made?

Secretary LAWLESS. I believe it was made, sir, at the first donors conference which took place in Tokyo, approximately 6 months after the end of the conflict in Iraq. I believe it was made very very early on, and that it initially involved a \$2 billion grant donation up front, if my memory serves me correctly. And to be followed by an additional \$3 billion dollars.

Senator KERRY. The original commitment was for 1,000 troops. Is that right?

Secretary LAWLESS. It was approximately 1,000, yes. Actually the commitment was for a capability and that capability, I believe, was for an engineering battalion that was specialized in specific activity, and that was water purification.

Senator KERRY. But the folks who are there are essentially involved in humanitarian aid and reconstruction are they not?

Secretary LAWLESS. Absolutely yes.

Senator KERRY. Exclusively?

Secretary LAWLESS. Yes.

Senator KERRY. It's my understanding we're running about 600 at the moment?

Secretary LAWLESS. That's correct.

Senator KERRY. Could we not use 1,000?

Secretary LAWLESS. I suppose we could use 1,000. The issue has always been what capability was needed in that location, and what capability would they bring with the equipment that they would bring with them. And I believe that that capability, plus the airlift capability, I think, which is also in the region probably gets that number maybe closer to 1,000 if you include the airlift capability they brought in with them to help sustain the presence.

Senator KERRY. And when you say in that location, you're talking about Samawah?

Secretary LAWLESS. Yes, the engineering battalion is there, but I believe the airlift is out of Iraq sitting in—on the periphery in another location.

Senator KERRY. Australian and British troops are there in addition?

Secretary LAWLESS. Yes, the Australians, approximately 6 months ago or so, committed to take over the immediate security duties when another force was withdrawn and the Australians have been there based on a commitment to work with—specifically to work with the Japanese and to provide security for their presence.

Senator KERRY. It's my understanding that if the constitution passes in October, both of those countries are planning a withdrawal of those troops by May of next year.

Secretary LAWLESS. That is not my understanding. We have not heard that. By both those countries you mean U.K. and Australia?

Senator KERRY. Yes. Yes sir.

Secretary LAWLESS. I believe, and I don't want to get ahead of my colleagues in CENTCOM on this, but I believe that's a subject still open for discussion and there are two levels of discussion, there is a political level of decisionmaking and then there is a peer military level of discussion. And I don't know if that suggestion has been made on either one of those two levels yet.

Senator KERRY. Now part of the global repositioning of our troops et cetera has seen the initiation of a shifting of commands. I think there are two commands that are now being shifted to Japan: One, the 1st Army Corps (I Corps) headquarters, is going from Washington State to Camp Zama, and then you have the 13th Air Force in Guam, into the 5th Air Force in Yokota. What's the status of those proposals. Obviously, well why don't you answer that first.

Secretary LAWLESS. Let me give a little bit different characterization on the former one in particular. The U.S. Army is really transforming itself, and constructing itself, as you know, in a different way. And that process is probably going to take about 2 to 4 more years.

One of the constructs they're going to is eliminating, or evolving, the existing headquarters type structures. So the structure that will exist, it's a much more modular concept than the way they're organized—will not be I Corps as it exists now, it will be a transformed I Corps. So it will be very headquarters heavy, and very light, if you will, in terms of the actual forces assigned to it. So it's essentially a headquarters unit. A mobile headquarters unit.

We have had some discussions with the Japanese about the relocation of that headquarters unit to Camp Zama. Those discussions have not concluded yet. I've mentioned in my presentation that we hope to conclude this entire defense transformation and realignment process by the end of the year, that's our goal. That will be included in that transformation, but as of today, that has not yet been decided.

The other adjustment, is actually an adjustment that's taken place essentially outside Japan, and that is, as you say, the elimination of the 13th Air Force and the transfer of some of those functions actually to Guam. And so what we see as part of our global posture realignment in the Pacific there is a significant upgrading of our presence in Guam, and part of the restructuring of the headquarters relationships is the merger, if you will, of the 5th Air Force and the former 13th Air Force.

Senator KERRY. What's the attitude of the Japanese Government with respect to those?

Secretary LAWLESS. I think in the case of the transformed I Corps unit that would be brought to Zama, it's something that they've asked us to explain to them in great detail. We're in the process of doing that. And remember that again, the Army is just figuring out how it wants to reorganize itself and order itself. So as we determine from the Army how it wants to be organized, we're

then going to the Japanese and explaining that to them. In fact, an additional explanation just took place this week. We're not quite there yet, but we're getting there.

I think the more that they understand about what we're doing and how we're doing it, and what the net result will be, the more comfortable they are. But they're not there yet.

On the headquarters—excuse me—the transformation of 13th Air Force, elimination of 13th Air Force, and the melding of 5th Air Force and the former 13th, I think they're completely comfortable with that. The 5th Air Force Commanding Officer will remain in Japan as the Commander of U.S. Forces Japan, that was a very important issue for us to discuss, and for us to confirm to them. They wanted to make absolutely sure that that relationship remained. It's a relationship that they're very comfortable with, these past 50 years, and we did assure them that that relationship would be sustained and that command relationship would remain in Japan.

Senator KERRY. Have there been any signs at all of popular discontent with respect to the Japanese people and the Japanese involvement in Iraq?

Secretary LAWLESS. I'm really not—are you suggesting the opinion polls and things of that nature?

Senator KERRY. I'm not; I'm just asking.

Secretary LAWLESS. You know I don't believe, I may be wrong, but as Secretary Hill just observed, Prime Minister Koizumi and his party just enjoyed a smashing victory on the 11 September election. And I don't really believe that this issue was in anyway an election issue for them in spite of the fact that they have a presence in Iraq. It may have been an issue in some of the individual races, but it certainly didn't rise to be a major issue across the board in the election. And I sort of take that to mean that it has not elevated itself to a national issue at this point.

Senator KERRY. Secretary Hill, first of all, a lot of us were gratified by the final movement obviously with respect to the talks with North Korea, and I certainly offer you my respect for having been central to that I think, and helpful in that process. There also, as you know, has been a long cry up here on the Hill about getting to the place you got a lot sooner. And a strong belief that the agreement we finally wound up with was in fact one that could have been achieved a lot sooner. But we really are there and that's positive. I know you're going to come back, and there's going to be another hearing on it. But I do want to touch on a couple of things with respect to it. But before I do let me ask you, a lot of medical device companies in Massachusetts are having troubles with the market place in Japan, and this again is the kind of thing that has gone on for a long time. These market access issues don't seem to change. What is the State Department currently doing with respect to those issues, which I know you're familiar with, and to promote access?

Secretary HILL. Well the issue of market issue has continued to be a major issue in our relationship with Japan for some time. And especially some of these hi-tech medical devices which we are extremely competitive at. And we have continued to raise this with the Japanese Government and it's been a very much focus of what

our trade section does in Tokyo. We—earlier I discussed the beef issue, but indeed this is not the only one. We have a number of questions and medical devices that are really high up on the agenda.

Senator KERRY. What does that mean?

Secretary HILL. Well, we have to deal with Japanese authorities on this. We have to try to—

Senator KERRY. But hasn't that always been true?

Secretary HILL. It has always been true, and—

Senator KERRY. What's the methodology, what's the lever? What's the recourse if we don't get somewhere?

Secretary HILL. Well, ultimately, of course it effects our ability to keep our markets open when we have—when we cannot get the Japanese to open up there. So we have to remind them that this has to be a two way street.

Now the recourse is, there is no magic formula to this. You have to work on these specific issues, you have—we have trade talks with them. We have our special trade representative working on these questions, and we go at it very much on a retail basis. You have to go at specific items.

Senator KERRY. Is the administration prepared to take recourse if necessary.

Secretary HILL. I mean the administration is prepared to pursue a very, very tough policy of market access. This is the policy and this is very much where our focus is.

Senator KERRY. Is there a timeframe that you can offer people who are losing business and getting frustrated?

Secretary HILL. I do not have a timeframe to offer on this, but what I can assure is we're very much engaged on it.

Senator KERRY. Turning for a moment to the Six-Party Talks, if I can a little bit. On August 15, Assistant Secretary of State Matt Reynolds wrote the ranking member of the committee informing him, "As you may have seen in some press reports, the North Korean insistence on the right to a civil nuclear program remains the major impediment to progress in the Six-Party Talks." So what exactly is the administration's position on North Korea's right to peaceful uses of nuclear energy?

Secretary HILL. Well our position is, we have—we have put together an agreement with four other partners, a Six-Party agreement which puts on the table a number of incentives for North Korea to get out of its nuclear business. That is give up it's weapons, and give up all it's existing programs. What we have agreed to do at this point is that once North Korea gives up all its existing programs, gets back into the nonproliferation treaty, gets back into with IAEA safeguards, we are prepared to have a discussion, a discussion with our other partners, and with the North Koreans, on the subject of the provision of the light water reactor. At this point that is as far as we are prepared to go, we are not prepared to say at this time that they have a right to restart a nuclear program. They have abused their nuclear programs in the past, and they have had great difficulty keeping peaceful programs peaceful, and we're not prepared to support this. The purpose of the agreement is to layout a path by which—on which they do not need nuclear power. The light water reactor generating capacity that was envi-

sioned in the agreed framework in the 1990's is taken up by conventional power supplied by South Korea to the tune of 2,000 megawatts.

Senator KERRY. But doesn't the agreement actually say that you have agreed to respect their right to peaceful use of nuclear power?

Secretary HILL. No. Specifically they have asserted that they have a right to peaceful use of nuclear power. And the other parties have respected that assertion. But we have not said that we support it. Or want them to return, or it would be our policy that they should have this right. We want them to get rid of their nuclear weapons, get out of all these programs. Get back into the NPT, get back with IES safeguards and we'll have a discussion at that point.

Senator KERRY. What's the road map then to that? I mean, most of the agreements we've reached with different countries have a sort of step by step process. Is it crystal clear what steps have to be taken by whom and in what order?

Secretary HILL. First of all I want to emphasize that this is an agreement on a set of principles, principles that will guide us as we continue in the next phase. The next phase will deal with the important question of sequencing, that is, of timing. It will deal with the very important question of verification, of the question of listing their programs, including the purchases they've made which are entirely consistent with an HEU, with a highly enriched uranium program. So we are not there yet in terms of laying out what you very importantly describe as having a road map and a way forward. Our view is they need to start by a clear strategic choice, that is to get out of the business of weapons production and nuclear programs. And after that, we are prepared to move on a number of fronts including a process toward eventual normalization.

Senator KERRY. Can we anticipate additional one on one discussion?

Secretary HILL. Throughout the Six-Party Talks, or throughout the Six-Party Talks that I've been involved in, I have engaged in one-on-one discussions with the North Koreans. It's in the framework of the Six-Party Talks, but I found that as a practical matter, it's very important to sit across the table and make sure they understand our position, and make sure we understand where they're coming from. There are many times when we have the other four parties in the room, but there are many other times when we have to just do it one on one across the table, and we will continue to do so.

Senator KERRY. To what degree is there a risk here of separate tracks, because China, Russia, and South Korea all agree that they do have a right to a light water reactor? We seem to be out there alone in asserting the non-right, or reservations about it.

Secretary HILL. To be sure, there are different view points on the question of their having a right to pursue peaceful nuclear energy. Our point is they haven't done so in the past, and we're not prepared to say that they can do so in the future. I would say however there is no disagreement between us and our other Six-Party partners, on the need for them first, to get out of nuclear weapons production, out of nuclear programs, back into the NPT, and back into the IAE safeguards. No country—no country in the Six-Party process is prepared to sit down with North Korea and discuss nuclear

cooperation in the absence of their taking these steps. And indeed the Russian Federation was quite clear about that. That they have their own internal regulations that prohibit such cooperation, such discussions of such cooperation while they're outside—while they have pulled themselves out of the NPT. So there's really unanimity on that issue. Down the road when they're out of all these activities, and when they're back in good standing I'm sure differences will emerge, but at this point, we do not have differences.

Senator MURKOWSKI. Senator Kerry I appreciate the line of questioning, because I'm really very interested in it. We do still have another panel to bring up, I know that you were interested in the medical equipment issue. So if you have any more questions on the Japanese relations, otherwise we will let these two gentlemen retire.

Senator KERRY. With respect to the medical device issue, just very quickly. The Government does a reimbursement program, is that correct? The hospitals get reimbursed by the Government, but the Government won't pay as much as the companies need for the device. Is that part of the—

Secretary LAWLESS. That's my understanding. The Government has a reimbursable system. And through their regulation we have found that U.S. manufactured—

Senator KERRY. Are discriminated against—

Secretary LAWLESS. Are essentially not reimbursed. So it's a use of regulation, of internal regulation in order to discriminate against the foreign supplier.

Senator KERRY. Thank you. Thank you Madam Chairman.

Senator MURKOWSKI. Thank you. I appreciate the testimony from both of you gentlemen, and your time here this afternoon. We'll move on to the second panel please.

OK. We have the second panel assembled before us. We're pleased to have join the subcommittee this afternoon Ms. Amelia Porges, Mr. Stephen P. MacMillan, the president and CEO of Stryker Corporation and Dr. Gerald Curtis, of the Department of Political Science of Columbia University. Ladies and gentlemen, welcome this afternoon. Why don't we start down here with you Dr. Curtis, and we'll just work our way down the line. Thank you, and welcome.

**STATEMENT OF DR. GERALD CURTIS, BURGESS PROFESSOR
OF POLITICAL SCIENCE, COLUMBIA UNIVERSITY**

Dr. CURTIS. Thank you, Madam Chairman, I'm honored to be here today to perhaps give a somewhat different take on what we've been discussing so far, which is to give you a sense of how recent developments in Japanese political affairs impact on the United States and our bilateral relationships, and to say a few words especially about the election, the important election that was held a couple of weeks ago and what it signifies in terms of Japanese policy and U.S. relations.

This election was a huge personal victory for Prime Minister Koizumi. As you know, he decided to call it after his bill to privatize the postal system was rejected because of defections by members of his own party. He quickly dissolved the house, called elections, purged the incumbents from his party who had voted

against him, and framed the election as a referendum on one issue, and one issue only.

The issue was reform of the postal system, which in Japan doesn't only deliver the mail, it's the biggest bank in Japan and in the world. If you oppose change vote against him, if you are in favor of change vote for him. That's the way he framed the election and he succeeded brilliantly. Prime Minister Koizumi is in a league all of his own when it comes to political savvy, media smarts, and he managed to portray his party, the LDP, which has resisted almost everything he's tried to do for the past 4 years as the party of reform, and the Opposition Democratic Party which was formed to pursue reform, as a party opposed to change. He pulled it off, the LDP won 296 seats out of 480.

I want to say just a couple of words about this very extraordinary political leader in Japan. He's very popular and he's very popular because the man exudes an innate optimism. He basically tells people, let's do this and things will get better. That is kind of obvious to American politicians, but in Japan, politicians so often talk negatively about having to do this or things are going to get much worse. Here's a man who actually inspires hope, and confidence in the public.

He has another quality which is very important, and I think unusual for any politician, he's not afraid to lose. He wasn't afraid to lose because he didn't think there was any point in staying in office if he couldn't get what he was after, which was further liberalizing the Japanese economy. And I don't believe the Japanese public supported him and his party because they were all that enthusiastic about postal reform. They were enthusiastic about a leader who was willing to sacrifice everything to get through a reform that he thought was necessary for Japan. So they bought his conviction and his belief.

Two other points that I think are very important to keep in mind. He won because the economy is a lot better in Japan, and people are feeling more optimistic. If deflation were deepening, if unemployment were increasing, if corporate profits were down, if growth was at zero, or close to it, we wouldn't have had this result.

But deflation is moderating and may be coming to an end. Corporate profits are at records high, the economic growth rate is up, probably 2½ percent or so. Consumer confidence is up. Business confidence is up. People feel the worse is behind Japan and the mood is more up beat than it has been for 15 years. Finally, the reason Koizumi is the Prime Minister of Japan in the first decade of the 21st century is that Japan changed enormously, especially in the last decade of the 20th century.

That wasn't a lost decade, it was a watershed. Values, attitudes, behavior, assumptions changed and that has had a direct impact on Japanese security policy and economic policy. We've ignored Japan for the past decade. Now it's important to take a new look. This is a very different country than it was in the 1980's or the early 1990's. And it presents new issues and new opportunities for the United States.

So, what are the consequences of these changes? First, postal reform will pass. Second, Koizumi will pursue other related reforms

mainly in dismantling several government agencies, particularly financial institutions that aren't responsive to market forces.

He will not increase the consumption tax. This is very good news, I believe. One thing I'm hoping he will do, but he has not spoken to it, is agricultural reform. He has now elected a lot of people from urban Japan in his party and it's an opportunity for him to push hard on agriculture reform. Agriculture reform is needed for domestic reasons in Japan. You have a very old population farming very small, inefficient lots of land.

Japan, not only for its international relations, but for domestic purposes has to come to grips with agricultural reform. And I'm hoping he will do so. Now what does this mean for the United States? Since my time is limited here, let me just briefly tick off a few points that strike me as important.

The implications of what's going on in Japan domestically are only good as far as the United States is concerned. First of all there's continuity, we know who's in power. We've gotten used to them, we know them well. And there is a Prime Minister who enjoys an exceptional relationship of trust and friendship with the President of the United States. That is all very good.

The opposition party which was defeated so badly is restructuring, and has a dynamic young leader, 43 years old, whose fundamental position and the party's fundamental position on Japan's foreign policy orientation and alliance with the United States, is really quite the same as the LDP's. Bipartisanship is emerging very much like our country. Republicans and Democrats differ about policies in Iraq or wherever it may be. But we basically, I think, are on the same page in terms of fundamental assumptions. That is now happening in Japan, so even a change in the party in power in Japan, there's not going to be a problem for the United States.

Third, the results of what happened in this election means there is no backtracking of economic reform. That is really good news for American business community. There is going to be new expanded opportunities for American business. Not as much, not as fast, not as big as we would like, but surely it's moving in the right direction, and it's very important to keep an eye on these opportunities, make sure there's a level playing field, and encourage American business to pursue them.

Now finally, I think it's very important in thinking about Japan's role in the world—the kind of issues that Mr. Lawless and Secretary Hill raised—to understand that there are continuing important constraints on Japanese security policy. There are domestic constraints in terms of public opinion, which you're well aware of, but they're particular important in terms of regional relations. Japan's relations with China and South Korea are very difficult ones. It's most difficult relations are with its closest neighbors. We have important relations, we have an alliance with South Korea, we have an important relationship with China. We need to see Japan, China, and Korea have a good relationship with each other. We have nothing, nothing to gain and a great deal to lose if those relationships deteriorate, become more strained. They are strained now, and I think it's very important for our Government to encourage Japan and China to work out their problems and to find a way

to improve their political relations. The economic relationship is growing more and more dense, and it's linked to a growing economic relationship among all three of us, with the United States as well. But bad political relations between China and Japan will draw the United States into very difficult problems. There are territorial issues that we do not want to see become more a cause of strain and that will force the United States to become involved.

So, I want to stress, in conclusion, that we talk about U.S. Japan relations, it's important not to focus only on the bilateral relationship. This takes place in a context, regional and global. I think there's a strong impetus in Japan now to seek out a larger global role, a political and security role, and that's very good for the United States. But we need to keep our eye on exactly how to work with the Japanese so that we don't exacerbate political problems in East Asia, and use the capabilities that Japan has to utmost benefit for all of us.

The U.S.-Japan relationship today is better than it's ever been before. It's stronger than it's been before and there's much that the United States and Japan can do together in dealing with regional and global, political, economic, environmental, social problems and so on. So I'm delighted that these hearings are being held and I hope it's part of a new effort to engage Japan in a very close dialog.

Thank you very much.

[The prepared statement of Dr. Curtis follows:]

PREPARED STATEMENT OF DR. GERALD CURTIS, BURGESS PROFESSOR OF POLITICAL SCIENCE, COLUMBIA UNIVERSITY

It is an honor and a pleasure to appear before this committee to discuss the consequences of recent developments in Japanese politics for economic and foreign policy and for Japan's bilateral relationship with the United States. The focus for my remarks will be the September 11th Japanese parliamentary election, one of the most important elections in recent Japanese history.

The trigger for the election was the rejection by the Diet (Japan's parliament) of a government bill to privatize Japan's postal system. The bill only barely passed the lower house when nearly forty LDP members voted against it. It was defeated in the upper house when a large number of LDP members decided to vote against it. Prime Minister Koizumi immediately dissolved the lower house, saying that he wanted the public to indicate whether it supported his policy on the reform of the postal system or agreed with those who were opposed to it.

Prime Minister Koizumi's strategy was to frame the election as a referendum on postal system reform. He drove all of the LDP members who had voted against his bill in the lower house out of the party and ran new candidates against them, including several high profile women. The media quickly labeled these new candidates the "assassins," thus bringing a sense of high drama to the election and getting the public excited about it. The result was a nearly 8 percentage spike upwards in the voting rate. Koizumi managed to portray the LDP, which for the previous 4 years had resisted much of his program, as the party of reform, and the Democratic Party (DPJ), which had been founded several years earlier to pursue a reform agenda, as a party opposed to change.

There is little evidence that the public knew what to make of the details of the postal reform bill. What attracted them was the courage of a prime minister who was willing to risk losing power rather than give up a policy that he believed was essential for Japan's economic revitalization. Koizumi convinced the voters that he had the conviction of his beliefs and would rather leave office than betray those beliefs.

His strategy succeeded brilliantly. A prime minister who until just a few weeks earlier looked as though his popularity was ebbing and whose ability to survive in office until the end of his term as LDP president in September 2006 was being publicly questioned now suddenly enjoyed a huge upswing in popularity. His party swept the election, increasing its representation in the 480 member lower house by 84 seats for a total of 296 seats. Together with its coalition partner, the Komeito

which won 31 seats, it controls two-thirds of the lower house seats. That means that it has the numbers to pass legislation defeated in the upper house.

The opposition DPJ suffered a humiliating defeat. It won only 113 seats, a loss of 64 seats. Of the 31 purged LDP incumbents, most of whom ran as independents, only 15 won. And they remain outside the party and isolated. With the adoption a decade ago of a predominantly single-member district system, small parties such as the once powerful Socialist Party (renamed the Social Democratic Party) and the Communist Party have fared poorly. Neither was able to break out of the single digits in terms of seats won.

EXPLAINING THE RESULTS

The first point to stress is that this election was not won by the LDP. It was won by Prime Minister Koizumi; nearly 300 LDP candidates rode into office on his broad coattails. Koizumi is in a league of his own when it comes to political skill and media savvy. He has often said that he would destroy the LDP if it did not support reform but in fact he is not destroying it but saving it from itself.

Koizumi is often compared to Ronald Reagan and Margaret Thatcher because of his emphasis on shrinking the government's role in the economy, but the more apt comparison is to Tony Blair. Reagan and Thatcher succeeded in convincing the public to support positions long identified with their parties. Koizumi, like Blair, forced his own party to embrace policies they had long resisted and then got the public to support the party because of its new stance. Koizumi has not yet succeeded in creating a "New LDP" in the way Blair created New Labour. But he has created the possibility that it will do so.

The phenomenon of a "Koizumi boom" driving up public support for his party is not without precedent. A little more than a decade ago, there was a Hosokawa boom that propelled Morihiro Hosokawa into the prime minister's office. In the 1970's, the current Speaker of the Lower House Yohei Kono, who had split from the LDP to form the New Liberal Club, enjoyed a similar outpouring of public support. Every decade or so a politician appears who seems to capture the imagination of the Japanese public.

The difference this time is that the object of the boom was the prime minister rather than an opposition party leader and, most importantly, that it was the first such boom to occur in the context of Japan's predominantly single member district system. Such a system magnifies the effects of a leader boom, sweeping members of the leader's party to victory across the country.

The size of the LDP victory was unexpected, even to the party's leaders. In Tokyo, for example, it won every single member district seat save one, and won so many seats in the proportional representation contest that it did not have enough candidates to fill all the seats it won, causing it to forfeit one seat to the Socialists.

Koizumi's appeal since he first was elected prime minister in 2001 is rooted in his innate optimism. Japanese politicians tend to warn about how bad things will get if people don't try hard to avoid calamity. When times are good, people may be responsive to a politician who warns that good times do not last forever. But when a country has been in the economic doldrums for more than a decade, the last thing the public wants to hear is a politician tell them how much worse things are likely to get unless they take power.

Koizumi's message was simple and straight-forward. Privatizing the postal system and reducing government interference with the operation of the marketplace will energize the Japanese economy. Make these changes, he told the voters, and things will get better.

The opposition DPJ took a more traditional Japanese approach. Its slogan was "we are not giving up on Japan," hardly a message to inspire hope, and it warned how terrible things would become unless something were done about fiscal deficits and pension reform. What it neglected to do was tell the public why the DPJ's coming to power would make life better.

Koizumi's great strength going into this election was that he was not afraid to lose. Koizumi was not confident that he would win the election when he decided to dissolve the house. What he knew was that if he did not call elections, he would spend his remaining months in office unable to accomplish anything the LDP party bosses opposed. He concluded that if he won the election he would gain new momentum, and if he lost, he would take the LDP down with him. LDP politicians who opposed him on postal reform and thought that he would accept some kind of compromise simply failed to take the full measure of the man.

They also failed to understand that Koizumi has total confidence in his instincts. He has limited patience for chewing over issues, which oftentimes turns out to be more of a weakness than a strength, and once he has made up his mind on a course

of action he does not look back or waver. He also simply refuses to abide by the informal rules that have long constrained LDP leadership behavior. Consequently, he constantly caught other politicians by surprise and threw them on the defensive while delighting the public with his willingness to challenge the LDP from within.

Three other factors deserve mention as having contributed to Koizumi's victory in this election. One is the improvement in Japan's economic performance. Fears about a crash of the country's financial system are now history. The banks have written off an enormous amount of bad loans and are now beginning to lend again. Corporate profits are setting new records, the stock market is up, exports have been driving growth and consumer and business confidence has improved. The sense that the worst is behind Japan and that the economy is on a path to sustained growth clearly provided a backdrop to this election that was favorable to Koizumi.

Another important factor was the ineptitude of the DPJ campaign. The DPJ made a strategic mistake by not putting forward an alternative to Koizumi's postal privatization bill. Party leaders assumed that there would not be an election before he left office and thus put more emphasis on maintaining harmony among the diverse interests represented in the party than broadcasting an appealing message to the public. The result was that Koizumi was able to portray the DPJ as being against change as much as were the LDP members who had opposed the legislation. The DPJ never got off the defensive and was unable to convince the voters that they should consider the election as anything other than a referendum on postal reform. They did everything possible to deserve the fate the election results bestowed on them.

Finally, and crucially, Koizumi's victory is not only changing Japan. Japan's changing made Koizumi's victory possible. The 1990's was not a so-called lost decade for Japan; it was a watershed decade in terms of changing values, expectations, attitudes and behavior. The political machine is collapsing, even in rural areas. Faith in the bureaucracy's ability to guide the economy disappeared with the bursting of the bubble economy. The idea that things will somehow be OK as long as people do not rock the boat is no longer accepted. Someone like Koizumi could become prime minister in the first decade of the 21st century only because of what had happened to Japanese society in the last decade of the 20th century.

ASSESSING THE CONSEQUENCES

The election results insure that postal system reform legislation will be passed by the Diet very quickly. Those LDP members who opposed it in the Upper House have lost no time to declare their readiness to support it when it is submitted again. Koizumi probably could get passed a stronger bill than the watered down one he submitted in August but he is going to submit exactly the same legislation as was defeated earlier.

Koizumi framed the election as a referendum on postal reform. He did not say what he would do after reform legislation was passed except to indicate in vague terms that he would pursue further economic reform. Therefore there is still a lot of guesswork involved in forecasting what he will do after passing postal system reform legislation.

Some things seem clear. He will focus his attention on continuing to try to shrink government by dismantling government special agencies, especially the large number of government financial institutions. His goal is as much to reduce the power of the bureaucracy and to eliminate sinecures for retiring bureaucrats as to make the economy more responsive to market forces.

He will pursue further cutbacks on public works spending and look for other ways to cut costs.

He will not raise the consumption tax before his term in office expires next September.

He will push for a bipartisan consensus on pension and medical system reform but it is unlikely that agreement will be reached before his term expires.

He will try to push through legislation to turn more tax making authority over to local governments and reduce the power of the central government over localities, though here too the devil is in the details.

He has the opportunity, now that his party has scored such big successes in urban Japan, to champion the cause of agricultural reform. Japanese agriculture is characterized by elderly people farming inefficiently small plots protected by high tariff walls. There is a growing public discussion in Japan about the need for fundamental reform, but Prime Minister Koizumi has not yet given any indication that he plans to take on this very big issue.

Koizumi faces the political problem of moving the reform process forward so as to respond to the high expectations the public expressed in the election. Having won so big, he now has to figure out how not to disappoint the voters.

As far as the economy is concerned, what Koizumi does is probably not as important as the mood his victory has created. First of all, there is confidence in the investor community, and especially among foreign investors, that there will be no backtracking on the course of reform. Second, the Japanese public is generally upbeat about the Koizumi administration and the future of the economy. There is an expectation that things will get better and that in itself creates a virtuous cycle of positive expectations, conducive to consumers spending more and business investing more. The sharp rise in the stock market since the election is an indicator of this positive mood.

The longer term political consequences of the election are less certain but it is my considered view that this election, contrary to appearances, has moved Japan further along the road to evolving a competitive two party dominated political party system.

It is very questionable how strong the LDP will be without Koizumi. What this election showed is that the great majority of Japanese voters do not identify strongly with any political party; they are floating voters who were attracted this time to Koizumi's party. It is hard to imagine that they will support the LDP in as large numbers as they did this time after Koizumi is gone. The LDP will lose seats in the next election. The question is how many.

The DPJ's massive defeat was good medicine for the party. If it had lost by a smaller margin, the pressure to rejuvenate the leadership, to reject the influence of public sector unions (which were responsible for the DPJ's opposition to privatization of the postal system), and to change its strategy would have been insufficient. But this election taught the DPJ important lessons. One is that it cannot expect to come to power simply by waiting for the LDP to lose it. It has to aggressively, proactively fight for the voters' support. The second is that elections are one-time events. The DPJ has talked about building its support over a number of elections so that it would "hop, skip, and then jump" into power, but it hopped, skipped, and fell flat on its face. The result is that it now has a new and young leadership core that is trying to change the party so as to make it a real alternative to the LDP. One should not underestimate the ability of the political opposition in Japan to betray expectations that it will challenge the LDP for power, but I believe the coming years will be a period of intense and healthy political competition. What is particularly noteworthy is that the DPJ opposes the LDP on a number of important policy issues, both in domestic and foreign affairs, but that these two parties share essentially the same ideological space. There is a fundamental bipartisan consensus on basic foreign policy strategy, which is anchored in a close alliance with the United States, and on the need to reduce the role of the state in the economy and to make it more open.

There is a need to be cautious in interpreting the significance of this election. It was after all a one off event, unlikely ever to be repeated. It was turned into a referendum on a single issue, postal reform. That is not likely to happen again. Thirty-seven incumbent Diet members were purged from the LDP. LDP Diet members will think harder about going against party discipline the next time a controversial piece of legislation comes to the Diet. The LDP swept urban Japan because of the popularity of its leader. But the LDP has not been transformed, at least not yet, into an urban party.

What can be safely concluded about this election is, first, that politics cannot go back to what they were like before Koizumi. He has irreversibly broken the old system. Factions will never again recover the role they formerly enjoyed in deciding who becomes prime minister and who joins his cabinet. Koizumi has made the cabinet the prime minister's cabinet, not the LDP's cabinet, and that is likely to continue. And the center of gravity for policymaking has shifted from being centered in an LDP-bureaucracy alliance into the prime minister's office. These are fundamental and important changes that are likely to outlast Koizumi and that probably will be his biggest legacy.

Koizumi, however, has done more to destroy the old system than define the contours of the new one. That will be up to his successors. One political issue Japan now confronts is how to institutionalize a new system of checks and balances, something that is necessary to every democracy. In the past the LDP's factional system itself provided checks and balances and an ideological opposition also acted as a brake on the governing party. Koizumi has made the LDP a more unified party than ever before so the old factional system no longer works. The opposition has been humbled and weakened by the election results so its ability to act as a strong check on the ruling party is at least for now quite limited.

There are two sources of checks and balances operating at the current time. One is the Komeito, the LDP's coalition partner. The Komeito's support is crucial for the LDP both because it needs the Komeito's votes to get legislation through the Upper House and because the Komeito supporting religious organization, Soka Gakkai, is one of the few organizations capable of mobilizing large numbers of voters in support of LDP candidates, something that will become much more important in the post-Koizumi era.

The second source of constraint on the government is the stance adopted by Prime Minister Koizumi himself. Koizumi has been very careful to emphasize that the election gave him a mandate for one thing and one thing only: to pass postal system reform legislation and other related reform measures. Much to his credit, he has not claimed public support for anything else, whether in domestic or foreign policy. And he has insisted that he will resign when his term as LDP president ends in September 2006. This results in concentrating the energies of his administration on accomplishing the reform goals he has set out and making support for reform the key issue in choosing his successor. Koizumi is no doubt sincere about his intention to resign next September. Given his character, he would not remain longer simply to help the LDP win the next election for the Upper House in the summer of 2007. But if he comes convinced as his term approaches its end that there is important unfinished business to attend to that only he can successfully resolve he may in the end change his mind. In any event, between now and September 2006 we should expect to see Koizumi focus his attention on pushing forward his reform agenda.

IMPLICATIONS FOR THE UNITED STATES

Recent developments in domestic Japanese politics should be welcomed by the United States. They contribute directly to strengthening our bilateral relationship.

Koizumi's reelection means that there will be continuity in Japanese policy and the continued presence of a prime minister who is committed to sustaining a strong affiance with the United States and who enjoys a strong relationship of trust with President Bush.

The major opposition party, the DPJ, is on the same page as the LDP in terms of its belief in the central importance of a strong US alliance, creating a bipartisan consensus on the fundamental underpinnings of Japanese foreign policy.

The privatization of the postal system and the general thrust for reforms to further liberalize the economy will contribute to creating a stronger Japanese economy that will offer new and expanded opportunities for American business.

It is also important not to entertain excessive expectations (or apprehensions) about Japan's security policy. There is a cautious searching out for a somewhat expanded role for Japan in international political and security affairs, and that will continue. But radical changes, are neither likely nor desirable. However, the constraints on Japanese foreign policy that derive from the public opinion in Japan and the difficulties of Japan's relations with its closest neighbors, China and Korea, remain strong.

In considering our security relations with Japan, it is important to understand that they do not occur in isolation. What happens in our relations with Japan impacts directly on our relations with China and with South Korea and other countries. The U.S. needs to have a regional security strategy and to avoid thinking in purely bilateral terms.

In that context it is in American national interests to see Japan and China improve their political relationship. It is not in our interests for relations between these major powers to deteriorate further. Prime Minister Koizumi has stressed that he believes that it is important for Japan and China to have good relations and that he is looking for ways to improve them.

In that regard, however, a looming issue is whether Prime Minister Koizumi decides to visit the Yasukuni shrine again. Yasukuni is not simply a shrine to honor the young men who fought and died for their country. As a visit to the war museum at the shrine makes all too obvious, Yasukuni is a shrine that honors the ideology and the policies of the government that sent these young men to the battlefields of Asia and the Pacific. It endorses the view that the attack on Pearl Harbor was a preemptive attack taken in self-defense and Japanese aggression in Asia was in fact a noble endeavor to liberate Asia from western imperialism and colonialism. Those convicted of Class A war crimes are enshrined at Yasukuni, but that is only a symbol, not the essence of the problem that has made Yasukuni an international controversy. A decision by Prime Minister Koizumi not to go to Yasukuni will not necessarily result in an improvement of Sino-Japanese relations. But it is a necessary condition for making improvement of those relations possible. It is in our national

interest to encourage both Japan and to China to seek ways to improve their political relations.

In summary, Japan is a dynamic political democracy with an immensely popular leader who has contributed in a major way to make the United States-Japan relationship today stronger than it has ever been before. There is a great deal that the United States and Japan together can do to deal with pressing regional and global political, economic, environmental and social problems. It is important that U.S. policymakers engage Japan in a close dialog to pursue those opportunities.

Senator MURKOWSKI. Thank you Dr. Curtis, let's go to Mr. MacMillan, welcome.

**STATEMENT OF MR. STEPHEN P. MACMILLAN, PRESIDENT
AND CHIEF EXECUTIVE OFFICER, STRYKER CORPORATION
ON BEHALF OF THE ADVANCED MEDICAL TECHNOLOGY
ASSOCIATION (ADVAMED)**

Mr. MACMILLAN. Thank you Madam Chairman. I'm Steve MacMillan and I ask that my full written statement be entered for the record.

Senator MURKOWSKI. It will be included.

Mr. MACMILLAN. Thank you. AdvaMed represents over 1300 medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. Our products save and improve lives, and enhance economic productivity.

To deliver this value to patients, our industry invests heavily in R&D, about 11 percent of sales, which is about three times the U.S. industry average. Our members manufacture nearly 90 percent of the \$84 billion U.S. health care technology market, and nearly half of the \$175 billion global market. In 2004, U.S. exports in medical devices and diagnostics totaled over \$24 billion dollars, which I note from comments about the beef industry earlier, that's more than double that industry.

Our company Stryker Corporation is a leader in the worldwide orthopaedic market. Our company has significant operations in Michigan, New Jersey, California, Florida, Tennessee, Massachusetts, New Hampshire and Texas. I would also like to point out that the other leading U.S. orthopaedic companies DePuy, Zimmer and Biomet are based in Senator Lugar's home State of Indiana. AdvaMed and its member companies would like to thank the committee for holding this important hearing today. Japan is our industry's largest overseas market, but the obstacles we face there get worse every year.

Japan's system for approving use of new medical technologies is the slowest and most costly in the world. The medical technologies patients receive in Japan are often several generations behind those available in the United States and Europe. Japan is compounding the problem with even more burdensome and costlier regulations. In fact, in just April of this year, Japan instituted the PAL measures which are estimated to cost our industry an extra \$1.5 billion just to comply by 2010.

But immediately following these measures, which have just dramatically increased our costs, they now wish to slash our prices by unprecedented levels. So while raising our costs, Japan is cutting the reimbursements for medical technologies. Between April 2002

and March 2006, the total revenue loss from the already enacted reimbursement reductions will be about \$3 billion.

Japan issues price cuts every 2 years. In two ways, one, they survey its hospitals and reduce reimbursements to reflect the prices hospitals are paying for all medical technologies. This approach is at least based on conditions in Japan. Since 2002, Japan has also begun to use a foreign average pricing, or FAP, scheme to cut prices for selected devices. FAP aims to base reimbursements on prices paid for medical technologies in the United States, France, Germany, and the United Kingdom. They want technology prices to be based not on the expensive Japanese market, but on unrelated conditions in foreign markets.

We have strong objections to FAP. Japan's market is vastly different from, and much more expensive than, the four countries used to compute the FAP. The three European countries impose relatively low price ceilings, or price controls on the medical technologies and distort prices.

Comparing prices even within markets, let alone across national boundaries, is difficult. Our companies sell a wide range of products under a variety of terms and conditions. Japan appears to be seeking even lower prices for medical technologies in part, to avoid correcting massive inefficiencies in its own health care system. For example, in Japan, patients stay in hospitals five times longer than in other developed countries. Japan's threatened cuts would have no perceptible effect on moderating Japan's overall health expenditures. Medical devices account for only 8 percent of their total health care spending. And the specific products targeted for these cuts represent less than 0.7 percent of those costs.

Virtually all technologies targeted for cuts are made by non-Japanese companies. The cuts are counterproductive to Japan's goals, as studies show that investing in health care, including technologies, reduces long-term health care costs.

We have recommendations to help ameliorate the situation and facilitate patient access to advanced medical technologies. For the regulatory environment we ask the Japanese Government to simplify and speed the approval process, while ensuring the products are safe and effective.

Regarding reimbursement, we seek a fair, transparent, and predictable system based on operating conditions and the cost of doing business in Japan. We look to work with the Japanese Government on a system that would limit the size of reductions in any given year, and would allow us to build such cuts into our long term planning.

Thank you again for inviting us to raise these issues today. We hope you will continue to recognize the importance of the medical device industry, as well as access to foreign markets for the sustained growth of our industry and U.S. jobs.

In our relationship with Japan, congressional and administration involvement is critical to maintaining our exports to this important market.

Thank you very much.

[The prepared statement of Mr. MacMillan follows:]

PREPARED STATEMENT OF STEPHEN P. MACMILLAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, STRYKER CORPORATION ON BEHALF OF THE ADVANCED MEDICAL TECHNOLOGY ASSOCIATION (ADVAMED)

AdvaMed and its member companies would like to thank the Chairman, Ranking Member, and Members of the Committee for holding this timely and important hearing today. Japan is our industry's largest overseas market, second only to the United States. We applaud the Committee for recognizing Japan's continued importance in the global economy, world trade, and U.S. foreign trade. We also greatly appreciate the work executive branch agencies have done on our industry's behalf.

THE MEDICAL TECHNOLOGY INDUSTRY

AdvaMed represents over 1300 of the world's leading medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. AdvaMed is proud to represent an industry that brings new hope to patients around the world, and U.S. companies are still benchmark manufacturing leaders in terms of total production, innovation and highest quality products. Our member companies manufacture nearly 90 percent of the \$94 billion U.S. health care technology market, and nearly 50 percent of the \$220 billion of medical technology products that are purchased globally each year. In 2004, U.S. exports in medical devices and diagnostics totaled over \$24 billion. The medical technology industry directly employs about 350,000 workers in the U.S.

Our industry is fueled by intensive competition and the innovative energy, driving very rapid innovation cycles that in many cases can lead to new product iterations every 18 months. About 70 percent of AdvaMed's membership is comprised of small and medium sized enterprises. Accordingly, our industry is most successful in fair, transparent, global markets where products can be adopted in a timely fashion and on their merits.

Innovative medical technology saves and enhances peoples' lives. Our products enrich patients' productivity and quality of life, thereby improving living standards and benefiting society overall.

Medical technology also contributes substantially to economic growth. Our products increase productivity by allowing workers to recover from illness faster, remain longer in the work force, and thrive without expensive long-term care. Studies show that funds invested in health care yield far greater benefits than costs to a nation's economy over the long term.

The use of medical technology will become even more important as a nation's population ages. According to the 2002 Commission on Global Aging, medical advances will bring "longer, healthier, more productive lives with declining rates of disability for the elderly." Innovative medical technologies offer an important solution for nations that face the challenges of balancing serious budget constraints and the demands of serving aging populations.

To deliver this value to patients, our industry invests heavily in research and development (R&D). Today, our industry leads global medical technology R&D, both in terms of innovation as well as investment. The level of R&D spending in the medical devices and diagnostic industry, as a percent of sales, more than doubled during the 1990's—increasing from 5.4 percent in 1990 to 8.4 percent in 1995 and over 11 percent last year. In absolute terms, R&D spending has increased 20 percent on a cumulative annual basis since 1990. Our industry's level of spending on R&D is more than three times the overall U.S. average.

GLOBAL CHALLENGES

Despite the great advances the medical technology industry has made in improving patient quality of life and delivering considerable value for its innovations, patient access to critical medical technology advances can be hindered by onerous government policies. Patients and health care systems experience much less benefit from our industry's R&D investment when regulatory procedures are complex, non-transparent, or overly burdensome—all of which can significantly delay patient access and drive up costs. In the future, patients will be further disadvantaged if reimbursement systems fail to provide appropriate payments for innovative products—which will subsequently affect the availability of R&D funds and the stream of new technologies.

The medical technology industry is facing these challenges around the world as governments enact more regulations. While we support those regulations that ensure product safety and efficacy, many others are being imposed without scientific justification, and in non-transparent processes, which only adds to costs and delays without improving patient outcomes.

As governments prioritize difficult budget decisions, they sometimes look to short-term decreases in health care expenditures without accurately assessing the long-term implications. In most cases, governments do not effectively measure the contributions medical technology makes in enhancing patient outcomes and productivity as well as expanding economic growth, which would more than offset the costs of providing these products. Instead, governments often inappropriately include reduced reimbursement rates as part of overall budget cuts.

THE CHALLENGE IN JAPAN

This is the situation we are facing in Japan, and it is getting more difficult every year. Japan's system for approving use of new medical technologies is the slowest and most costly in the developed world. Although Japan is one of the wealthiest countries in the world—the second largest economy in the world—its spending on health care is among the lowest of major developed countries. On a *per capita* basis, Japan's spending of 7.8 percent of GDP is lower than 17 other Organization of Economic Cooperation and Development (OECD) member countries.

Japan is compounding the problem by imposing more burdensome and costlier regulations, thereby penalizing the U.S. medical technology industry. Japan's latest regulations are expected to cost our industry over \$ 1.5 billion just to achieve compliance to 2010.¹

At the same time, Japan has made significant reimbursement reductions for medical technologies that impact the medical device industry in many ways, including limiting the availability of funds that could be devoted to R&D of new and innovative products. Inventing products that save and enhance lives requires large investments. Deep cuts for medical technologies in Japan have put downward pressure on companies' ability to invest in R&D. For the period April 2002 to March 2006, the total revenue loss from these reimbursement reductions is expected to be about \$ 3 billion—a significant share of which would have gone toward R&D.²

Japan appears to be making these changes, in part, as a way to avoid correcting the existing inefficiencies in its health care delivery system. Yet, because of its country's practices, Japanese patients often must wait 2, 3, or even 5 years longer for access to technologies that are already available in most other countries. Japanese patients are being denied access to our most advanced medical technologies.

AN INEFFICIENT HEALTH CARE SYSTEM IN JAPAN

Japan's hospitalization practices are the major contributor to high healthcare expenditures in Japan, with patients staying five to six times longer in hospitals than in other developed countries. For example, the average hospital length of stay in the U.S. is 6 days compared to 37 days in Japan, and these additional days clearly escalate the cost of care without significantly contributing to the quality of patient care. Japanese doctors own the hospitals in Japan, so there appears to be little incentive to diminish costs by better managing hospital stays.

The monetary cost of the inefficiencies of this system is huge. Japan's MHLW has estimated that excessively long hospital stays alone inflate annual costs by at least \$ 20 billion. This figure was found by comparing the average length of stay for Japan in total to a "best practice" length of stay in its most efficient district—leading to a reduction of stay length to 28 days. Using this same methodology, we estimate that Japan could save over \$ 68 billion by bringing its hospitalization lengths of stay down to the average in other developed countries (7.3 days) and \$ 71 billion if Japan reduced its hospitalization durations to the U.S. average of 6 days.

In addition, Japan has the highest ratio of beds to population of any of the 30 OECD nations and four times the number of hospital beds per person than in the U.S., which increases costs and reduces efficiency in several ways. First, Japan maintains many hospitals that would otherwise be closed. While we are sensitive to cultural differences between Japan and the U.S. or Europe, even the country's own Ministry of Health, Labor and Welfare (MHLW) has recognized that the current number of beds is excessive.

Second, Japan's diffuse hospital settings prevent the cost savings offered by specialized centers. A source of savings in specialize centers is the enhanced expertise doctors achieve when performing specific operations many times. The Japanese system limits the opportunities for Japan's health care professionals to develop optimal skills for performing complex medical procedures. Doctors who implant only a few devices each year would not receive as much training to perfect their skills as doc-

¹ LEK Acumen Consultant. 2005

² LEK Acumen Consultant 2005

tors practicing in specialized surgical hospitals, where a doctor might perform several implants (such as pacemakers) on a daily basis.

Unquestionably, this system substantially drives up costs for our industry. Since clinicians in Japan are often less familiar with the technical specifications and use of our products, service costs—including physician training and assistance during procedures—are much higher for industry. Medical technology products are often handled by two or more layers of distributors in Japan, each adding their own mark-up or margin. In comparison, the vast majority of medical technologies in the U.S. are sold directly without distributors.

A SLOW REGULATORY PROCESS FOR MEDICAL DEVICES IN JAPAN

In addition to the overall inefficiencies of its health care system, Japan's new technology approval process remains the slowest and most costly in the developed world. Even after creating a new agency last year to process applications for medical technology products, Japan had a backlog in February of over 491 applications filed before April 2004. When new applications are included, the backlog is reportedly much longer. A problem for this new agency is the number of staff reviewing applications for approval of medical technology products—about 40 officials, compared to over 700 in the U.S. Due to the long approval process, the medical technologies patients receive in Japan are often several generations behind the products in the U.S., Europe, and even developing countries like China, India and Thailand. Lengthy approvals also translate to higher costs for the U.S. medical technology industry, which must maintain out-of-date product lines just for Japan.

Japan should be examining ways to streamline its regulatory system, achieving greater efficiencies and facilitating patient access to the most advanced technologies available. We have made such suggestions to the Regulatory Reform Council, established by Prime Minister Koizumi, on some changes. We also have been working with MHLW officials and are willing to continue doing so.

So far, however, instead of facilitating patient access to medical technology, Japan has been compounding the problem by imposing more burdensome and costlier regulations that discourage innovation. Its revised Pharmaceuticals Affair Law (PAL), which covers medical technology products, went into effect on April 1, 2005. Even our largest companies are experiencing difficulties meeting PAL's complicated provisions. Some of our smaller companies have indicated they may have to exit the Japanese market because of PAL requirements. The initial and on-going costs of \$1.5 billion through 2010 are monies that otherwise could have been invested in furthering innovation for patients who need it most.

CONTINUED REDUCTIONS IN REIMBURSEMENTS FOR MEDICAL DEVICES IN JAPAN

At the same time our industry is facing these onerous and costly regulations, MHLW is threatening severe reimbursement rate cuts. In Japan, the government sets the maximum reimbursement rates, which usually act as ceiling prices for all medical technology products. These prices are reviewed and usually reduced every 2 years.

Before 2002, Japan adjusted prices according to a process it called "reasonable-zone" or "R-zone." In brief, MHLW surveys its hospitals for prices paid to distributors, and allows for a reasonable margin (or "zone") for discounts off of the government's reimbursement rate. While there are some difficulties with this system—as identified in bilateral Market-Oriented, Sector Specific (MOSS) negotiations between the U.S. and Japanese governments—our industry recognizes that it is at least based on factors in the Japanese market.

In 2002, however, Japan also adopted a system called Foreign Average Pricing (FAP). This system calls for the establishment and revision of reimbursement rates on the basis of prices paid for medical technology products in the U.S., France, Germany, and the United Kingdom (U.K). The prices of medical technology products in Japan are designed to be based not on that market's requirements, but on completely unrelated conditions in foreign markets.

The U.S. medical technology industry has several strong objections to this method of calculating reimbursement rates.

As a methodology for setting reimbursement rates, it is not economically sound to compare prices in foreign markets that operate under vastly different conditions. Japan's regulatory system is far costlier to comply with than European or U.S. regulations. In addition, the overall cost of doing business in Japan is far higher than in the U.S. or Europe. Just in terms of basic cost of living, Tokyo is ranked the most expensive city in the world, with Osaka number 2. Tokyo is about twice as costly

in general as New York City and about 2.5 times as expensive as a mid-western city, like Minneapolis. No U.S. city is in the top 20 cities on this list.³

Operating in Japan compounds costs by our industry compared to selling in other countries. For example, the added expenditures for product redesign, development, distribution, research and marketing all increase the cost of supplying Japanese patients by hundreds of millions of dollars each year.

Conditions in the three European countries included in the FAP analysis are different from both the U.S. and Japan. The European Union member states use a product approval system that, in many cases, is more streamlined than the U.S. process. However, France, Germany and the U.K. also maintain pricing interventions that place a ceiling on medical technology pricing.

Comparing prices even within markets let alone across national boundaries—is difficult. Our member companies sell products under a variety of terms and conditions. In the U.S., our companies can often offer lower prices to buyers willing to commit to much larger volumes for longer periods of time, but Japan does not have such buyers and offers minimal channels for efficient selling and distribution of medical technologies. Additionally, Japan's FAP system is an attempt to compare prices for products that are not the same in Japan as they are in other countries. Due to Japan's regulatory delays, U.S. manufacturers must incur the cost of maintaining older or outmoded production lines for sale in Japan.

Japan established its FAP system and continues its plans to cut reimbursement rates because of the "perception" that prices for certain medical technology products are much higher in Japan than in other countries. As previously noted, there are many reasons prices are higher in Japan than in other countries. In addition, Japanese doctors and others in Japan, often obtain this perception by comparing U.S. hospital purchase prices to the official Japanese reimbursement rates, which are usually higher than the prices medical technology products are sold in Japan.

As previously mentioned, the net effect of Japan's reimbursement rate cuts could have a detrimental effect on the funds available for research and development (R&D) of innovative products that are intended to lessen the time, pain and expense of treatments for a wide range of illnesses.

Ironically, Japan's planned reimbursement decreases are likely to have no perceptible effect on moderating Japan's health care budgetary expenditures. While some of the other practices mentioned in this testimony are very inefficient and obvious drivers of inflation of Japan's health care costs, medical technology products account for only about 8 percent of Japan's total health care spending, and products targeted for price cuts represent less than 0.7 percent of all health care expenses. Virtually all technologies targeted for these cuts are made by non-Japanese companies.

Instead of trying to balance its budget on the backs of the medical technology industry, Japan should look to major reforms of its inefficient hospital system. Such reforms would provide huge savings and would be good for Japanese patients and for Japan's economy.

U.S. GOVERNMENT SUPPORT

The U.S. Government has provided our industry with tremendous support in trying to convey this message to the Japanese government. We have enjoyed bipartisan congressional support, with these hearings serving as just the most recent manifestation of that support.

Our industry has also benefited from continuous support from the executive branch. We want to thank the Departments of Commerce, State and Treasury, the Office of the U.S. Trade Representative (USTR), and the U.S. Embassy in Tokyo for their hard work on our behalf. Since the mid-1980's, executive branch agencies have included regulatory and reimbursement issues in the MOSS negotiations. More recently, these issues have also been a topic for high-level USTR-Commerce negotiations with Japan under the Regulatory Reform Initiative.

We believe that U.S. Government support has been a major reason that total U.S. medical technology exports have flourished worldwide for many years, exceeding imports. In fact, this past year was the first time that total U.S. imports of \$25.2 billion ever exceeded exports in the medical technology sector.

While U.S. exports of medical technology have enjoyed a surplus with Japan, we see disturbing signs that this too could change. During the 1980's and 1990's, our industry's exports rose steadily. Since Japan introduced its FAP system in 2002, U.S. exports have basically stagnated at essentially the same level of exports in 2004 as in 2001. At the same time, Japan's exports of medical technology products in 2004 rose by 10 percent, contributing modestly to Japan's burgeoning total trade

³Mercer Report, 2005

surplus with the U.S. of \$75 billion—an increase of 14 percent last year. With added regulatory hurdles and reimbursement reductions, U.S. exports to Japan could deteriorate further.

The World Trade Organization (WTO) recognizes that standards and regulations can be non-tariff barriers (NTBs). While we are not alleging a WTO violation, we do believe that Japanese policies are essentially creating new NTBs for our industry to try to overcome.

RECOMMENDATIONS

We have several recommendations to help ameliorate the situation in Japan and, at the same time, facilitate patient access to advanced medical technology products. AdvaMed members want to cooperate with the Government of Japan to find solutions that are mutually beneficial to patients, Japan, and our industry. We have met frequently with officials from MHLW and other government agencies, including at senior levels, to seek such solutions. We respectfully request that such solutions be based on actual operating conditions in Japan and not on circumstances in other countries.

In terms of the regulatory environment, AdvaMed members will continue our efforts to understand and comply with existing regulations. At the same time, we ask that MHLW seriously examine our suggestions to facilitate patient access to advanced technologies.

Regulatory Improvements. Japan should urgently address the growing backlog of product applications and to reduce the review times of new product applications—particularly in light of Japan’s User Fee system and its commitment to meet performance measures. One concrete step would be to quickly expand the number of experts employed in Japan to review product approval applications for product safety and efficacy, which would help reduce the considerable backlog. As part of this effort, the expertise and training of reviewers could be broadened to include necessary skill sets, such as a background in engineering and biostatistics. Another step would be for Japan to accept results of scientific studies conducted in the U.S. We have made recommendations of this nature to the Government of Japan, and we would hope they receive serious consideration.

Reimbursement Improvements. We seek a fair, transparent and predictable system based on actual operating conditions in Japan. We believe such a system should reward innovation by providing higher payments for truly innovative products. If there is a clear demonstrable reason to reduce some product prices, we would welcome the opportunity to work with MHLW on a transparent system that would limit the size of reductions in any given year and would allow us to build such cuts into our long-term planning, instead of being unpredictable and dictated every 2 years.

CONCLUSION

Thank you, Mr. Chairman, and the other members of this Committee for providing us the opportunity to submit the views of our industry in the context of a hearing on overall U.S.-Japan trade relations. We hope you and other Members of Congress will continue to recognize the importance of the medical device industry, as well as access to foreign markets for the sustained growth of our industry and U.S. jobs. In our relationship with Japan, congressional and administration involvement is critical to maintaining our exports to this important market.

Senator MURKOWSKI. Thank you Mr. MacMillan. We will next go to Ms. Porges. Am I saying that right, or even close?

STATEMENT OF MS. AMELIA PORGES, COUNSEL, SIDLEY AUSTIN BROWN AND WOOD, LLP, WASHINGTON DC

Ms. PORGES. Senator Murkowski, my name is AMELIA Porges. I am an attorney in the Washington DC office of the law firm Sidley Austin Brown & Wood LLP, where I specialize in international trade matters. I speak today in a private capacity, not on behalf of my law firm and not on behalf of any client. I have been asked to provide my perspective on trade issues and the overall trade environment between the United States and Japan.

I would note, for the record, that our firm has provided and continues to provide legal advice on certain matters in which the Japanese Government is involved pro, and con. The trade relationship

between the United States and Japan is of major importance to the world economy and to the United States. Japan is the second largest economy in the world, the third largest U.S. market, and our fourth largest supplier. Americans have a huge stake in Japan's continued economic revival and in better economic ties between the United States and Japan.

This is a bilateral trade relationship that has greatly changed over the last 20 years, as the Japanese economy has changed as Professor Curtis has pointed out, and the overall world environment for trade has changed. In that time, we and Japan changed the way they deal with each other.

We negotiated better trade rules, and expanded multilateral enforceable commitments under WTO agreement. Both parties can and do settle their disputes under WTO rules, and they negotiate with each other in the WTO. The business communities of both countries are now working with their counterparts in Europe and elsewhere to urge governments to reinvigorate the Doha Round negotiations and set a high level of ambition for new market opening and improve trade rules, the two governments should work together and do what it take to ensure the successful completion of the Doha Round.

Now the border barriers that monopolized the trade agenda 20 years ago have been largely displaced by the structural issues today like postal reform, broadband access, energy sector reform, financial reform, and corporal governance reform. The U.S.-Japan Regulatory Reform and Competition Policy Initiative established by President Bush and Prime Minister Koizumi in 2001 has discussed these issues in depth. These issues require negotiators and stakeholders to master the details of domestic regulation, to engage in a meaningful dialog, but they offer a bigger payoff both for U.S. business to compete in the Japanese marketplace, and for Japan itself.

This change in the bilateral trade agenda reflects Japan's difficult decade of economic stagnation that Japan has gone through, and the stagnation from which Japan finally appears to have emerged. It also reflects change in the economic fundamentals.

Production and distribution networks are now globalized both for Japan's companies and for our own. To respond to this globalization and for a way to exert leadership in East Asia, Japan has even launched its own program negotiating "economic partnership agreements," with its Asian-Pacific trading partners.

U.S. firms compete directly in the Japanese market as investors as well. Foreign direct investment is now welcomed as a source of jobs and growth, and it increases every year, including from the United States.

The trade issues that matter to these U.S. companies in Japan are mainly structural. For example, a fair regulatory regime; health care reform; measures to strengthen corporate governance; and transparency in policymaking.

Prime Minister Koizumi's huge election victory on September 11 has provided him with an unquestionable mandate for postal privatization and more reform. His proposal for postal reform is about putting to efficient use the immense assets of the postal system.

Japan Post now includes not just delivery, but also the world's largest savings bank, and a life insurance company that is bigger than its four largest private competitors combined. Postal privatization involves \$3 trillion in assets, one third of all household assets in Japan. It's important to ensure that it goes forward on terms that are fair for all concerned.

Now the outcome of these structural reform initiatives remain to be seen. But the United States potential economic interest in their success is even greater than at stake in the sector specific issues that characterize the U.S.-Japan relationship in the past.

For this reason the progress of reform in Japan will be worth following on a continuing basis for this subcommittee and for others interested in U.S.-Japan relations.

Thank you, Senator Murkowski. I would be pleased to answer any questions.

[The prepared statement of Ms. Amelia Porges follows:]

PREPARED STATEMENT OF AMELIA PORGES, COUNSEL, SIDNEY, AUSTIN, BROWN & WOOD, LLP, WASHINGTON, DC

Senator Murkowski and members of the subcommittee, my name is Amelia Porges. I am an attorney in the Washington D.C. office of the law firm Sidley Austin Brown & Wood, where I specialize in international trade matters. I speak today in a private capacity, not on behalf of my law firm and not on behalf of any client. I have been asked to provide my perspective on trade issues and the overall trade environment between the United States and Japan.

The trade relationship between the United States and Japan is of major importance to the world economy and to the United States. Japan is the second largest economy in the world, the third largest U.S. market and our fourth largest supplier. Americans have a huge stake in Japan's continued economic revival and in better economic ties between the United States and Japan.

This is a bilateral trade relationship that has greatly changed over the last twenty years, as the Japanese economy has changed and the overall world environment for trade has changed. In that time, we and Japan have changed the way we deal with each other. We negotiated better trade rules, and expanded, multilateral, enforceable commitments, under the WTO Agreement. Both parties can and do settle their disputes under WTO rules and negotiate with each other in the WTO. The business communities of both countries are working with their counterparts in Europe and elsewhere to urge governments to reinvigorate the Doha Round negotiations and set a high level of ambition for new market opening and improved trade rules. The two governments should work together and do what it takes to ensure the successful completion of the Doha Round.

The border barriers that monopolized the trade agenda twenty years ago have been largely displaced by the structural issues of today—postal privatization, broadband, energy sector reform, financial reform, corporate governance reform. The U.S.-Japan Regulatory Reform and Competition Policy Initiative established by President Bush and Prime Minister Koizumi in 2001 has discussed these issues in depth. These issues require negotiators and stakeholders to master the details of domestic regulation to engage in a meaningful dialog. But they offer a bigger payoff both for U.S. businesses that compete in the Japanese marketplace, and for Japan itself.

The change in the bilateral trade agenda reflects Japan's difficult decade of economic stagnation, from which Japan finally appears to have emerged. It also reflects change in the economic fundamentals. Production and distribution networks are now globalized both for Japan's companies and for our own. To respond to this globalization, and as a way to exert leadership in East Asia, Japan has now launched its own program negotiating "economic partnership agreements" with its Asian and Pacific trading partners.

U.S. firms now compete directly in the Japanese market. Foreign direct investment is now welcomed as a source of jobs and growth, and is increasing every year. The trade issues that matter to these companies are mainly structural—for example, a fair regulatory regime, healthcare reform, measures to strengthen corporate governance, and transparency in policymaking.

Prime Minister Koizumi's huge election victory on September 11 has provided him with an unquestionable mandate for postal privatization and more reform. His proposal for postal reform is centered on putting to more efficient use the immense assets of the postal system. Japan Post now includes not just delivery, but also the world's largest savings bank and a life insurance company that is bigger than its four largest private competitors combined. Postal privatization involves over \$3 trillion in assets—one quarter of all household assets in Japan. It is important to ensure that it goes forward on terms that are fair for all concerned.

The outcome of these structural reform initiatives remains to be seen. The United States's potential economic interest in their success, however, is even greater than its stake in the sector-specific issues that characterized the US-Japan relationship in the past. For this reason, the progress of reform in Japan will be well worth following on a continuing basis for this Subcommittee and for others interested in U.S.-Japan relations.

Senator MURKOWSKI. Thank you, appreciate that. Let me start off by picking up where you have left off, Ms. Porges. And the issue of postal reform, this is as you have noted Dr. Curtis, this is key to the election. This is key to what is happening in Japan right now. What is it going to mean to our U.S. companies?

Ms. PORGES. Postal reform is immensely important for those companies that could compete with Japan Post, and also for those who could partner with it. This will bring great opportunities and great challenges for those firms. For that reason we hope that privatization will move forward on conditions that are transparent and that are fair for all. They could—for instance there are new opportunities to partner with the Post in selling for instance financial products through post offices, equally there may be new opportunities in postal delivery.

Senator MURKOWSKI. Will it be restricted to just those areas, or do you believe that it can go further to other financial interests and aspects?

Ms. PORGES. Pardon me?

Senator MURKOWSKI. Will it be limited to just those areas where you're speaking about Post, or can it expand to other financial interests where U.S. businesses can come in and offer their expertise, come in and operate in Japan?

Ms. PORGES. Certainly there maybe opportunities opening up, we can't really know until we see the details of how it's implemented. You're talking about a \$3-trillion privatization in which all those assets will be divided up, the assets will be divided up into four subsidiaries held by a holding company, two of the subsidiaries, the bank and the insurance company will be set up as private companies, and should be regulated just like a regular bank, and a regular insurance company. And their stock is supposed to be sold off entirely, 100 percent to the public and privatized over a 10-year period, so you're talking about very fundamental changes involving large private organizations. And this is certain to create change and opportunities in the market place.

Dr. CURTIS. I might add just a word of caution, to restrain our enthusiasm. This is a 12-year program and the final stage of privatization doesn't occur until 2017. It sort of gets kicked off in 2007, so you don't know what might happen after Mr. Koizumi is gone in terms of backtracking. There's all kinds of opportunities for the government to change its mind. I think the reform is a good one. It could have been a stronger bill, but given the political realities before this election that was the best that Koizumi could get

through. He just wants to get it over with now, and pass it. So he's not going to try to reopen the debate on it. And I think it's important that the United States keeps a very close eye on the implementation process, and makes sure that the opportunities that are given to the private sector in Japan are also made available to the private sector in the United States. But my sense is that this is a direction of change in Japan that's irreversible, that is opening the economy, making it more liberal, making it more open to the outside world, particularly American financial institutions have expertise about these complicated new financial products that are going to make them a very big player.

So I think the message is positive for the world economy, for the U.S. business in Japan, and for Japan itself. But we shouldn't jump to conclusion that tomorrow morning the world is going to look very different when seen from Japanese Post Office, it won't.

Senator MURKOWSKI. Uh-huh (Affirmative). Let me ask you about the reform agenda, it is ambitious. This is a major step for Koizumi and his party. Reform is always difficult and I appreciate your couching his success, not necessarily because people believe that this Postal reform was a good thing, but because they believe so strongly in a man who was so passionate about achieving something, and that he had given them a level of optimism and hope and that's good for a period of time, unless, and until it starts to personally effect you and you don't like it. With the reforms that he is suggesting, not only through the Postal reform, but you mentioned agriculture reform, is this level of public confidence in him going to make it through some very politically difficult and challenging reform issues.

Dr. CURTIS. Well thank you, that's a wonderful question. There are two answers to it. One is that his biggest problem right now is to not disappoint the public by not coming up with an ambitious reform agenda. They just elected the LDP to a huge victory, not because of support for the LDP, but support for the idea that Koizumi is going to do things that are good for the economy. He doesn't have a concrete agenda in place after Postal reform. So he is going to have to scramble to do a lot of things, not to disappoint the electorate. Some of the things I've mentioned about dismantling government agencies and so forth and so on. But the second point is that if you really push hard on reform, some people are going to feel pain, even if the overall economy benefits as a result.

But I think that what I said earlier about the 1990's being a watershed decade is important, because what it means is that I don't believe that Japanese believe anymore that simply not rocking the boat, doing the things the way they've always been done that somehow they will muddle through and things will slowly get better.

Now I think people believe that you have to have change, even take some risk, maybe have some pain; because if you don't change, things won't get better. The sense is that there is a positive attitude toward reform and change. Japanese are still, on the whole, pretty risk averse, say compared to Americans. Koizumi's great strength is to have public confidence in him as a leader. And so he'll be fine. But what of September of 2006, when his term is up, what happens after that. That's another story. But for the next year, I think you'll see a lot of momentum coming out of this vic-

tory that he had, and he'll push on some issues, and public will be basically with him.

Senator MURKOWSKI. And it's not just Koizumi himself, it's those incumbents that sort of came along with him, will that optimism, and the public confidence continue and if so for how long?

Dr. CURTIS. Well I think so, and you know I think for example that Japan faces two really big, huge issues. One how to deal with the fiscal deficit. And in the end there's only one way to do it, and it involves the raising of some taxes. And the second is what to do about their social security system, pension system, and medical care system. Very similar problem to what we have. And in the end, there's only one answer. You increase the amount the money people pay into the system, and you lessen the amount they're going to take out of it. It's not a pleasant experience to go through and it's very difficult for politicians to take this head on, as you're well aware. But there is a growing consensus in Japan that this is unavoidable, and in fact the Japanese Government has moved in many ways in trying to improve the finances of their social security system. They'll continue to do so, and the public won't be happy about it, but they'll support it because they know there's no alternative. Japan is a rapidly aging society, they have a demographic problem because they don't have immigration, they have a very low birth rate, it's becoming a very old country, there's going to be fewer people working and supporting a lot of healthy but retired older people. I think one can be cautiously optimistic about the reform agenda in Japan. It's not going to go as fast as far as it should. But as you know, that's politics.

Senator MURKOWSKI. Let's talk a little bit—we've heard some discussion perhaps about agricultural reform, but Ms. Porges given Japan's reticence to put the agriculture issues on the negotiating table, how likely do you see a U.S.-Japan free trade agreement today?

Ms. PORGES. I'm glad you asked that. There have been a number of proposals for such a free trade agreement on the industrial side, in some ways we have a rather similar tariff profile. But it's true that agriculture would be a great stumbling block. It would be the major stumbling block. We're—I think we're hoping that perhaps Prime Minister Koizumi can bring some of that reformist zeal to come up with a new vision for Japanese agricultural, which is in fact aging even faster than the Japanese population at large. I think at this point about 20 percent, 20 percent of Japanese farmers are over 65. There are very many farms where there are no farm successors. And by 20 years from now, I think the majority of farmers, perhaps the overwhelming majority of Japanese farmers will be over 65. So clearly the demographic part is pushing, has to push for some sort of fundamental agricultural reform and it's time to start thinking about that.

Senator MURKOWSKI. The value of U.S. exports to Japan has been apparently stagnate over the last few years, what do you see in the future years, is there any way that we can increase these numbers, any advice, or optimism that you can offer our U.S. exporters?

Mr. MACMILLAN. I could certainly take it from specific medical devicing, I think what we're—I'm sorry, I can answer that on be-

half of the medical device industry. What we've clearly seen is a remarkable slow down in approvals of new technologies. One of the other ways their managing costs is under staffing the NHLW, not allowing new technologies to get approved into the marketplace, and that has prohibited us from bringing some of our latest technologies to the marketplace. And I can't really speak beyond our industry.

Senator MURKOWSKI. So, can you speak to any level of optimism, it doesn't sound like it?

Mr. MACMILLAN. Not right now. I think we were probably hopeful that with the PAL reforms and you know, if they were obviously increasing some of our costs of doing business there that might, as in the United States where we put in the drug user fees, or the device user fees, and it led to increase levels of staffing, it's allowed a better product flow. We're clearly not seeing that, and in fact on the other side, seeing them now turn around and want to slash prices by literally 25 percent over the next few years. So we're—why we're coming here actually.

Senator MURKOWSKI. Is there a Japanese domestic medical devices industry.

Mr. MACMILLAN. It is very limited. It is much more underdeveloped, which is why we feel that it's kind of fair game to go and attack you know, disproportionately changes they make here will effect U.S. and frankly European based companies far more than their own environment. And I think they've not created the environment, nor supported the development of that industry in their country the way they have many other industries.

Senator MURKOWSKI. Do I understand that Stryker Corporation purchased a Japanese company to help with your distributorship within Japan?

Mr. MACMILLAN. Yes. Actually we, that would have been back in the late 1990's, about 1996 or 1997. So we acquired a distributor in Japan that helps us navigate what is a very complex and multi-tiered structure of distribution which is also what dramatically increases our cost of doing business. You know it's very hard to sell directly to a hospital there, we have to go through many chains all of them take a price cut. And then when the NHLW decides well let's go compare your pricing to what it is in France, where we can be selling direct, you know it's just where we feel it's an unfair comparison. We had actually even gone a step further over the last few years, our business, Stryker, specifically has been very healthy in Japan, because we've been designing implants custom made for the Japanese anatomy, and we've introduced a knee system that's doing very well and a hip system where we were placing greater levels of investment to try to cater to that market place, now with this latest turnaround of reimbursement that's obviously going to have to effect our strategy because we won't be able to continue to afford to serve their patients better than what we thought we were doing.

Senator MURKOWSKI. If you had not purchased the company that you did several years back, would that have limited your ability to even be where you are within the Japanese market now, I mean was that something that really had to happen in order to do business over there?

Mr. MACMILLAN. For us to establish our self as a leading player, we did feel we needed to make that acquisition, just to better manage the distribution chain. Because otherwise we were feeling cut out and unable to penetrate a number of the markets without having that local ownership, yes.

Senator MURKOWSKI. But now given what you are facing with the pricing cuts, the reimbursement cuts coming at you, I would imagine it causes you to question how you continue to do the business that you need to do, with the markets. Particularly given that you're trying to cater to a very specific market with your technology.

Mr. MACMILLAN. Madam Chair, I would tell you it is an issue that we're losing sleep over as we start to plan the next few years. Japan is our second largest market, it's been a very important market for us, and we've invested a lot of time and money in that market really over the last 20 plus years to get to the position we're at today, all of a sudden to be staring down the barrel of a gun, you know it's just an unprecedented level of price cuts that you just can't plan and—we literally, just as a company, we hired 75 new people just earlier this year to comply with the PAL reforms, now—and those are not cheap people, they are regulatory people, a lot of expertise all of a sudden to sit around and say OK, now we're going to price your product differently puts us in a tough bind and clearly forcing some tough choices going forward for what we do there.

Senator MURKOWSKI. So for the 20 years that you have been doing business in Japan, it's really been these past few years where it has made—regulations have made doing business very, very complicated and costly.

Mr. MACMILLAN. Yes. We would categorize it probably that there's been a gradual effect, every 2 years or so, we've been used to some kind of biannual, getting nicked on pricing reductions, 4 or 5 percent price cuts on certain product lines, some enhanced level of reform. There's really been just a watershed event with this PAL reform coming in that's just dramatically increased our costs, and then all of a sudden just as they got that implemented they start talking about the 2006 price cuts as not being part of this biannual thing that we've tried to manage for, and plan for. At least if you know it's coming, and it's manageable, you can plan for that, in terms of staffing, not adding as many people, and trying to find other efficiencies in the system. But when they all of a sudden put that cost, and then turn around and say, we want 25 percent price reductions.

Senator MURKOWSKI. But is that 25 percent from where you were last year?

Mr. MACMILLAN. Yes, where we are currently, and that's following last year's actually we took a price cut in 2004, of about 5 percent. So it's a 25 percent on top of that. Which is as you know, in any industry to incur that kind of a hit off, is very hard to recover from.

Senator MURKOWSKI. OK. Check through here and see if there isn't anything that I wanted to followup with. I think I've kept everybody here a sufficient amount of time here today.

I appreciate the time you have given to us, the information that you have provided to us, and thank you very much. And with that we are adjourned.

[Whereupon the hearing was adjourned at 4:25 p.m.]

APPENDIX

Additional Material Submitted for the Record

PREPARED STATEMENT OF HON. NORM COLEMAN, U.S. SENATOR FROM MINNESOTA

Thank you, Madame Chairman, for holding this hearing on U.S.-Japan Relations, and for allowing me the opportunity to provide opening remarks. It is a pleasure for me to participate in this hearing to discuss a topic that I regard as a key element of U.S. foreign policy. In addition, I find this hearing extremely timely for addressing key issues relating to the U.S. relationship with Japan that specifically affect the state of Minnesota.

My tenure as a member of the Foreign Relations Committee has led me to a greater appreciation for the friendship our country has with our longstanding ally, Japan. The unique relationship between the U.S. and Japan has proven vital for both countries, as we have become highly integrated through collaboration on issues ranging from economics to security. On all of these fronts Japan has demonstrated that it is both a committed partner of the U.S. as well as a global leader in its own right. It is because Japan has demonstrated its leadership on the global stage that I support its bid to become a member of the U.N. Security Council.

I would like to take the opportunity to recognize a few of the contributions made by Japan in the global arena that warrant applause from the U.S. Japan has been a partner to the U.S. in our efforts in Iraq, and the magnitude of our mission in that country means that the support of our allies is critical for achieving success. Japan has also been a valuable partner in the broader War on Terror, which is underscored by their leadership on efforts such as the Proliferation Security Initiative. Finally, the commonality of American and Japanese security interests is underscored by our joint efforts in the Six-Party Talks to address the North Korean nuclear crisis. In all of these areas, Japan has demonstrated its commitment to its relationship to the U.S.

I am particularly interested in participating in today's hearing because I believe that there are ways that the U.S.-Japan relationship can be strengthened. As with any partnership, the U.S. and Japan face challenges in their relationship. While I think it is important to point out the issues that exist in the U.S.-Japan relationship, I also want to emphasize that I believe that addressing them will positively benefit both countries. My specific concerns regarding the U.S. relationship with Japan stem from trade issues relating to the medical technology industry.

One issue that must be tackled is the need for a trade regime with Japan that allows for reasonable access to its health care system, which in turn has a direct impact on the people of Japan. Last Congress, I introduced a Resolution in the Senate expressing my significant concern that discriminatory practices and systematic barriers have limited the ability of the U.S. medical device industry to introduce new technologies into the Japanese healthcare system.

Discriminatory practices targeting the medical device industry directly affect my state and many of my constituents. This is due to the fact that Minnesota is the proud home to a thriving medical technology industry. Minnesota's Medical Alley is a rich corridor of more than 8,000 medical-related companies—12 percent of our work force—and is home to over 520 FDA-registered medical technology manufacturers. Employment in the industry increased 33 percent from 1991 to 2001, adding over 23,000 jobs to the state of Minnesota. The jobs produced by the medical technology industry represent a lucrative opportunity for my constituents, as the aggregate figure for wages exceeds \$1.3 billion—an average of over \$56,000 per employee.

Recently I was asked to support a grant application to ensure that the demand for skilled workers in the medical device industry is met in the future. The projected growth in the industry is expected to lead to the creation of 15,000 new jobs for Minnesota's top 4 device companies. I couldn't be more thrilled.

The benefits that Minnesota has derived from being home to a flourishing medical technology industry are well-deserved and a product of hard work. Minnesota ranks second only to California in device companies, and our state is home to many technology firsts: the first implantable cardiac pacemaker, first artificial heart valves, first implantable drug transfusion pump, first wireless cardiac monitoring system, first blood pumps, first anesthesia monitor and more—and much more to come!

Despite all of these positive trends in the medical technology industry, one area that does not reflect all of this progress is that of trade with Japan. Japanese policies have hindered the entrance of medical technology goods into the Japanese market. I would like to point out several of these problematic policies.

Japan has adopted a foreign reference pricing scheme to reduce reimbursement prices in Japan's health system—a tool long opposed by the U.S. Government and the medical technology industry. This foreign reference pricing policy is an arbitrary price control mechanism that fails to account for the high costs of bringing advanced technologies to the Japanese market.

In addition, I am also concerned about the non-tariff barriers that players in the U.S. medical device industry face in their attempts to access the Japanese health care system:

- *Regulatory:* The regulatory hurdles embedded in the Japanese medical technology industry conflict with regulatory commitments made to the U.S. under the MOSS trade agreement. They also contradict the philosophy underpinning the Global Harmonization Task Force, to which the U.S., Europe and Japan are a party. Even our friends need to be held accountable to their commitments.
- *Reimbursement:* Japan's foreign average pricing system, which is primarily targeted at devices made by non-Japanese manufacturers, fails to take into account costs unique to operating in Japan. Operating costs in Japan often greatly exceed those in other countries. For example, the costs of basic inputs such as salaries, office rent, and transportation are extremely high.

We are very proud of our health care system in Minnesota. Its stellar reputation draws people from all over the world to receive top-quality medical care. It saddens me to acknowledge that our friends in Japan do not have access to the same quality of care due to bureaucratic barriers embedded in their health care system.

These bureaucratic barriers have effectively blocked access to many high quality treatments to Japanese patients that are available internationally. Instead, the Japanese are forced to utilize older generations of products that do not reflect the maximum benefits that can be achieved with existing technology. Several examples how this lack of access is adversely affecting the welfare of the Japanese include:

- Japanese patients cannot receive the latest implantable cardiac defibrillators for the treatment of tachyarrhythmia—a condition characterized by a fast heart rate. They also do not have access to the most innovative cardiac resynchronization products for congestive heart failure.
- Japanese patients lack access to carotid and intracranial stents for neurological surgery.
- Japanese women with breast tumors cannot benefit from a vacuum assisted biopsy device which helps gain a larger and more easily diagnosed sample from the tumor. Japanese women also do not have access to the most advanced test for the primary cause of cervical cancer.
- In the orthopedic area, products that are not available in Japan include artificial spinal disks, antibiotic bone cement, and bone morphogenic protein.

I urge our friends in the Japanese government to take aggressive action to remedy this clearly disadvantageous situation. Non-tariff regulatory and reimbursement policies discriminate U.S. manufacturers. While these policies hurt U.S. manufacturers' economically, ultimately the biggest losers of these policies are Japanese patients. Innovative medical technologies offer the possibility of key health solutions all nations, including those that face severe health care budget constraints and the demands of aging populations. I think the importance of the U.S.-Japanese relationship demands that inequities within it be addressed. As has been the case in many other aspects of our relationship, both countries stand to gain significantly by addressing these shortcomings.

Thank you very much for the opportunity to address the subcommittee this afternoon.

RESPONSES BY HON. CHRISTOPHER R. HILL TO QUESTIONS FROM SENATOR COLEMAN

Question. What is the State Department doing to convey its concerns about Japan's economic policies that hurt U.S. industries such as the medical device?

Answer. The U.S. medical technology industry is one of the most innovative industries in the world. It manufactures products that improve and extend lives—like pacemakers, orthopedic devices (hips, shoulders), and diagnostic equipment.

The State Department is actively involved in the Regulatory Reform Initiative. Under that Initiative, the U.S. Government is pressing Japan's Ministry of Health, Labor and Welfare (MHLW) to implement reimbursement pricing and regulatory policies that reward U.S. companies for developing innovative, life-enhancing medical technology.

Our Ambassador to Japan (J. Thomas Schieffer) has met with industry representatives regarding their concerns. Ambassador Schieffer has pledged to continue working to ensure that highly competitive U.S. industries, such as the medical technology industry, are treated fairly in Japan.

We will keep urging the Japanese Government to ensure its policies do not unfairly discriminate against American medical devices.

Question. While China is getting all the headlines, Japan is still our largest overseas economic partner by far. Is the administration devoting enough effort to dealing with Japan's restrictive economic policies?

Answer. We have come a long way with Japan over the years, and have found ways of doing business on the trade front that are generally yielding improved results. While the Japanese market as a whole is more open than it used to be, some substantial problems remain, most notably Japan's continued ban on beef imports from the United States. We, USDA, USTR, and other agencies press senior Japanese officials on the beef issue at every opportunity and at every level, and we will continue to do so until American beef exports to Japan resume.

We, USTR, the Department of Commerce, and other agencies seek to reduce barriers to foreign investment in Japan through our Investment Initiative, led by the State Department. We also work to open markets in Japan further in key sectors such as telecommunications, information technologies, medical devices and pharmaceuticals, energy, and agriculture, through our interagency Regulatory Reform and Competition Policy Initiative led by USTR. For example, we have called on Japan to establish a level playing field in the privatization of Japan Post and eliminate any legal, tax, and regulatory advantages for Japan Post that put private U.S. and other companies at a competitive disadvantage.

In addition to the U.S. Government agencies in Washington, the U.S. Embassy in Tokyo works closely with the U.S. business community in Japan to address restrictive economic policies in Japan.

RESPONSES BY STEPHEN P. MACMILLAN TO QUESTIONS FROM SENATOR COLEMAN

Question. Is there a Japanese domestic medical device industry?

Answer. Surprisingly, Japan does not have a strong domestic medical device industry.

From a business development perspective, Japan has all of the capabilities for developing a strong domestic medical device industry—world class technology, research facilities, and design capabilities, not to mention outstanding manufacturing prowess. And, with its rapidly aging population, it also has strong built-in demand for these products.

However, Japan has failed to create the conditions that would lead companies to take the risks involved in entering this field. Companies need a predictable pricing environment where they can achieve a reasonable return on their investment—but the only predictability in Japan is that prices will be cut every 2 years. Companies also need a timely and predictable regulatory environment—but Japan's regulatory process is the slowest in the world.

A few large Japanese companies have medical devices divisions, but none of them hold leadership positions in the categories where they compete in the Japanese market. There are also a number of small niche players who compete at the lower end of the market in terms of product performance, quality and price. For example in the hip implant market we believe that there are approximately 30 Japanese companies with a combined market share of about 20 percent.

Question. Why does it take so much longer for Japan to approve U.S. medical devices? Are they stricter on safety standards than the United States?

Answer. A number of factors contribute to the slowness of Japan's approval process, without measurable improvement to safety and efficacy:

Japan's approval agency is understaffed—only 23 staffers reviewing medical device approval applications. This compares to over 700 FDA staff devoted to reviewing medical devices.

In Japan, there is a backlog of unprocessed applications inherited from their predecessor organizations when the present agency was established in April 2004. Each reviewer has a stack to review that would be over 30 feet high if put in a pile.

Japan's regulatory requirements are the most cumbersome in the world—and Japan just made the situation worse under a new law that adds a large number of time-consuming and onerous requirements. For example, Japan requires huge amounts of documentation that is not required by regulatory authorities in other countries. In most cases they also refuse to accept the results of scientific studies conducted elsewhere. The U.S. and other countries routinely use worldwide data versus having to repeat expensive studies in Japan.

In Japan if a company wants to upgrade existing products with new materials, the process is long and expensive. In the U.S. changes of this nature take approximately 1 year under the FDA's 510k provisions. Japanese officials require a 4 to 5 year study that is completely paid for by the companies who are proposing the changes.

Question. You mentioned that it takes much longer to get new technologies into the Japanese market. Can you tell me what devices Japanese patients are unable to benefit from that are available for patients in the United States or Europe?

Answer. There are a large number of examples:

In the orthopaedic market, where Stryker competes, products that are not available in Japan include artificial spinal discs, antibiotic bone cement, and bone morphogenic proteins.

In the cardiovascular area, Japanese patients cannot receive the latest implantable cardiac defibrillators for treatment of tachyarrhythmia (fast heart rate). They also do not have access to the most innovative cardiac resynchronization products for congestive heart failure.

Japanese women with breast tumors cannot benefit from a vacuum assisted biopsy device which helps gain a larger and more easily diagnosed sample from the tumor.

Japanese women also do not have access to the most advanced test for the primary cause of cervical cancer.

These are just a few examples of the many products that are available to patients in the U.S. or Europe but not to Japanese patients.

Question. What are the costs of the Pharmaceutical Affairs Law (PAL)?

Answer. Japan has adopted extremely complex changes to its regulatory process as a result of PAL.

The *total cost* over the next 5 years will be \$ 1.5 billion for medical device companies.

The *initial cost* for compliance that was born by these same companies was \$340 million (40 billion yen). It will cost another \$ 1.2 billion (140 billion yen) in *ongoing compliance costs* over the next 5 years.

At Stryker we have added 75 people to meet the new requirements to provide inbound inspection on imported products, comply with additional quality inspections, track the useful life of all surgical instruments and conduct post-market surveillance studies.

Question. Why are costs/prices different in the United States, EU, and Japan?

Answer. Costs of doing business are much higher in Japan:

The new regulatory requirements mentioned above have added significant cost to an already costly system.

Facilities costs (i.e.: office leasing)—7 times higher in Japan than in the U.S.

Labor costs—39 percent higher in Japan vs. the U.S.

Utilities and communications costs—1.5—2 times higher in Japan vs. the U.S.

Tokyo and Osaka—world's most expensive cities (no cities in U.S. in the top 20)

Sales/administrative costs—1.4 times higher in Japan vs. U.S.

Amount of write-offs—2.3 times higher in Japan vs. U.S.

Value of consignment inventory—3 times higher in Japan vs. U.S.

Inventory carrying costs (as percent of sales)—3.6 times higher in Japan vs. U.S. even though monthly sales volume is 9.9 times higher in the U.S. vs. Japan.

Multiple distribution layers in Japan (at least one layer for all products and 2+ for 14 percent of products—including orthopaedics) compared to the U.S. where 73

percent of products are sold directly to customers and the rest have only one layer of distribution expense.

Twice as many hospitals in Japan vs. U.S.—over 60 percent are small private hospitals that perform few procedures, but require representatives from manufacturers to be present during procedures. This expense is not reimbursed separately and is only covered if it is reflected in the product price.

Question. What do you want the outcome of the next Japan pricing cycle to be?

Answer. We would like Japanese officials to recognize that substantial cuts have already been made and the costs of doing business in the Japanese market are substantially higher than in other parts of the world.

We want to work with the Japanese officials if they identify some specific products they believe are priced too high. These should be addressed in a predictable phased reduction.

For the future, we would want Japan to work with us to adopt a new system for determining reimbursement that is predictable, fair, transparent, and based on factors in the Japanese market—not on markets outside Japan.

Question. Why have device exports to Japan stagnated?

Answer. The adoption of FAP in 2002 has had a significant impact on reimbursement prices in Japan. Companies will supply the market as long as they can achieve adequate returns. When prices are cut dramatically, companies must reassess whether it makes business sense to continue to supply products whose returns have been seriously affected. In some cases, products may be withdrawn in order to avoid severe losses.

In addition, Japan's regulatory system is the most burdensome and costly among developed countries, greatly reducing the attractiveness of the Japanese market, particularly for our smaller companies.

The current reimbursement system that provides the same level of reimbursement for substantially different products discourages companies from providing advanced technology. For example, ceramic-on-ceramic hip cup liners are reimbursed at the same level as those that are made of polyethylene despite the big difference in both product performance and costs.

THE PRIVATIZATION OF JAPAN POST: ENSURING BOTH A VIABLE POST AND A LEVEL PLAYING FIELD (BY AMELIA PORGES AND JOY M. LEONG)¹

1. INTRODUCTION

In the last year, postal reform in Japan has emerged from the shadows to become the single policy issue that could remake Japanese politics. After his legislative package for postal privatization was blocked by opposition from his own party, Prime Minister Junichiro Koizumi dissolved the lower house of the Diet, and made the election into a referendum on postal reform. Appealing to urban voters with an attack on entrenched interests, he won a landslide victory. His legislative package will be resubmitted soon to the Diet and is predicted to pass easily, ushering in a new political era.

In contrast to Europe, the driving force behind postal reform in Japan is not competition in postal delivery, but unlocking the immense financial assets of the postal system. Japan's postal system now includes not just postal delivery, but also huge postal bank and postal life insurance operations. The postal bank is the world's largest bank, with total assets of ¥227 trillion (US\$ 2.07 trillion)² in individual accounts—30 percent of household savings in Japan and over twice the asset size of Mizuho Financial or Citigroup, the two next largest banking groups in the world. The postal life insurance scheme, with ¥122 trillion (US\$ 1.11 trillion) in policies, has 40 percent of Japanese households' life-insurance assets and is larger than its four largest private competitors combined. Postal savings and postal life insurance together hold a quarter of Japan's personal financial assets. (Economist, 2004).

Postal privatization will make it possible to remobilize these assets, and remove distortions to competition in the banking and insurance sectors. Yet postal savings and postal life insurance are now provided only by the postal network of close to

¹Both of the authors practice law at Sidley Austin Brown & Wood LLP in Washington, D.C. specializing in international trade and WTO law (Porges) and in postal and delivery law and global supply chain issues (Leong). The views expressed are those of the authors and do not necessarily represent the views of Sidley Austin Brown & Wood LLP, nor of any of its clients.

²Exchange rates used are the yen-dollar rate for specific dates, or otherwise the yen-dollar rate (¥109.6/US\$ 1) as of August 15, 2005.

25,000 post offices, which also provides postal collection and delivery. This means that while Koizumi's reform program may be driven by public finance concerns, it will necessarily entail fundamental changes in the postal delivery sector—creating opportunities in delivery and logistics services for Japan Post and perhaps for its competitors. This paper presents a political perspective on the evolution of postal reform in Japan, an account of the Koizumi proposals, and an evaluation of them in the context of legal and economic principles of postal reform.

Japan's policymakers face the dual dilemmas of postal reform: In privatizing Japan Post, they must structure four viable entities—a privatized bank, insurance company, postal network, and postal delivery company—and at the same time ensure a level playing field for competition in these markets. The concern expressed by many observers is that policymakers will create either a strong post that enjoys so much preferential treatment and so many subsidies that it can overpower its competitors and threaten competition in the industry, or a weak post that will struggle to meet its universal service obligations and its deferred liabilities and ultimately need a government bail-out. This paper examines some of the challenges and pitfalls in structuring a privatization scheme that walks a line between these two extremes and attempts to ensure both a viable post and a strong competitive market.

2. BACKGROUND

The official provider of postal services in Japan is Japan Post (Nihon Yūsei Kōsha), a public corporation established under the Japan Post Law of 2002 as the inheritor of the people, assets and organization of the former Postal Services Agency (Yūseichō), including 271,000 employees and close to 25,000 post offices. In fiscal 2003–04, Japan Post delivered 25.6 billion items, down 2.3 percent from the year before. Per capita mail volume in Japan (202 items) was slightly over half the European level and less than 30 percent of the level in the United States. Sealed mail (designated First Class) and postcard mail (designated Second Class) together accounted for approximately 90 percent of mail items. Parcels delivered by Japan Post accounted for only 698 million items. (Japan Post, 2004).

Japan Post has less than a 10 percent share of the parcel market, compared to the market leader, Yamato Transport, which has over 30 percent. Yamato Transport gained its market position through its “black cat” *takkyūbin* parcel pickup and delivery service, and other value-added product innovations. Direct mail advertising constitutes a relatively small sector in Japan; the number of persons in Japan receiving direct mail is one seventh of the number in the United States and one half of that in Europe. (Yamato, 2004).

For Japanese public policy as a whole, the most important aspect of the postal complex has been its connection to postal savings and postal insurance. After launching a national post office in 1871, Meiji period modernizers established a postal savings scheme in 1875. The postal savings scheme offered small savers a government-guaranteed place to put their money, and starting in 1916, the post office also sold life insurance. The postal savings scheme has been exempt from banking regulation: it does not pay any deposit insurance premiums or taxes, and the interest rate was historically set higher than bank interest rates. The most popular postal savings product is the *teigaku chokin*, a high-interest 10-year time deposit account with no early withdrawal penalty after 6 months. The postal life insurance scheme is similarly exempt from taxes and insurance regulations applicable to other insurance providers. Both postal savings accounts and postal life insurance policies are still guaranteed by the state.

Historically, postal savings and life insurance monies were placed with the Ministry of Finance Trust Fund Bureau, which then provided the funds to the Fiscal Investment and Loan Program (FILP). FILP provided money to public corporations, local government and other government entities, for public works projects, housing, small business assistance and policy finance. As of March 2001, FILP involved ¥418 trillion (US\$3.3 trillion), equal to 82 percent of GDP, and FILP's uses of funds statement totaled more than the GDP. In the 1990's, FILP began to come under increasing criticism as a source of wasteful spending.

Prime Minister Hashimoto then took up the cause of administrative reform in the late 1990's. The Administrative Reform Council (*Gyosei Kaikaku Kaigi*) issued a draft plan in August 1997 to reorganize the government, privatize postal insurance, and consider privatization of postal savings. After lobbying by special postmasters and their political allies in the ruling Liberal Democratic Party (LDP), the Council's December 1997 final report called for the combined postal delivery, savings and insurance business to be shifted to a single independent public corporation. The report

urged followup consideration of breaking the link between postal savings funds and the FILP, and of allowing private sector entry into postal delivery. (Kawabata, 2004)

The legislation to carry out these recommendations became one of Prime Minister Koizumi's major agenda items when he took office in April 2001. His ascent in 2001 reflected widespread public desire for fundamental change to pull Japan out of the economic doldrums and to build a better future. Koizumi immediately chartered a commission to study the future of the three postal businesses and moved forward on the first round of postal reform legislation. After difficult negotiations within the LDP, he finally sent his package of four bills to the Diet without prior LDP approval, and it was enacted in July 2002 after debate and amendment. (Kawabata, 2004).

The 2002 package established Japan Post as a public corporation staffed by civil servants and supervised by the Ministry of Internal Affairs and Communications (MIC). It also authorized limited competition for some types of mail delivery. Postal account monies were no longer sent to the Finance Ministry, but were to be invested in Japanese Government Bonds (JGBs), or bonds issued by FILP on capital markets. (Japan Post owns about one quarter of the outstanding stock of JGBs today.) Koizumi did not stop there; in 2003 he was re-elected as head of the LDP promising postal privatization, and postal privatization by April 2007 was part of his platform for the 2003 Diet election (Kawauchi, 2005).

Koizumi then gave the job of developing a plan for postal privatization to his chief policymaking group, the Council on Economic and Fiscal Priorities (CEFP), led by the economist Heizo Takenaka, Koizumi's Minister for Economic Reform.³ On April 26, 2004, the CEFP issued an interim report proposing to split Japan Post into four units, to have the four businesses compete in the marketplace, and to liberalize their management. The cabinet then established an advisory committee on postal privatization, with a preparatory secretariat staffed by almost a hundred experts from government and business, to plan the details and draft legislation. The planning process and its related political discussions involved a dialog of interests. On the one side were Japan Post president Masaharu Ikuta, MIC Minister Taro Aso, and LDP Dietmen aligned with the postal lobby, seeking to maximize the postal network and maximize the post's ability to enter new areas; on the other side were Takenaka, Koizumi and competing private businesses, pushing for smaller government and for placing the system's financial assets in private hands.

The plan finally came together with the CEFP's Outline of Basic Privatization Policy announced on August 6, 2004. After difficult political discussions, the Cabinet adopted a Basic Policy on Privatization of Japan Post on September 10, 2004. Takenaka, tapped as the Minister for Postal Privatization, then moved forward on planning with the privatization secretariat, consulting with an advisory committee, with a new cabinet-level Postal Privatization Headquarters chaired by Koizumi, and with Japan Post, Dietmembers, and stakeholders.⁴

The Basic Policy on Privatization

The policy announced in September 2004 promised a reform of historic dimensions. It envisioned three phases: preparation, a 10-year transition starting on the privatization date of April 1, 2007, and a final post-privatization configuration of companies. After April 1, 2017, operations would be split into six more or less privatized entities: (1) a privately owned bank; (2) a privately owned insurance company; (3) a majority-private holding company which would wholly own (4) a postal delivery company and (5) a postal network company; and (6) an entity to hold pre-privatization bank and insurance assets.

During the fall of 2004, work proceeded on fleshing out the business and legal details of privatization, and on drafting the legislation. The privatization headquarters prepared a management simulation for the four operational companies, predicting that all four could show after-tax profits in fiscal year 2008. (Yuseimineika Junbishitsu, 2004; Ikuta, 2004) LDP resisters continued to seek a broad USO including financial services and parcel delivery, tax concessions for the privatized postal units, and measures to maintain post-office employment by prolonging the

³The eleven-member Council, chaired by Prime Minister Koizumi, includes five key Cabinet members (Takenaka, Minister for Internal Affairs and Communications Taro Aso, Minister of Finance Sadakazu Tanigaki, Minister of Economy, Trade and Industry Shoichi Nakagawa, Chief Cabinet Secretary Hiroyuki Hosoda) plus five private sector members (Bank of Japan Gov. Toshihiko Fukui, Toyota Motor Corp. Chairman Hiroshi Okuda, Ushio Inc. Chief Executive Officer Jiro Ushio, Prof. Masaaki Honma of Osaka University, Prof. Hiroshi Yoshikawa of Tokyo University).

⁴The documents from this process, and summaries of meetings, are all available at the official postal privatization webpage, <http://www.yuseimineika.go.jp/index.html>.

linkage and cross-subsidy between the banking and insurance units and the postal units. Banking and insurance interests weighed in as well.

In January 2005, Koizumi announced that postal privatization would be his No. 1 legislative priority for the new year, and he and Takenaka pursued negotiations. While many LDP members supported economic reform unconditionally, and some opposed any privatization, others were willing to consider privatization if the four businesses were under integrated management. Koizumi's negotiators tried to win over this middle group without losing too much of their original objective to remobilize the assets of the postal bank and insurance system.

During the early months of 2005, more details fell into place. Japan Post released accounts for individual post offices showing that the great majority run a deficit on their mail operations. The negotiators agreed to provide tax breaks to the privatized companies, and to require network offices throughout Japan assisted by a USO fund of ¥1 trillion (US\$9.35 billion). On February 24, the government released a scenario projecting profits of ¥1 trillion in 2016, premised on successful entry of the privatized units into new lines of business: the postal delivery business would enter international distribution and logistics, the postal bank would enter securitization and lending, the insurance company would issue large-value policies and health insurance, and all of these activities would yield enhanced commissions for the postal network. Attempts by the LDP to block foreign ownership of the privatized bank and insurance companies were rebuffed, as the government concluded that such action would violate Japan's commitments under the WTO General Agreement on Trade in Services.

On April 27 the Koizumi Cabinet transmitted to the Diet its package of six privatization bills. After much discussion and minor amendments, the legislation ultimately passed the lower house by 233 to 228, but on August 8 failed in the upper house by 125 to 108. Koizumi had consistently threatened to call a snap election if the bills did not go through. He then delivered on his promise. On August 8, by Cabinet resolution, the Emperor dissolved the lower house of the Diet.

Koizumi then did everything he could to focus the election on postal privatization as the turning point for shrinking government and pursuing economic and political reform. He blocked LDP endorsement of Dietmembers who had voted against the postal bills, and ran competing LDP-endorsed "assassin" candidates against them. After the short campaign, Japan gave a landslide victory to Koizumi on September 11. The LDP won 296 seats, and with the 31 seats of Komeito, its coalition partner, gained a majority sufficient to override the upper house. Upper house Dietmembers who voted against the postal legislation announced they would support it in the next Diet session; newspapers predicted easy passage of the bills within a few weeks.

The legislative package

Like the September 2004 proposal, Koizumi's postal privatization bills called for activity in three periods: a preparation period through March 31, 2007, a transition period from April 1, 2007 through March 31, 2017, and the period from April 1, 2017 onward. On September 16, Koizumi's team announced that his resubmitted legislation will be revised to postpone the target date for privatization to October 1, 2007, retain the 10-year transition period, and incorporate changes agreed to in earlier Diet deliberations; they stated that there will be no other substantive changes. The discussion below is based on these assumptions.

The legislation provides for establishment of a new government company, the Japan Postal Services Corporation (JPSC), to be set up within 6 months of enactment. The legislation also establishes a Cabinet-level Postal Privatization Headquarters, advised by a five-person Postal Privatization Commission (PPC), both of which will cease to exist on October 1, 2017. The Prime Minister and MIC Minister, through the Headquarters, are to develop a succession plan, and JPSC is to produce an implementation plan subject to approval by the Prime Minister and MIC with input from the Commission. The succession plan will resolve key issues such as how the assets, liabilities and employees of Japan Post will be divided between the successor companies.

The legislation authorizes Japan Post to enter or invest in international freight transportation and related domestic delivery services before 2007, if approved by MIC after receiving the views of the PPC. The bills call for MIC to consider potential damage to the interests of competing private sector businesses, when it decides whether to permit Japan Post to enter or invest in competitive areas. Japan Post had reportedly been negotiating with TPG and other international distribution firms, with plans to invest ¥10–20 billion (US\$93.5–187 million) over the 2 years from fiscal 2006, but the upper house's rejection of the bills put these talks on hold. (Nikkei, 2005)

On October 1, 2007, Japan Post is to be dissolved and its functions inherited by new companies established for four business areas: government-chartered companies for postal delivery and the postal network (counter services), and private companies carrying on the postal bank and postal life insurance businesses. JPSC will initially hold all the stock in these four companies. In addition, a government corporation will be established to hold pre-privatization savings and insurance accounts of Japan Post. Present Japan Post employees will become employees of JPSC or one of the new companies. The four companies will be taxable, but will receive special tax benefits. The postal bank and insurance companies will pay into depositor or policyholder security funds, and the government will not guarantee bank accounts and insurance policies opened after October 1, 2007.

During the period between October 1, 2007, and September 30, 2017, JPSC will be required to progressively sell off all of the shares in the postal bank and the postal life insurance business, and the government will sell almost 2/3 of JPSC's shares. The Minister of Finance has stated that the proceeds will be used to reduce Japan's national debt. The four companies will be able to expand into new areas with the approval of the Prime Minister and/or MIC (not the Ministry of Land Transport, which regulates freight companies).

As of October 1, 2017, the postal bank and postal life insurance company will be privately held, and subject to the same regulation as private banks and insurance companies. Both the Postal Privatization Headquarters and the PPC will cease to exist on October 1, 2017. JPSC will continue in operation as a holding company for the postal delivery and postal network companies.

Much political attention has gone into the continuing relationship between the financial units and the network company. As Takenaka pointed out in August 2005, 60 to 70 percent of current postal operations are supported by financial operations. (Kyodo, 2005) The privatization package envisions that the network company will provide counter services for the other ex-postal units, private companies and local government, and receive fees in return. This separation will make visible any cross-subsidization by postal financial services units. Resisters from the LDP and the opposition Democratic Party (DPJ) sought to prevent any post-office closures and maintain postal jobs, attempting to build in cross-holding of stock between the four ex-postal enterprises and to prevent full privatization of the postal bank. Koizumi and Takenaka agreed only that after JPSC sells all of the bank and insurance company shares, it will not be prevented from buying the shares back. During Diet deliberations on June 30, Koizumi clarified that if these two units have become a normal bank and insurance company, their shares can be held by the postal network company. It is also clear that the postal bank and insurance company will be *de facto* compelled to enter into long-term agency contracts with the postal network.

The legislation required JPSC to set up a ¥1 trillion (US\$9.1 billion) fund, to be financed by share sales. JPSC will make grants from this fund to the postal delivery and postal network companies for the costs of socially mandated free and reduced-rate mail, and other USO-related functions in local areas. In June, Koizumi agreed that JPSC will be able to retain up to ¥2 trillion (US\$18.2 billion) in the fund; the purpose of increasing the fund is to ensure that universal service includes not just mail delivery but also financial services.

3. ANALYSIS

As regulators throughout the world have struggled with adjusting the monopoly aspects of postal delivery to today's competitive markets, they have confronted a similar set of problems, much discussed in the postal economics literature. In Japan, however, we are presented with a situation that confounds some of our standard approaches. The government has proposed a privatization scheme for postal services to move the huge financial assets now tied up in postal savings into investments to create jobs and growth in the Japanese economy. The benefits of postal competition may only be an afterthought. In fact, concerns running in the other direction, as the LDP pushes for maximum retention of the existing postal network, may lead to cross-subsidization of postal services, competitive distortions in financial services, and sub-optimal solutions that reduce the value of the assets to be privatized. Moreover, the postal system presently in place in Japan has unique characteristics. For example, there is no "sanctity of the mailbox" in Japan, the "last mile" of postal delivery has not been accepted to be a natural monopoly, (Maruyama, 2005) and "special postmasters" have been a potent political force.⁵ (MacLachlan, 2004).

⁵ Of Japan's 24,715 post offices as of March 31, 2004, 77 percent were special post offices, each headed by a special postmaster; 81 percent of the special post offices do not pick up or deliver

Continued

As Koizumi's policymakers implement the postal reform package, they will face the dual dilemma of postal reform: they must structure the privatized post so that the post has a fair chance of increasing mail volume, offering stable rates, maintaining service standards, and, most importantly, meeting its universal service obligation. At the same time, they cannot create such overwhelming advantages for the privatized entities of Japan Post that competitors are discriminated against and competition is discouraged. The playing field must be level—not tilted in favor of Japan Post or its successors, nor tilted in favor of competitors. We examine below the specific decisions facing policymakers and how each may be resolved to favor either the post or competitors or to balance the interests of both.

As has been demonstrated in other countries, one of the basic problems of introducing competition into postal services is the vertical integration of a natural monopoly component (local delivery of letter mail to mailboxes) with potentially competitive activities (*e.g.*, sorting or transportation). The service provider that controls the monopoly component can use its control to block access to this component, to cross-subsidize activities in the competitive domain, and to thus frustrate competition. To address these problems, policymakers may use such mechanisms as opening access to the monopoly component, requiring structural separation between the monopoly and non-monopoly businesses (and corresponding accounting transparency), allowing limited competition through worksharing, and regulating the ability of the monopoly service provider to compete in non-monopoly businesses. Or the regulator can create a legally reserved area as a *quid pro quo* for the post's universal service obligation.

Prime Minister Koizumi and his postal policymakers have chosen neither the path of worksharing, as in the United States, nor the path of liberalization based upon the weight of the mail piece, as in the EU. Instead, driven by the problem of financial and fiscal reform, they have chosen the more radical solution of privatization to unwind the financial (banking and insurance) and postal (network and delivery) activities.

Concerns of the Post

Universal Service Obligation (USO): One of the primary missions of a post is to fulfill its universal service obligation. The new legislation obligates the postal delivery company to provide ubiquitous 6-day delivery at a regulated price, and requires the postal network company to provide offices throughout Japan. The USO debate has focused on whether postal network offices must offer savings and insurance services in addition to classic postal services. Japan Post, MIC and postal-lobby Dietmembers have argued that the private sector will not meet the demand for financial services in rural areas, and that the privatized postal bank and postal insurance companies should have a USO so that they do not leave rural areas unserved. Takenaka and others have argued that extending the USO this way would impair competitive conditions for regional banks and other financial services companies, and ultimately increase government burdens. The legislation would not formally extend the USO to cover financial services, but during previous Diet debate it was amended to provide explicitly that post offices' business activities will include banking and insurance, and the final legislation will include that change.

Reserved Area: The mainstay of support for the USO for postal delivery is revenue from the reserved area. Although competitors can use household mailboxes, Article 5 of the Postal Law forbids anyone other than Japan Post or its subcontractors to engage in postal business, or to engage as a business in delivery of "correspondence," defined as "a document expressing the intentions of the sender or communicating facts to a specific recipient." The law specifically forbids transportation businesses from delivering correspondence. The reserved area does not include parcel delivery, and companies such as Yamato Transport have successfully competed with Japan Post in the parcel market by establishing nationwide collection, sorting, and distribution networks. These competitors have used their economies of scope to deliver not only parcels, but also magazines, catalogues, and form letters to household mailboxes all over Japan. (Maruyama, 2005).

The Correspondence Delivery Law, enacted as part of the 2002 postal reform package, created an exception to the reserved area—if MIC grants a license to a private operator for either "special correspondence delivery" or "general correspondence

to individual delivery points. (Japan Post, 2004). Until Koizumi split from the special postmasters over privatization, they were a major element in mobilizing rural voters for the LDP. Special postmasters are selected by regional postal bureau officials from local notables. R, reportedly one quarter to one third of them inherit their jobs, and they often own the space leased for special post offices. (MacLachlan, 2004). The September 2005 Koizumi landslide left them, and the postal unions, shaken. (Yomiuri Shimbun, 2005)

delivery.” The law and its regulations define “special correspondence delivery” as delivery of correspondence items whose combined length, width and thickness exceed 90 cm, or which weigh over 4 kg, or which are delivered within 3 hours, or for which the delivery fee exceeds ¥1000 (US\$9.12). If the licensee is engaging only in special correspondence delivery, it need only show that it is fit to carry out this business, and that its business plan is appropriate and is adapted to protecting the confidentiality of correspondence. Over a hundred firms have obtained such licenses. However, entry into general correspondence delivery is subject to much more stringent rules, designed to avoid cream-skimming. A provider of general correspondence delivery may handle all types of correspondence, but must deliver throughout Japan at least 6 days per week, must set up approximately 100,000 of its own collection boxes (distinct from Japan Post boxes) throughout Japan, must meet service standards set by MIC order, and must charge MIC-regulated uniform rates. Upon passage of the 2002 law, Yamato Transport, the firm considered most likely to enter the general correspondence delivery business, issued a statement stating that the conditions were impossible to meet. (Yamato, 2002)

The spring 2005 legislative package did not alter the existing provisions of the Postal Law on “correspondence” or on entry by general or special correspondence providers. Thus, after privatization, the postal delivery entity’s *de facto* monopoly of general correspondence delivery will not change. The question is whether revenues from that business alone will be sufficient to sustain the postal delivery company.

New Opportunities: Most commentators believe that Japan Post’s postal operations have been subsidized by the more profitable banking and insurance branches. When the banking and insurance operations are separated from the postal operations, cross-subsidies will end. The postal delivery company will also be required to pay the postal network company for counter services and other services the postal network supplies. The USO fund is intended to provide some support for the postal delivery company’s universal service obligations, but the prerequisites for tapping into the fund are as yet unclear. The postal delivery company will have an incentive to take dramatic steps to compensate for the loss of subsidies by entering new lines of business, increasing its mail volumes, and cutting costs. One such step, already articulated by Japan Post, would be to enter the logistics industry. This is a growing but complex industry, one which may require the Post to partner with an established logistics provider at the outset.

Throughout the political process described previously, the Post has consistently advocated maximum freedom for its privatized companies to enter new business areas. Business studies carried out by the postal privatization policy team in February 2005 projected that the new entities would reap increased profits if allowed to enter new businesses such as international logistics, securitization, consumer lending, and health insurance, with increased commissions paid to the postal network. (Yuseimineika Junbishitsu, 2004).

Another step for the Post to take would be to develop a strategy to increase mail volume, an action that other posts have focused on in order to sustain the USO and fend off a graveyard spiral.⁶ A fruitful avenue for Japan Post may be to encourage addressed solicitation mail, which would fall within the general correspondence monopoly. Whereas, for example, the average household in the UK receives 157 items of direct mail per year, and in the US 356 items per year, the average Japanese household receives only 44 items per year. UPU statistics for 2003 show 32 addressed advertising items per capita for Japan compared to 246 in the US. In the United States, the growth of solicitation mail has had a major positive impact on the postal industry. There is thus much potential for growth in direct mail for Japan Post.

The survival of Japan Post’s delivery unit may be of great concern to Japan’s policymakers as they structure the privatized Post. They may want to equip the postal delivery entity with the ability to enter new businesses, maintain or increase mail volume, control its costs, and meet its USO. On the other side of the equation from the Post’s survival, however, stands the need to encourage competition in competitive services, not allowing the Post so many advantages that it can squeeze out its competition.

Concerns of Competitors

Encouraging competition in postal services is based on sound economic principles which provide that increased competition generally results in greater efficiency and lower costs and/or better service to the consumer. To ensure viable competition in

⁶For an example of an approach to maintaining and/or increasing mail volume, see Levy, Leong, Buc, and Plunkett (2005).

special services, Japan's policymakers must not give preferential treatment to the Post or allow cross-subsidies from its monopoly services to its competitive services—even as they attempt to equip the Post for survival.

Preferential Treatment: To the extent the privatized postal delivery business receives preferential treatment that discriminates against its competitors, the playing field will be tilted toward the Post, with negative effects on competition. For example, if the Post does not pay taxes, parking tickets, or other government fees that its competitors must pay, the Post receives an unfair advantage. If the Post enjoys priority treatment in customs processing, it receives preferential treatment that allows it to outpace its competitors—not based on its own efficiency but based on the government's regulatory scheme. If the Post has sole access to key facilities (such as post offices) or pays less than its competitors to rent those facilities, it again receives preferential treatment. The regulator for Japan Post and its postal successor entities is MIC, not the Ministry of Land, Infrastructure and Transport, which regulates its competitors in the package and express industry. Moreover, the LDP has reportedly agreed to reduce by half the fixed asset tax payable to municipalities on postal buildings and other assets. Japan Post has also sought exemption from the consumption tax for fees and commissions received by the postal network from the other ex-postal companies. Adoption of these proposals could grant Japan Post preferential treatment and place its competitors at an unfair competitive disadvantage.

Cross-Subsidies: The design for privatization in the legislation represents an attempt to achieve structural separation between the postal delivery and network businesses and the Post's financial services businesses. The final privatization of the bank and insurance company will complete that process, but only after a 10-year transition. As long as the banking and insurance businesses are tied to the network and/or delivery companies by equity or contract relationships, the pressures for cross-subsidies will continue. If the postal banking and insurance entities are compelled to subsidize the postal network, and indirectly the postal delivery entity, the cross-subsidies will not only prevent a level playing field, but will also reduce the value of the banking and insurance assets to be sold in the privatization process, lower the expected reduction of Japan's national debt and reduce the benefit to Japan's fiscal position.

Furthermore, even assuming that the postal delivery entity no longer receives subsidies from the banking or insurance operations, unfair cross-subsidization may arise if the postal delivery entity uses funds from its monopoly services to cross-subsidize its competitive services. Oversight by an independent regulator together with accounting transparency by the Post in the allocation of costs and revenues may be a critical factor in preventing cross-subsidies.

Independent Regulator: Postal reform experience in other countries has shown that the role of an independent regulator is critical in striking a fair balance between the interest of the Post, the competitors, the consumers, and the public. The Koizumi reform package requires MIC approval for major decisions of the successor companies; key decisions concerning the postal bank and insurance company must be made jointly by the Prime Minister and the Minister of Internal Affairs and Communications. As noted above, the legislation also establishes the cabinet-level Postal Privatization Headquarters led by the Prime Minister, and within it the Postal Privatization Commission (PPC), a body of five persons of "superlative judgment," appointed by the Prime Minister for renewable 3-year terms. The PPC, which will have its own staff, will carry out reviews each 3 years and must be consulted about many decisions in the course of postal reform. The Headquarters and the PPC will exist only through the end of March 2017, and will be abolished thereafter.

The PPC will have an important, but limited role in ensuring fair and efficient advancement of privatization. For instance, MIC must obtain the PPC's opinion about any authorization for Japan Post to enter or invest in international freight transportation, or for the postal delivery company to enter new business areas. The PPC will also have the authority to obtain accounts and information from the ex-postal companies, like the subpoena powers of postal rate regulators in other countries. This is a step toward greater transparency to detect unfair cross-subsidies or preferential treatment. The leadership of the present and future Prime Ministers and Ministers of Internal Affairs and Communications, and the expertise and independence of future Commissioners, will be critical in ensuring successful privatization with equitable results.

However, proposed provisions on postal ratemaking, in amendments to the Postal Law that are part of the Koizumi package, appear to give the postal delivery company increased ability to set rates with reduced regulatory supervision. While Japan Post now must obtain MIC approval for postal rates, under the revised Postal Law the postal delivery company would set postal rates and simply notify MIC. MIC ap-

proval would only be required for discounted third and fourth class mail, and there would be no role at all for the PPC or private parties in postal ratemaking.

Allocation of Assets: Many crucial issues remain to be resolved. One of the most important, from a business standpoint, is the allocation of assets to each of the successor companies. When Japan Post is dissolved on April 1, 2007, its remaining employees, assets, and liabilities will be divided among the successor entities; obviously, this division will be key to each company's future. In the case of mail delivery, the physical plant must be divided between the network and delivery entities, perhaps allocating all counter service facilities to the postal network company, and allocating trucks and sorting facilities to the postal delivery company. These allocation decisions will affect the playing field—making it level or tilted—and transparency in accounting will again be a key factor in whether the regulator will be able to accurately allocate assets and liabilities.

Capitalization: It is not clear how Japan Post's net capital position will be treated. As of March 31, 2004, Japan Post's postal delivery business had ¥2.2 trillion (US\$ 20.8 billion) in assets and ¥2.7 trillion (US\$ 25.6 billion) in liabilities, for a negative net worth of -¥0.5 trillion (US\$ -4.8 billion). Observers, including President Ikuta of Japan Post, have argued that the postal delivery business will need additional capital of ¥1.4 trillion (US\$ 12.8 billion) to ¥1.8 trillion (US\$ 16.8 billion) in order to be a viable competitor. Recapitalizing Japan Post through a cash infusion from the government would be contrary to Koizumi's liberalization and privatization agenda. Observers have suggested that this capital could also come from private sector investment. (Feldman, 2004).

Business Opportunities

Banking reform, enhanced financial sector regulation, and remobilization of assets have been key to pulling the Japanese economy out of stagnation under Koizumi's plan. As the September 2004 Basic Policy promised, Postal privatization, if done right, can yield "enormous value for the Japanese people." It can unlock the value of the assets tied up in postal savings and insurance, use the proceeds to reduce public debt overhang, and remobilize those assets in private hands. In the process, opportunities will be created for collaborators, investors, or competitors in Japan's delivery, insurance and banking industries. A decision to invest in these opportunities, however, will turn upon the result of the September Diet elections and the legislation enacted thereafter.

New business opportunities will include competing with the newly formed entities, which will no longer have a strangle-hold on their respective markets. Other opportunities capitalize on partnering with the new postal entities. For example, mutual funds, other funds management companies, and a range of service companies could develop new opportunities to market to Japanese consumers through the postal bank or the postal network company. The postal bank and insurance company may seek to invest their assets more effectively through improved money management or through securitizations offered by other companies. The postal delivery company could utilize the freedom provided by the legislation and enter into arrangements with international partners, such as logistics services or services using the postal network as an agent to collect mail. The bank and insurance company may choose to collaborate with partners in offering new banking or insurance products. The legislation appears to leave all of these opportunities open. Again, a strong independent regulator will be critical as each of the entities enters new lines of business during the transition period.

4. CONCLUSION

In crafting the final design for privatization of Japan Post, Japan's policymakers must structure four viable entities: a privatized bank, insurance company, postal network, and postal delivery company. The electorate has overwhelmingly endorsed Koizumi's vision of postal privatization, but many details remain to be decided as the plan is implemented. Will Japan's policymakers create a strong post with so much preferential treatment and so many subsidies that it will overpower its competitors and threaten competition in the industry, or a weak post that will struggle to meet its universal service obligations and its deferred liabilities and ultimately need a government bail-out? Koizumi's team and the Diet have a challenging, but hopefully not impossible, task before them: to create a postal privatization scheme that walks a line between these two extremes and results in both a viable post and a flourishing competitive market.

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