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JAPAN'S ROLE IN THE INTERNATIONAL TRADING SYSTEM: PROSPECTS FOR MARKET LIBERALIZATION AND ECONOMIC REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

JULY 14, 1998

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JAPAN'S ROLE IN THE INTERNATIONAL TRADING SYSTEM: PROSPECTS FOR MARKET LIBERALIZATION AND ECONOMIC REFORM

TUESDAY, JULY 14, 1998

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:38 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, D'Amato, Mack, Moynihan, Rockefeller, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

In today's hearing, we will take stock of our economic and trade relationship with Japan. The economic situation in Japan, and in Asia, generally, has recently overshadowed basic market access issues. This is understandable, given the recent news throughout the region.

This, I believe, is the wrong perspective to bring to bear on the current economic problems in Japan and Asia. The lack of economic growth in Japan and elsewhere in Asia is perhaps the most profound barrier to U.S. exports we currently face. Market liberalization would complement the efforts of Japan and other Asian nations to kick-start their economies and undertake needed economic reforms.

Much of the recent criticism has been focused on Japan. While I believe that criticism often overlooks the continuing strength of many sectors of the Japanese economy, the basic thrust of the criticism is apt. Japan is the world's second-largest economy. It makes up 70 percent of the GDP of the Asian region. That places it in a unique role in the regional and world economies and it must live up to its responsibilities.

As some of you know, I have maintained a longstanding interest in the U.S.-Japan relationship, beginning with my service under General MacArthur. Given the perspective I believe I have, I can say with assurance, Japan remains our strategic partner in Asia. In fact, the bilateral relationship between the United States and

Japan is arguably the most important economic relationship in the world.

It is very much in our interests, not to mention that of Japan, Asia, and the rest of the global economy, for Tokyo to restore its economy to health. American businessmen and women depend on the vitality of Japan's economy. Our farmers depend on it, financial markets depend on it, and our families depend on it.

I believe it is crucial that we have hearings such as this. It is our responsibility to ask, just as the markets are asking, whether the reforms Japan has proposed for its economy are sufficient and whether those reforms will remain the policy objective of a new government, and if so, will they actually be carried out.

Only four weeks ago, Secretary Rubin declared that the weakness of the yen reflects the economic conditions in Japan and can only be remedied by restoring economic strength in Japan. After pointing that out, the yen plummeted.

After a short but tense few days, the U.S. intervened in the currency markets, reportedly after gaining promises from Japan that Tokyo would undertake necessary reforms.

These reforms have been in limbo as we awaited the recent Upper House elections. That election this weekend yielded some surprises, not only in terms of the defeat suffered by the Liberal Democratic Party, but also in terms of voter turnout. Needless to say, Japan's political situation is now in some flux, as are the plans for reform.

The bottom line, however, is that the Liberal Democratic Party remains in power and drastic policy shifts by the LDP, regardless of who becomes Prime Minister, are unlikely to happen overnight.

That said, the LDP so far, helpfully, has not backed away from what it has called its total plan for revitalizing Japan's financial sector. At the same time, fundamental tax reform remains high on the LDP's agenda and deregulation, or, more accurately translated from the Japanese, loosening of regulation, is still progressing modestly.

Obviously, there are no quick fixes for problems that trace their origins back well more than 10 years, or even as some of our witnesses today have argued, back to the formation of Japan's post-war system a half century ago.

But Japan's new government must clearly define the reform program it will institute as soon as possible, if for no other reason than the markets will not wait. Moreover, if the markets judge that program or its execution inadequate, I believe we can expect the yen once again to come under attack.

In such a scenario, the United States will be put in a difficult position. If we intervene to support a yen weakening as a result of the leaders' failure to make the reforms required to stem these currencies decline, do we not allow those leaders to put off necessary reform?

If we choose not to intervene, what will be the impact on the rest of Asia, which remains in such fragile economic condition, particularly if China feels compelled to devalue its own currency? What will be the impact on our growing trade deficit with Japan and the rest of Asia?

This is a critical period, an important hearing. I remain hopeful that Japan will rise to meet the serious challenge it faces. If she chooses the right path, Japan will emerge stronger than ever and the barriers to her markets will necessarily diminish to an extent that those of us in Congress and our trade negotiators could only dream about until recently.

Most important, Japan will achieve recognition for the enormously positive role it will have played as a leader on the global stage.

We have an outstanding list of witnesses today, and I thank them all for joining us. I would, however, like to give special thanks to the witnesses who have flown here from Japan. The time and the expense they have volunteered in traveling here and their pluck in appearing before this committee deserves special recognition.

With that, I would like to turn to Senator Moynihan for any opening statement that he would like to make. Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I would like to open on the note that you concluded, which is to say that in 22 years here on the Finance Committee, I have never had the experience of, we are now about to enjoy three distinguished visitors, scholars, practitioners, who come all the way from Japan to tell us about their situation. This is singular. I do not know that there has ever been its equivalent. Once again, you have done this.

I look forward to what we will hear. Our visitors will know how much we appreciate their presence and how much we are concerned about the matters which they will be discussing.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Kerrey?

OPENING STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Well, Mr. Chairman, last fall you held some hearings on the Internal Revenue Service and the hearings sparked a significant call for enacting legislation to reform that agency.

I believe the subject you have called today's hearing for is more important than even that. My hope is that the witnesses today will be able to provide us some assistance in answering questions along the lines you have described.

Japan is a true strategic partner. This is a democracy. We have had a long relationship with Japan in the post World War II era. I was not aware that you were an employee of General MacArthur.

Senator MOYNIHAN. Comrade.

Senator KERREY. What was that?

Senator MOYNIHAN. Comrade.

Senator KERREY. Comrade of General MacArthur. That does give you an unusually important and unique perspective to guide us in our decision making. Japan is a friend. Japan is an ally. There can be no equivocation on that. Their population has the education, their population has the strength of families, their capacity to produce, and the savings rate that should not make it difficult for them to answer the question, where do we go from here, so as to regain that financial strength that we had just 2 years ago.

So, Mr. Chairman, I think the hearings that you have started here today are extremely important and I hope that this committee will follow on them. I think if we can answer the question, what do we need to do, and focus America's attention on this particular problem and try to forge an even stronger relationship between ourselves and Japan, the world will be the beneficiary of our work.

The CHAIRMAN. Thank you, Senator Kerrey.

Senator Grassley?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman. This is a very, very important hearing. It is important for Congress to hear first-hand what is happening in the Japanese economy. It used to be that the United States had the luxury of viewing the economic crisis of the world from afar, knowing that it would have little effect on our own economy.

But with barriers of communication, trade, and capital flows coming down in the latter part of this century, economies have become very much interlocked and economic calamities in one part of the world often affect the others, hence this hearing.

We should be especially concerned when the economy is in crisis in Japan, because Japan is our second-largest trading partner. It is our second-largest export market, just behind our exports to Canada. It is our largest export market for agricultural products, very important for my State of Iowa.

Yet, Japan continues to erect significant barriers to U.S. exports. In fact, the 1998 Report on Foreign Trade Barriers lists 49 pages of barriers, which is 12 percent of all the trade barriers listed worldwide.

High profile cases like the Kodak Fugi dispute are only the tip of the iceberg. For many American-produced products, Japan remains a relatively closed economy. Interestingly, many of the trade disputes between our two countries arise from the same structural defects that have caused the economic problems in Japan, such as a lack of transparency in banking and regulatory system, cronyism in the financial sector, and the strength of unaccountable bureaucrats in the manipulating of the trade system.

Of course, the root of all these problems is a noncompetitive political system. Frankly, reforms were never implemented because government leaders felt no compelling political reason to do so. Fortunately, that may have changed with the elections this past weekend. I hope that the surprising losses of the ruling party and the Upper House elections will provide an impetus for very serious political and economic reforms.

Japan must take the necessary step to get its economic house in order, like cutting taxes, encouraging more private spending, bringing transparency to its banking system, and resolving its non-performing loans. Japan must open its markets to U.S. exports, as well as exports from other Asian nations.

Japan must continue to deregulate key industries to allow all competition. All of these actions would help to restore confidence in Japan's economic leadership. It is crucial that that country undertake these measures as soon as possible.

It is unlikely that Asia will recover fully without a very, very strong Japanese economy and a government to back it up, one with greater deregulation, one in which the bureaucracy does not make all the policy, but the policy making is responsive to the mandate of people expressed in an election.

Unfortunately, it will be difficult to sustain the economic growth enjoyed in the United States without a healthy Japanese economy with all these reforms that must precede it, which will be necessary for having a healthy Asian economy.

I look forward to hearing from the witnesses on these very important issues.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Mack?

OPENING STATEMENT OF HON. CONNIE MACK, A U.S. SENATOR FROM FLORIDA

Senator MACK. I will be very brief. I just want to thank you for calling this hearing. I think that the discussions that we will have today will be very helpful. I do not want to go over the same ground that others have already talked about, but I do hope that part of the discussions today will touch on monetary policy in Japan.

There are many who believe that monetary policy in Japan has created a disinflation, a mentality with the Japanese consumer that they expect prices to be lower in the future, and, therefore, they do not consume as a result.

I would just put on the table that, at least from the information that I have, that since 1992 the Japanese Government has invested about $600 billion in Keynesian-type incentives for the economy that have not worked.

So, it seems to me, and I know there would be a significant debate about what the right monetary policy would be, but I think this is a part of the discussion that should take place.

Again, I thank you for holding this hearing, and I hope that our vote at 10:00 will not disrupt us to a major extent. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mack.

Our first panel consists of three distinguished Japanese leaders in the business and academic world who have joined us here today.

Our first witness, is Mr. Akio Mikuni, the president of Mikuni & Company of Tokyo. He will then be followed by Mr. Yasuo Kanzaki, chairman emeritus of The Nikko Research Center of Tokyo. Our final witness, is Professor Fukao, of the Department of Economics, Keio University.

I would like to point out that, in addition to the testimony of these three distinguished gentlemen, we have the written testimony of Mr. Ohmae. Unfortunately, Mr. Ohmae was unable to join us today, but his testimony has been submitted for the record and serves as an important contribution to this hearing.

[The prepared statement of Mr. Ohmae appears in the appendix.]

The CHAIRMAN. With that, we look forward to the testimony of this distinguished panel. We would ask to start with Mr. Kanzaki.

STATEMENT OF YASUO KANZAKI, CHAIRMAN EMERITUS, THE NIKKO RESEARCH CENTER, LTD., TOKYO, JAPAN

Mr. KANZAKI. My name is Yasuo Kanzaki, Chairman Roth. I am greatly honored to be invited to share my views about the Japanese economy with you and other members of this august committee.

But, Senator, you have chosen not a good day for the Japanese. On Sunday, the Liberal Democratic Party was roundly defeated in the Upper House election. Therefore, before presenting my prepared statement to you, which I submitted last Friday, I would like to make a couple of brief points.

First, I believe that the LDP's plan for banking reform will not be lost, whoever succeeds Mr. Hashimoto as the Prime Minister. As I will stress later, it was the LDP's leadership, not the bankers or the bureaucrats, who have spearheaded the reform plan. This will not change.

Second, however, there is some concern about the financial bills relating to the banking reform which was supposed to be enacted during the next session of the Diet. If you would like to look at page two of my submission with the green cover, there are several bills, including a bill to establish the so-called bridge banks, which must still be passed. These bills will have no trouble in the Law House, where they still have majority, but they may now face some difficulty in the Upper House.

With this proviso, I feel that my prepared statement is still valid, so allow me to present it now.

To revitalize the Japanese financial system is an urgent issue, not only for Japan, but also for the world economy. The Comprehensive Plan for Financial Revitalization, better known as the Total Plan, has now been released.

My appraisal of this Total Plan is positive. It grants banks what they have demanded as conditions for their decisive action. Whether the Total Plan is enough to solve long-standing Japanese banking problems and revitalize the financial sector will depend on actions taken by banks and the leadership of their new supervisors.

As I see it, the Total Plan has four main objectives. First, the plan pushes for prompt and aggressive disposal of bad loans. Second, it aims to improve transparency and disclosure. Third, it also aims to strengthen organizational structure for inspection, surveillance and supervision of the banking industry.

Fourth, the Total Plan promises at long last to close Japan's "bad banks," while protecting "good borrowers" from loss of credit resulting from the banks' failure.

To win confidence in Japan's financial institutions, a standard equivalent to that of the SEC has been adopted for the disclosure of bad loans. Furthermore, the Financial System Reform Law enacted in the last Diet session, mandates, through sanctions, that all financial institutions must fully disclose their problem loans.

The Financial Supervisory Agency, called FSA, was created on June 22 to perform fair and transparent supervision based on clear rules, ensuring a move away from oversight based on discretionary guidance to checking based on laws and regulations.

To facilitate the marketing of bad loans by banks, it is necessary to create a liquid secondary market in these loans through the use of such methods as bulk sales and securitization.

The law on securitization of specific assets by Special Purpose Companies was approved by the Diet to serve as the legal infrastructure to facilitate the disposal of bad loans by financial institutions.

In a related move, the government is planning to form a body to sort out real estate-related rights and obligations as part of an effort to enhance the liquidity of real estate and other assets.

This body will attempt to settle the complex set of claims and liabilities associated with bad loans and related collateral real estate. This will stimulate transactions in immobilized assets, enhance efficient utilization of land, and return to financial markets their proper function of channeling funds. The vague tax treatment for banks giving up their claims has now been improved upon.

The FSA will conduct a detailed inspection of troubled banks. Weak banks so designated by the FSA will be placed under the direction of government-appointed trustees. If such a bank cannot be sold to a healthy bank, then it goes to a bridge bank.

The bridge banks will continue to provide credit to sound borrowers in good faith, but bad loans will be sold to a government-subsidized institution where they could be repackaged or auctioned off.

The bridge bank will either be sold within 2 years, with 3 years extension, to a private institution or will be liquidated.

From the above, I believe we can conclude that the Total Plan, ranging from the disposal of bad loans, more transparency, and the strengthening of supervisory power, to more efficient utilization of land, is worthy of its name, at least in its intent.

As I said earlier, the Total Plan is a good plan, but its success will depend on how the banks respond to its challenge. To explain my position, I would like to provide some background on the creation of the plan.

Japan wasted almost 7 years to reach public consensus on solving its banking problem. Politicians, bureaucrats, bankers, and even investment bankers, all contributed to this delay.

The initially-eager politicians burnt their fingers when the government injected 685 billion yen of public money to resolve the bad loan problems of housing loan companies in late 1995.

The politicians targeted to revitalize the property market, which was clogged with immobile collateral real estate associated with non-performing loans. While this was a worthy goal based on a desire to restore health to the financial system and Japanese economy as a whole, the politicians failed to address some fundamental issues.

The bureaucrats hoped that the banking problem would go away when the economy turned upward and did not take drastic action. Nor did they tell the public how large and serious this issue had grown.

The bankers dreamed that property prices would recover eventually and were busy raising capital in the equity market. But banks did not try hard to write off bad assets. Put another way, the banks were busy to increase the numerator, but did not try to reduce the denominator on the BIS capital RDPC requirement.

The bankers often cited reasons for not writing off bad loans, such as: no active property market; lack of legal framework to securitize bank assets; quagmire of conflicting claims and liabilities on collateral real estate; cumbersome process of auctioning off problem assets; negative economic and social impact of forcing closure of borrowers' business; vague tax treatment for banks writing off assets; and possible legal action against bank management.

All of these reasons were reasonable, but the banks did not voice them openly for fear of public backlash against their complaints. Public hostility towards banks has been intense.

The crisis of financial markets in November 1997, together with the ever-worsening Asian turmoil, gave a strong warning to Japanese politicians. Instead of letting the bureaucrats take the lead as in the past, policy makers in the LDP took the initiative themselves to meet the challenge. Thus, the Total Plan is a product of the ruling political party.

The creation of the bridge bank system was inspired by the experience of Hokkaido, where the failure of the leading bank in the region resulted in liquidity shortage for many healthy borrowers and general economic hardship in Hokkaido.

Will the banks act? One lawmaker involved in the creation of the Total Plan told me that the FSA would send problem banks to the "operation room for surgery," and would not hesitate to close banks that are found to be no longer viable. He further said that some banks would get "blood infusion." It is thus assumed that the new regulators will show leadership.

Another lawmaker believes that banks would indeed take serious action this time. Otherwise, depositors are clever enough to discriminate against such banks and walk off with their deposits. If, however, any bank fails to act quickly, the market will penalize them as it did the Long Term Credit Bank recently.

It is no longer possible for banks to be irresponsible with impunity; in the future, such banks will surely be punished by depositors and investors. Japanese banks, at the same time, should also formulate their own strategy to improve productivity as the U.S. banks did. They must get over the convoy system.

Although it is very difficult to measure the negative impact of the bad debt problem, our analysts estimate that 25 trillion yen, or 5 percent of GDP, was deducted from total output due to the bad loan problem over the past 7 years.

If the Japanese banking system returns to good health within 3 years, the GDP may be pushed upward by 1.6 percent every year simply by eliminating the bad debt problem. But I doubt that restoring the banking industry will be enough to put Japan on the growth path again.

What the government should do now, on top of tackling the banking problem, is to restore confidence of the Japanese public in their economy. This, I believe, can be done in two ways.

First, is the promotion of new business. The government is rightly emphasizing promotion of new business through deregulation. But high taxes discourage entrepreneurs from taking the risks of starting a new business. Investors are shy to take on risk of financial new business.

To change all of this, the tax system should be changed to give more incentive both to new business and to investors, to start up new ventures. If more new business starts as a result of reform, this will create a greater job opportunity.

The second way, is to focus on consumer confidence. Reducing the rate of personal income tax is one idea. Another idea, is to completely revamp the rules of government pension schemes to maintain the viability of the national pension system.

The Ministry of Health has recommended either to increase the premiums or to reduce the benefits in the future. But this certainly discourages middle-aged and younger people, who are afraid for their future, and encourages them to save more.

The Japan Government has not trusted the expertise of local fund managers. Due to the lack of competition in the past, the performance of Japanese portfolio managers was indeed disappointing. But, thanks to the ongoing deregulation, newly trained fund managers, including those at non-Japanese institutions, are showing better performance.

The government should respect the expertise of these professionals and let them manage the massive savings of the Japanese people. Japan boasts over 1,2000 trillion yen, or about $9 trillion, in individual financial assets, which have not been fully utilized. Using private-sector fund-managing skills is another way in which the Japanese economy can change toward greater market orientation.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Kanzaki.

[The prepared statement of Mr. Kanzaki appears in the appendix.]

The CHAIRMAN. We would now like to call on Mr. Mikuni, please.

Before you begin your testimony, I should forewarn you that there is going to be a vote on the Senator floor, so you will see members disappearing and then returning.

The reason for our disappearing, is not to be impolite, but because we have to go to the floor to vote. I apologize for whatever interruptions take place, but I just want you to understand what is happening.

Mr. Mikuni?

STATEMENT OF AKIO MIKUNI, PRESIDENT, MIKUNI & COMPANY, LTD., TOKYO, JAPAN

Mr. MIKUNI. Mr. Chairman, thank you very much for inviting me to speak before the important Senate Finance Committee. It is now widely understood that the Japanese economy has fallen into a recession. This recession will prove much worse than Japanese economic policy makers expect.

The government's recently enacted stimulus package may possibly help the economy to bottom out temporarily, but the economy would again sink once the effects of the stimulus pass.

The economy has been stuck in the doldrums since the beginning of the decade. The seeds of Japan's problems lie with its very success. Back in the 1950's and the 1960's, Japan could exploit external markets without affecting them.

But Japan is now too large. Of course, economically speaking, Japan can be made "smaller," as it were, in relation to its external markets by shrinking the value of the yen. The last time the size of the Japanese economy was deliberately shrunk in relation to its external markets occurred back in 1995.

In escaping one crisis, however, Japan unwittingly set the stage for another: the Asian economic crisis. Asian countries, whose currencies were largely tied to the dollar, found their competitiveness across a wide range of industries destroyed by the weak yen.

This declining competitiveness set the stage for the panics that hit one country after another. And in the process, these panics seriously damaged what had become Japan's most important export markets.

Japan's policy makers in the great economic ministries and the leading business bureaucracies do not, however, want to understand what has happened; they do not want to acknowledge that Japan's external markets are not longer limitless and can no longer be taken as given. Japan's policy makers are in denial.

They are in denial because acknowledging the reality of Japan's changed circumstances means that their own control over economic decision-making is slipping from their grasp.

It means acknowledging that they are being forced to surrender power to markets which they do not understand and cannot trust. But widespread acceptance of the reality of Japan's condition is the only way out of the morass into which the economy has sunk.

The core of these problems, however, likes with long-established economic policies dating to the war years, and even earlier, that aimed at the maximization of savings. A policy of savings maximization is another way of saying a policy of current account surplus maximization.

These savings were allocated not on the basis of the free play of market forces, but rather to those industries that were either politically powerful or deemed essential by Japan's economic bureaucrats.

The savings financed capital expenditures far in excess of those required by the domestic economy. The beneficiaries of the Japanese system in the great corporations did not need to consider the profitability of their investments. They were engaged only in the expansion of production. Their solvency was the responsibility of their banks and of the government.

The final guarantee of the solvency of Japanese industry lay with Japanese households, whose savings financed the economy. Those savings took the form overwhelmingly of bank deposits.

Under an unwritten social contract, households put their savings into banks or the post office and accepted very low interest rates in return for a guarantee, either explicit or implicit, that the principal would be safe.

Since deposits were effectively guaranteed, losses incurred by the banks and industrial companies who used those deposits to finance their activities could not be written off directly.

The only way for the economy as a whole to write off losses was through the general inflation that reduced the actual purchasing power of the deposit. But in the 1990's, the Japanese authorities found that they could no longer engineer inflation. Japan's position as the world's leading net creditor nation made it impossible.

The implicit guarantee given to all deposits was only the first of the policy tools aimed at maximizing savings. Of equal importance was the tax system that encouraged savings and discouraged consumption.

Japan's major industrial corporations have engineered rapid growth in productivity that, in many cases, is the envy of the world, but this impressive performance is nearly invisible in corporate financial statements. Nor is it visible in Japan's macroeconomic numbers, for Japanese companies have retained unnecessary employees either within their own ranks or in their affiliates'.

By utilizing these resources, Japanese companies make it impossible for the nation as a whole to maximize wealth and enjoy high economic achievements.

Today, however, the problem goes well beyond a refusal by Japan to enjoy the full fruits of our prosperity. Japan runs the danger of seeing the actual destruction of much of what she has achieved.

Let me describe what I mean by this. The Japanese system continues to work so well in extracting savings that savings are running far ahead of domestic investment requirements. This excess flow out of the country where it finances Japanese exports that are not politically welcomed by our trading partners.

The day will surely come when some combination of a stronger yen, severe trade frictions, and recessions in the economies of our trading partners will force a reduction in Japan's exports. When that day comes, Japan's low level of domestic consumption will be woefully insufficient to support the entire production apparatus built in my country.

The politically engineered suppression of the purchasing power of the Japanese economy will then pull Japan down into a recessionary abyss far deeper than anything seen in this country since 1945.

Japan's policy elite will thwart any serious change as long as it can maintain its instruments of control over the economy, suppress consumption, maximize savings, and rely upon external, rather than internally generated, demand to keep the Japan industry and machines going.

Thus, publicly voiced concerns over a weak yen-dollar rate are little more than crocodile tears. The entire thrust of policy is to keep the exchange rate of the yen as weak as possible, despite Japan's ever-rising current account surpluses and continual accumulation of claims on other countries.

Of course, there are plenty of reasons with which market observers and participants justify to themselves today's weak yen regime. The U.S. Treasury is thought to want it, too. The United States offers more profitable investment opportunities. Dollar interest rates are higher.

But what all this reasoning ignores is just how depend the United States is on a continued flow of funds from the rest of the world, most particularly from Japan. The funds keep flowing because of a set of politically determined policies in Japan that have brought about a recession. In a manner of speaking, Japan is deliberately depriving itself so that the United States can enjoy cheap access to foreign credit.

I fear that no economic turnaround in this country is possible until asst prices fall to a level where market players find it profitable to purchase them. Further, unemployment will have to accelerate until it forces the creation of an efficient labor market.

Interest rates and the yen will have to rise to the point where unprofitable companies are forced to close their doors. The profitability of those left standing will have to recover sharply.

these events, however, are not compatible with continued bureaucratic control of the economy. But, Japan's economic mandarins will not voluntarily give up their control. Loss of control will only be forced upon them by economic distress that will make today's bad economic news seem only like a prelude. Such distress could, however, be ultimately constructive.

It may be helpful at this point to ask ourselves what the government would need to do in order to restart the Japanese economy, especially after the Upper House election. The overriding policy goals must be the reversal of the traditional aims of maximizing production and savings by suppressing consumption, maximizing the current account surplus by driving up the dollar, and socializing all market risks through the support of stock prices and land prices, the suppression of interest rates, and the blurring of credit risk. These must be replaced by an entirely different program.

First, in order to maximize consumption and minimize savings, thereby reducing the current account surplus, the consumption tax must be eliminated. Interest income should be taxed as ordinary income. Both mortgage interest payments and property taxes should be deductible from taxable income.

To end the socialization of risk to establish a clear link between risk and reward, today's almost completely intermediated financial system should be replaced with disintermediated securities markets as the primary source of corporate finance. For properly functioning securities markets would force elimination of the great drag on the Japanese economy—unprofitable production capacity.

City banks must not be allowed to interfere with the necessary purging. They will have to be prohibited from supporting large companies. In other words, their role as "main banks" must end.

The government's attempts to control all financial risks should be abandoned. The government has a huge war chest that it uses for this purpose. It is the Trust Fund Bureau of the Ministry of Finance and it is funded with postal savings, postal insurance, and government pension funds. The bureau should be shut down. The government should tap personal savings through private intermediaries at market driven rates of interest rather than unloading the JGBs on the Trust Fund Bureau.

The Temporary Interest Rate Adjustment Law, which exempts financial institutions from anti-trust requirements and permits administered, cartelized interest rates on both lending and deposits, should be repealed so that interest rates and determined by market forces.

The core of the MOF licensing system should be changed. This system, by which the MOF licenses financial institutions to do business, gives the MOF immense power over credit allocation, leaving banks as little more than deposit gatherers. Both the risks and rewards of credit allocation should rest entirely with bankers who would thus be forced finally to understand real credit analysis.

With the flow of funds in the economy finally freed from government control, the next most important reform must be the creation of a genuine labor market. Today, we have essentially a one-window market. It opens for young people on finishing their education, and then promptly closes.

Company employees are expected to work for 30 years or more, or most of their productive lives, for single employers during which time wages rise according to seniority, but not according to contributions.

Japanese workers are underpaid for their contributions during their younger years; as they age, the situation is reversed. This system can only work, however, for bureaucracies and companies that can promise incoming recruits their jobs will be safe for 30 years.

Only companies that are free of the risk of bankruptcy, those protected by the government and the main-bank system, can make this promise. Bankruptcies of those protected entities like Yamaichi result in serious breaches of the social contract.

Smaller firms, whose viability is not protected, cannot therefore compete for high-quality white-collar and engineering recruits.

Finally, reform depends vitally on building an infrastructure of accountability. It is no longer possible for the Japanese Government to compensate everyone, to allocate losses and burdens while fulfilling all of the implied social contracts. For loss-allocation to be carried out in a manner that is perceived as just and fair, Japan needs transparent, impartial accounting standards and universally followed judicial procedures.

The number of accountants and lawyers in Japan is minuscule in proportion to the size of the economy. This must change and measures instituted o build the accounting and legal infrastructures necessary to a mature economy governed by market forces.

Thank you.

Senator GRASSLEY. Thank you, Mr. Mikuni.

[The prepared statement of Mr. Mikuni appears in the appendix.]

Senator GRASSLEY. We now call on Dr. Fukao.

STATEMENT OF MITSHUHIRO FUKAO, PROFESSOR, DEPARTMENT OF BUSINESS AND COMMERCE, KEIO UNIVERSITY, TOKYO, JAPAN

Dr. FUKAO. Mr. Chairman and members of the committee, it is a great honor to appear before you today. Since time is limited, let me discuss the most acute problem Japan faces today, the fragility of its financial system.

Japanese banks still suffer from the large amount of bad loans that is the legacy of the bubble economy in the late 1980's. Let me take some 150 commercial banks in Japan that are the core of its financial system.

They had 28.5 trillion yen of equity capital on their balance sheets as of March 1997. On their asset side, they had about 5 trillion yen of unrealized capital gain in their stock portfolio at the Nikkei index of 16,000.

On the asset side, they had 65 trillion yen of substandard loans. Because they could usually recover substandard loans until the collapse of the bubble, they have not put aside loan loss reserves against these.

However, according to a recent estimate by the Bank of Japan, 3-year cumulative loss rate of substandard loans was as high as

127 percent. If you apply, say, a 20 percent loss rate for substandard loans, the estimated hidden loss reaches 13 trillion yen, which is close to one-half of the equity capital.

Some analysts say that even this 20 percent loss estimate is too small because many weaker banks have postponed making provisions against bad loans so as to window-dress heir financial statements.

Japanese banks also have too much stock for their weak capital. They have about 48 trillion yen of stock portfolio evaluated at Nikkei index of 16,000. A 1,000 point fall in the Nikkei index will wipe out 3 trillion yen of banks' stock investment.

Thus, many Japanese banks do not have enough equity capital. At the same time, they clearly have too much risky stock on their balance sheets relative to their capital position.

The most important cause of the current turmoil in the Japanese financial system is the lost confidence in the balance sheets of financial institutions.

Senator GRASSLEY. Dr. Fukao, could I interrupt.

Dr. FUKAO. Sure.

Senator GRASSLEY. We are going to have to recess just for a few minutes, until the Chairman gets back, because there are only four minutes to go vote and the two of us will have to go. So we will stand in recess just for a short period of time.

Dr. FUKAO. All right.

[Whereupon, at 10:23 a.m., the hearing was recessed to reconvene at 10:29 a.m.]

The CHAIRMAN. The committee will please be in order.

Again, I apologize to our distinguished guests, but you will find this is very characteristic of our hearings.

Dr. Fukao, would you please proceed?

Dr. FUKAO. Yes. Let me restart from where I stopped.

The most important cause of the current turmoil in the Japanese financial system is the lost confidence in the balance sheet of financial institutions.

Hokkaido Takushoku bank showed 300 billion yen of equity capital at the end of March last year and even paid dividends. After its failure last November, it was found that the bank had a negative equity of more than 1.1 trillion yen. Similarly, Yamiachi Securities hid 270 billion yen of losses in their balance sheets until its collapse last year.

Both of them had been examined by the Ministry of Finance and the Bank of Japan. These failures have exacerbated suspicions both at home and abroad regarding financial statements, external auditing, and regulatory supervision of Japanese financial institutions.

After these big failures, financial institutions can no longer trust each other. The liquidity of money markets dried up, and many banks started to keep liquid assets as much as possible.

This shortage of liquidity and capital in the banking sector created a severe credit crunch in Japan. In spite of the very low money market interest rates, the loan market has been extremely tight since last fall.

Moreover, measures taken by the government to fight bad loan problems have been both ad-hoc and ineffective. First was the denial of the problem. The Ministry of Finance, the Bank of Japan, accountants, and the management of banks have been hiding the seriousness of the problem. Many banks have "amakudari" directors, that is, former officials of the Ministry of Finance and the Bank. This fact may have deterred the Ministry and the Bank to take decisive actions against banks at an earlier stage.

More recent measures are not effective either. For example, when a weak bank agrees to merge with a failed one, the weak one gets a capital injection with public money. Assisted mergers of weak banks are likely to create bigger weak ones.

Earlier this year, 21 large banks got across-the-board capital injection by the government. This was done with either rigorous audits of the bank balance sheets, nor the strict write-off of bad loans. 1.8 trillion yen was thinly distributed to 21 banks.

In order to regain confidence in Japanese banks, the Japanese Government has to move quickly and decisively. In the short-run, the new Finance Supervision Agency should strictly enforce the prompt corrective action on banks so as to regain confidence in their financial statements. Bad banks have to be restructured quickly, while avoiding adverse economic impacts.

However, this new agency has four major problems. Firs,t they do not have enough manpower to conduct massive bank examinations. Including regional office, the agency has only 570 bank examiners. This number is only one-twentieth of the number of the United States. Second, they do not have enough legal power to apply prompt corrective action vigorously.

When bank managers, shareholders, or employees of target banks resisted the agency's action by lawsuits, the agency has to fight court battles. Unlike the supervisory authorities of the United States, the agency does not enjoy legal immunity on the closure of banks. Moreover, the agency does not have any specific officials that would handle court battles.

Third, most staff of the agency is from the Ministry of Finance, 373 out of 403. Because about two-thirds of banks have some former officials of the Ministry of Finance in their boards, I wonder whether the agency can really apply prompt corrective action on a fair and impartial basis.

Fourth, the most recent measure is the creation of bridge banks. While it is good to have a clear resolution scheme for failing banks, this scheme allows bridge banks to operate for as long as 5 years.

This period is too long and it may create zombie banks: dead banks that still operate under the protection of the government without market discipline. Unless the zombie banks are privatized or liquidated quickly, healthy banks may start to fail under the unfair competition with zombie ones.

In the long run, Japan has to set up a better and much improved disclosure and audit system, including new accounting standards, more non-executive board members, and use of market indicators for supervision.

I am proposing that banks be required to issue market-traded subordinated bonds so as to allow investors to learn the soundness of banks easily from the market yields of these bonds.

Since a massive restructuring of the banking sector likely to induce failures of financial and non-financial companies, a strong short-run fiscal stimulus is indispensable. Given the fact that the government heavily advertised the future difficulties of the budget situations, I doubt if a "permanent" tax cut is really perceived as such. People would suspect that government would raise the tax as soon as the economy recovers.

Instead, I would propose having a sharp and temporary cut in the consumption tax. Cut the consumption tax rate from the current 5 percent to zero percent immediately. Then the government announces that the tax rate will be raised by 2 percentage points every 6 months, until the tax rage reaches 6 percent. This would stimulate the very weak consumption expenditures quite effectively.

Thank you.

The CHAIRMAN. Thank you, Dr. Fukao.

[The prepared statement of Dr. Fukao appears in the appendix.]

The CHAIRMAN. Let me ask you all three a series of questions. What effect, if any, do you expect Prime Minister Hashimoto's resignation to have on the prospects for economic reform in Japan? Some of you have touched on it, but I think it would be worthwhile underlining.

Mr. Kanzaki?

Mr. KANZAKI. Thank you, Mr. Chairman. I think the LDP has learned a lesson from the election last Sunday. The most serious thing, is they lost no members from the large towns like Tokyo, Osaka, Kobei, where almost one-third of the Japanese population lives. That means they have no representative from one-third of Japan. This must be a very serious lesson for LDP.

What they have to do, like we are saying, they should stimulate the economy by tax reform, a tax cut, instead of putting them in a suburban area or a country area of Japan, where there are many voters still for LDP.

Therefore, I think this loss of the Upper House election is a good lesson for the LDP and I do not think they will come back backwards. Instead, they will introduce more aggressive policies to stimulate the Japanese economy and to take the right track.

The CHAIRMAN. So you think they will be more active, more reformist.

Mr. KANZAKI. Yes.

The CHAIRMAN. Mr. Mikuni?

Mr. MIKUNI. I think, Mr. Chairman, the resignation of Prime Minister Hashimoto probably illustrates the problem in the Japanese political system very clearly to our people.

The Japanese Prime Minister in Japan is probably illustrated by the, so to speak, the ship of the state of Japan, whose bridge is commanded by Mr. Hashimoto. He is trying to steer the wheel of the boat from the bridge of the boat.

Really, what he is doing, he is not really steering, he is kind of following the direction of the boat, so to speak. So you wonder what is really going on, and you are rushing to the bottom of the boat to find out what is going on. You find that the steering wheel is not connected, but rather is firmly held by the bureaucrats in the dark. You think that, really, the captain on the boat cannot have control of the steering, the rudder of the boat.

Now, in Japan, regardless of who is going to become Prime Minister, the Prime Minister does not have real power to deliver the result. In the case of the LDP, the real handling of the matters, the enactment and implementation of rules, are left to the bureaucracies.

So I think that it is very much needed for Japan to connect the steering wheel and the rudder, and that it needs real effort on the part of the public to understand. They both are going to really work, as it did to some extent last time. I think that the votes are just cast for opposition's sake, not for the positive choosing of the candidates or the parties yet. Thank you.

The CHAIRMAN. Thank you, Mr. Mikuni.

Dr. Fukao?

Dr. FUKAO. Thank you, Mr. Chairman. I think it depends on who will become the key persons in the LDP and the ministries. If they can get good people who can handle things, I can be optimistic. But we have not.

The only person who clearly stated a means to resolve the banking system crisis is probably Mr. Kaziama. Others have not shown any clear plans. So if what he has been advocating can be adopted by the new administration it may work, but it depends on who controls the situation.

The CHAIRMAN. Mr. Kanzaki?

Mr. KANZAKI. Mr. Chairman, may I say one word against my two colleagues from Japan. I am not necessary pro-Liberal Democratic Party, but I sympathize with those people.

Mr. Mikuni mentioned that Prime Minister Hashimoto is the ship's captain and he is not necessarily turning a wheel, that the wheel is turned by the bureaucrat underneath the bridge. I do not think this is true.

For example, in the case of the Total Plan, this one is promoted by the LDP. Mr. Fukao said, only Kaziama can do it. But Kaziama-san certainly introduced a brilliant idea, and it was brought about by many people at the LDP, headed by Mr. Miazowa, and others. Thank you.

The CHAIRMAN. Let me ask you, gentlemen, this question. What constructive role can the United States play in furthering economic reform in Japan, if any? Mr. Kanzaki?

Mr. KANZAKI. Yes. In the securities industry, American firms are doing extremely well compared to the traditional Japanese investment banking house. For example, in the case of the bankruptcy of the Yamaichi—decided to recruit employees from Yamaichi Securities. So, more presence from America in Japan is quite helpful for progressing the foreign program in Japan.

The CHAIRMAN. Would that mean opening up the market so they could buy in?

Mr. KANZAKI. That is correct.

The CHAIRMAN. Mr. Mikuni?

Mr. MIKUNI. I think there is not much for the U.S. to help Japan to solve the problem. But there is only one area which I think is quite instrumental to the Japanese economic reform, which is that the United States has many, many economists. I think that they can discuss the many aspects of the Japanese problems. I think that, in Japan, I am afraid that arguments are not so diversified.

There are usually very few opinions expressed independently. I think, in the case of Japan moving toward more market economies, I think various opinions are very much needed and I think the U.S. economists can contribute to that end. Thank you.

The CHAIRMAN. Dr. Fukao?

Dr. FUKAO. Yes. As I explained in my statement, Japanese banks have too much stock, mutually-held stocks, and they have to be sold soon to the market. Probably, the reasonable way to absorb the stocks is, say, setting up mutual funds, or pension funds, and so forth. In that area, U.S. financial institutions can help to restore the confidence in the Japanese financial institutions, including security companies.

Japanese security companies have changed the accounts of customers and they have lost confidence of the customers. So I believe that the new entrance to the Japanese financial markets, by Merrill Lynch and other U.S. investment banks, can help to restore the confidence in the intermediary period in mutual funds in Japan.

The CHAIRMAN. I will ask one more question, then I will turn to Senator Kerrey.

Mr. Mikuni, you are very pessimistic about Japan coming to terms with its problems until Tokyo has no alternatives remaining. Is it accurate to interpret that to mean that Japan will have to face a crisis? If so, what form would that crisis take; would the yen have to drop, for example, say, to 200 to the dollar?

Mr. MIKUNI. Well, I am very pessimistic about the outlook of the Japanese economy because the Japanese political and economic system has been so firmly established for so many years.

So many infrastructures which are needed for a market economy do not exist in Japan, which means, in order for the Japanese economy to move towards a much more market-oriented economy, infrastructures have to be built. But the real building of the infrastructure has not started yet.

As I said in my remarks, to, so to speak, get the markets to play more of a role in the Japanese economy, the bureaucratic role has to be given up. But they are not going to give up so easily. That means, until we face real problems, a catastrophe or near crisis, I do not think they are going to move, or when the people ask the bureaucracy to change.

What kind of crisis I am talking about, is that probably asset prices have to come down quite rapidly and the interest rates have to go up. But, in the case of currency, I have another minority opinion, which is that, in my opinion, that will have to be supported by Japanese policies.

So if interest rates go up and if the Japanese institutions cannot continue to invest in the U.S. market because of the crisis in the domestic market, they will call back their dollar investments from abroad. I tend to think that the yen should rise, and that, so to speak, makes the exporting business unprofitable, again. Thank you.

The CHAIRMAN. I will ask the other two to comment. Let me point out, Mr. Kanzaki, in your written testimony you stated that the success of the total plan depends, in large part, on the leadership, the degree of leadership shown by the new Financial Supervisory Agency.

Now, this agency has only 600 inspectors, compared with 10,000 that we have in the United States. Most of the senior officers come from the Ministry of Finance. Given this, are you confident that the leadership you say is necessary will be exerted?

Mr. KANZAKI. Yes, Mr. Chairman. I do not think the present capacity of the Financial Supervisory Agency is good enough, as Mr. Fukao pointed out. I have been advocating to recruit more people, not from the Ministry of Finance, but also from various banking circles, or accountants.

The government should give more of the budget to FSA, because if they think stabilization of the Japanese banking system is one of the ways to restabilize the Japanese economy, they have to spend the money strategically. So, the number of staff in FSA should be increased. That can be done when they allocate more of the budget in 1999.

The CHAIRMAN. Dr. Fukao?

Dr. FUKAO. Yes. I agree with Mr. Kanzaki. They are spending 30 trillion yen to save the system. I think it is natural to spend, say, at least, 0.1 percent of 30 trillion yen for looking into the system to investigate the depths of the problem. The point is, nobody really knows the depths of the hole they are in. So, first, we have to know, what is the actual bank sheet of the Japanese banking system first, and they should spend money on that.

The CHAIRMAN. I will now call on Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman. Let me say, I hope that this hearing will be the first of several. I have learned a great deal from the testimony and I expect to learn more from the following testimony. It seems to me that this is one of the most important foreign policy questions that this country needs to answer.

Let me say at the outset, I am struck mostly by Mr. Mikuni. I am sorry, Dr. Fukao, I did not hear your testimony and have not had a chance to read it. But I did listen to Mr. Kanzaki's testimony.

It seems to me one of the fundamental problems that you have got to deal with at the beginning is that the people sometimes do not want to do what is best for them. Take, for example, your recommendations, Mr. Mikuni. Let me just as you directly, just you alone, could you get elected in Japan, saying these things?

Mr. MIKUNI. Could I?

Senator KERREY. Yes, sir. Could you stand up in Tokyo and say, I see your vote and support, and I promise, if elected, to do the following things, could you get elected?

Mr. MIKUNI. I have never thought of doing it.

Senator KERREY. I suspect that is one of the reasons you say these things. [Laughter.]

Mr. Kanzaki, do you think you could get elected, saying these things in Japan?

Mr. KANZAKI. If I say it, perhaps I would be elected. But I did not volunteer to be elected. [Laughter.]

Senator KERREY. Well, I mean, take, for example, our own situation in the 1980's. I mean, it is true that Japan has restrictive policies on importation of automobile parts, and it is true that it is difficult to establish dealerships and compete in Japan. But it is also true, you made better cars and our consumers saw that you made better cars, and they were buying your cars.

The most significant thing that has happened between then and now, is that our manufacturers have begun to compete, and the beneficiaries have been the consumers. They are more profitable. They are more successful as a consequence.

There were significant calls in the United States to protect our market, to make it difficult for you to sell more of your product here, and increase the price to the American consumer as a consequence. We still, in fact, in the area of trade, have to explain why free trade, as a consequence of its decreasing cost to the consumer, is good even if it means that we may lose some jobs in the United States as a consequence.

So, unless the Japanese citizens are different than the American citizens, my guess is, your prescription is not something that is likely to produce a standing ovation. My guess is, there is going to be some resistance.

The question that I have is, how can the United States of America, acknowledging this as a friend, as a fellow democracy, how can we assist the political leaders in Japan to make these kinds of very, very difficult decisions?

I was very impressed, Mr. Kanzaki, by your testimony, and Mr. Mikuni, I liked your prescription as well. It works for me in the United States, but I am not so sure how well it work for me if I was a Japanese politician. So the question is, how can we help Japanese politicians acquire the strength necessary to make the very difficult choices of allowing the marketplace to determine who wins and who does not win.

That is basically what you are describing here. If I am a Japanese worker, let me take my piece of my $9 trillion of savings and put it where I am going to get the highest rate of return. That is your prescription, allow me to do that. I think it would be a wonderful solution.

I think it would be good for Japan, and I think it would be good for the United States as well, but somebody is going to suffer the consequences. It is not going to be entirely a win-win proposition. Somebody is going to lose, and my guess it that it is going to be the Ministry of Finance, and it is also going to be some businesses that are currently being propped up with these monies, and they are not going to like it.

So if you could guide us U.S. politicians, that also do not like to have somebody—if you were coming over here telling us what to do, we probably would not like it.

You are basically coming here saying, this is what you ought to be trying to get the Japanese to do. My guess is, the politicians in Japan are just as resistant to being told what to do as we are. How would you suggest that we make the most constructive impact on political decisions in Japan?

Yes, Mr. Kanzaki?

Mr. KANZAKI. Senator, could you look at page 10 of the paper covered with green paper?

Senator KERREY. Yes.

Mr. KANZAKI. This is a chart of investment trust managed by known Japanese investment trust management companies. In December 1993, the percentage was less than 2 percent. But in May 1998, it went up to close to 7 percent.

The reason why known Japanese investment management companies were successful in this year is our consumers preferred putting their money into the portfolio manager which created relatively high return. That is exactly, Senator, what you have said. American consumers took the benefit of competition with the Japanese car industry when American car quality improved.

This is one of the examples. What we would like to ask you, is to encourage American companies to come to Japan to compete with the Japan. In the past, Japanese management looked out for only the interests of their own companies and the Japanese policy makers looked at the interests of the manufacturers. But they did not care much for the interests of consumers. But since they lost the election in the majority of big towns, they have to realize that. Thank you.

Senator KERREY. Just to follow up on that, Mr. Kanzaki. Just take a specific product we manufacture in Nebraska, beef, as an example. There is no question, there is tremendous demand in Japan for our beef, but the price is too high.

There is an imposition of additional costs charged on top of what we have been prepared to sell to the Japanese consumer directly and, as a consequence, the Japanese consumer is not buying as much of our product because the price is too high.

Mr. KANZAKI. It is called the middle man.

Senator KERREY. It is not just the middle man, it is duties that are imposed, non-tariff restrictions that make it difficult for the Japanese consumer to buy American products. Now, that might mean that you are not going to have much of a domestic beef industry, because we happen to manufacture that better. Our quality is superior.

Unless the Japanese manufacturers are going to get better and compete with us, then perhaps they can get their price going down. But right now, we have got a lot of products in the United States that we manufacture cheaper than you can manufacture in Japan, and we are fully prepared to sell them to you.

Now, again, it is easy for me to say because that is a political winner in the United States. What is not so easy for me to say, is that there are times when you manufacture a higher quality, better-priced product and we have got to resist the temptation to impose duties or countervailing tariffs of some kind that do not show up on any GATT document that makes it difficult for you to sell.

It seems to me that, if we want consumers to buy more, that both Japan and the United States has got to make certain that we keep our trade policies in shape so that our consumers can buy from whoever it is that is manufacturing the highest quality, lowest-priced product.

The CHAIRMAN. Thank you, Senator Kerrey.

Senator Grassley?

Senator GRASSLEY. Yes. My questions would be directed to any or all of you who would like to answer. But before I ask my question, I have to confess that there is a certain amount of inconsistency in a question I am going to address to you about savings in Japan, because we always have used Japan as an example of why Americans should save more.

Our distinguished Chairman has done a very good job of promoting policies to encourage savings in America. So it sounds like we use you as an example, and then the next time we turn around and say, well, you are saving too much. That is inconsistent, obviously.

But, still, as I see it, it might be a case of where there is a tremendous amount of savings because of your culture and the problems that you have had with overcoming the destruction of the war, as an example.

There also has been, probably, public policies promoting exports and having consumers subsidize exports that has encouraged savings. So maybe the free market has not worked in your country like it has worked in our country.

But, regardless, I would like to have you comment about the strong culture of savings in Japan. We have long envied it in the United States. But now this culture is dampening the prospects of economic recovery.

It seems to us in America that Japan sorely needs an increase in consumer spending and a demand for consumer products. Even those who advocate a permanent tax cut fear that the Japanese people might save the money instead of spending it.

How important is increased consumer spending to financial reform efforts, and how can the Japanese Government overcome the strong cultural presumption to save in order to increase spending?

Yes, Mr. Mikuni?

Mr. MIKUNI. To start with, in Japan, if we save money as bank deposits, interest income received by us is only subject to a 20 percent withholding tax, separate from our ordinary income. But in the case of ordinary income, the tax rate goes to 65 percent at the highest marginal level.

So there is a big incentive to save because we only pay 20 percent. If we earn money, high income through the working authorities, you have to pay 65 percent. That is a huge difference to the savings advantage.

Senator GRASSLEY. So there is a tax incentive to save.

Mr. MIKUNI. Yes. On the other hand, unlike the United States, interest expenses for housing is not generally expensed for income tax purposes. So, compared with a corporation which can expense interest expenses against their pre-tax income, consumers are disadvantaged tax-wise. This policy has been continuously been in place since the—and this system worked quite well, because savings in Japan account for a very high percentage of consumer income, 15 percent, or 13 percent.

The justification for high savings could be done because our private institutions, private companies, have been investing heavily in capital goods, accounting for, say, between 15 percent to 20 percent of the GDP.

Because in Japan, like for automobiles, we have the capacity to produce 40 million units. But domestic demand is only seven million units, which means we have a double capacity for the most important industries, compared with domestic demand.

Senator GRASSLEY. Would you like to answer, Dr. Fukao?

Dr. FUKAO. Yes, Senator. The problem is, using in a recession the savings rate declines, under normal circumstances, and consumption relative to income increases. This time, the savings rate rose under a sharp recession because of the collapse of confidence. That is, anxiety towards the future, retirement pension covered by the government, and also increased rate of unemployment. What we need to do, is restore the consumer confidence and keep the savings rate at the normal level rather than the abnormally high rate under the current recession.

Senator GRASSLEY. My last question would deal with another thing that is kind of an inconsistency on my part, arguing for years and years that our Federal Government should balance its budget. Now, somehow, you have lived within a balanced budget all the time. We ought to applaud you for balancing your budget.

But we have heard from economists in this country that one of the things that Japan ought to do is deficit spend. You strongly resisted that in the past. In fact, the ruling party recently raised taxes and interest rates because of concern over the budget deficit.

In my view, tax cuts are crucial to economic turnaround in Japan. Does the government have the political will to run a deficit, or better yet, reduce spending in order to finance a permanent tax cut? Yes?

Mr. KANZAKI. Yes, Senator. Until the policy makers realize the degree of economic activity is so low, they strongly resist spending because we are facing a so-called aging society much earlier than in the United States. But when they realize the economic recession is so severe, they are almost ready to spend more for a tax cut or fiscal stimulus.

Senator GRASSLEY. All right. Either one of you want to respond? Yes. Please, go ahead.

Mr. MIKUNI. I think the reason why the income tax reduction is resisted by the government is due to the fact that, in Japan, the minimum income for a family of four, a minimum income level to pay taxes, starts from around 4.9 million yen, which is a little less than $40,000, which is very high.

So it is known that, for those families whose income is low, usually the propensity to consume is high. But in order to give tax breaks, I think that consumption tax reduction is much more efficient to boost consumer spending rather than income tax reductions.

Senator GRASSLEY. Dr. Fukao?

Dr. FUKAO. I think a permanent income tax cut is advocated to stimulate the economy, but I doubt if the government would set a permanent income tax. Everybody would suspect that they would raise it later because of the pension budget will have a very difficult time in the near future.

So I think that, as Mr. Mikuni said, they should cut the consumption tax. You have a temporary cut in the consumption tax. That would be the most effective way to stimulate consumption and go through the difficult time when we have to have restructuring in the banking sector.

Senator GRASSLEY. I thank each of you for your response. Mr. Chairman?

The CHAIRMAN. I will now turn to our resident expert, Senator Rockefeller, who has a great deal of interest.

OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER IV, A U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. You are calling upon yourself, Mr. Chairman.

Let me say to the three of you, thank you very much. I think that this subject ought to be titled, "The Great Disconnect," because I think the American public and the Japanese public and the Japanese leadership underestimate, in profound terms, the consequences of what is happening in Japan today.

Let me just put it, briefly, into perspective. I returned last week from 10 days in China with the President, and there was this tremendous sense of euphoria, which there should have been, over a variety of things, symbolic and substantive, that happened in China. There was this talk about, China is going to overtake the U.S. in its economic size by the year 2015, et cetera.

I do not happen to believe that. The reason, is the following. Two-thirds of the economy of all of Asia is Japan. One-half of the remaining third, is China. Indonesia's economy has contracted close to 80 to 85 percent in the last year or so. South Korea's economy has contracted, diminished, 25 percent or so. This is beyond depression level figures in our own country in the 1930's.

I think it is not unfair to say that at least a case could be made that the yen today, standing at 141.12, that if the yen were to go, let us say, to 150 or 155, that would force the Chinese to devalue, which would then start a downward spiral which would envelop all of Asia, with all of its people and all of its market, and have, I think, potentially a catastrophic effect worldwide.

I think Japan is the key to the entire situation. Therefore, then what are we to do? The Structural Impediment initiative. We both talked at each other, neither of us liked it, but we both told the truth back in the 1980's. We did what you suggested we should do and Japan has not done so much what we suggested that Japan should do.

The election that Japan has just gone through, resignation of a Prime Minister, what does that mean? It was for the Upper House, which does not count, so it was a free vote, a chance to express dissatisfaction with the LDP. On the other hand, it was a 59 percent turnout, and they had been expecting 35, maybe 40 percent at the most.

So my first question is, is there any case at all to make that the Japanese people, traditionally quiescent in terms of government policy except in special situations, and also traditionally a Japanese population, when under pressure, when there is a crisis, the Japanese culture tends to bring the people back to what they know, i.e., LDP continued leadership as opposed to going into a new direction or a new leader.

Obuchi, I think, went into the Diet in 1963, did he not? So seniority has everything to do with leadership in Japan. Now, that does open the possibility——

Senator MOYNIHAN. And on the Finance Committee. [Laughter.]

Senator ROCKEFELLER. But the Finance Committee, that is a very strong point. You could not change the seniority system in the Senate with dynamite. I think there is a parallel in the LDP, because that is the way it has always been done. So does that give a chance for Miazawa, who I think does understand these economic problems very well? I do not know.

But my question is, the United States does have a right—every nation has a right, Montetire has a right, Indonesia has a right, Singapore has a right—to be looking to the Japanese with more than just passivity as to what is going to happen.

I think there ought to be a special APEC meeting called on the subject of what is going to happen in Japan, because I do not know how one brings pressure on the process.

So I asked just two questions, and I do not have to get three different answers. I mean, you can do that as you wish. One, do you think that some modest reveling in the streets, the high voter turnout, signifies that the Japanese, with their very high incomes, tremendous savings, and tremendous national savings, are beginning to understand that Japan is at the root of what potentially could be a world catastrophe? Number one.

Number two. Do you think that the LDP is sufficiently dislodged psychologically by the effects of this inconsequential election in the Upper House, having strong control in the Lower House where it counts, that the LDP will, in fact, make some kind of adjustment in its policy?

Mr. KANZAKI. Senator, the answer to your question number one. I do not think the Japanese public appreciates enough the importance of Japan in the economic stability of Asia.

I mean, the public. Why the public turnout, up to 59 percent, voted against the LDP, is they fear their own private life. That is the public. As I said, the Japanese economy is key to stabilize the Asian economy.

That view is held by many so-called senior people. But the public, they care about their own lives. Their own lives became very difficult, due to the economic slow-down and when the unemployment numbers started to increase.

In answer to your second question, what was the second question?

Senator ROCKEFELLER. So the answer was, no, the Japanese public is not yet sufficiently aware to bring pressure on the——

Mr. KANZAKI. The LDP.

Senator ROCKEFELLER. Yes.

Mr. KANZAKI. I think, yes. The reason why the voting rate went up so high, 59 percent, is they went to vote in place because they do not want to show yes to LDP.

Senator ROCKEFELLER. That means that they are dissatisfied with the LDP, but not yet ready to galvanize gradually into a public——

Mr. KANZAKI. No, they are not satisfied with LDP. They are not satisfied with the LDP. Therefore, they went to vote for some other party.

Senator ROCKEFELLER. All right. Mr. Chairman, I know I am overstaying my welcome here. But you keep talking about an Asian consequence. What I am trying to get across, is I think that Japan is the key to a worldwide economic potential disaster because of its enormous economy.

China, and all that its leaders are trying to do to take away and cut down 50 percent of the state-owned industries, all of that depends upon a growth rate in China of 8 percent a year.

If China goes under an 8 percent growth rate a year, all of these reforms which we saw happening, many of them will cease. There are those that say China is already at 7.5, which may, in fact, be closer to 7 or 6.5. I do not know. But the consequences are enormous.

So my second question is, is the LDP capable, within its seniority system, which I defend on the Finance Committee and question in Japan, is it capable of kicking out somebody for one who understands this crisis to be the leader? I think Miazawa is somebody who does understand the crisis.

Dr. FUKAO. Let me try. First, in a sense, the patient is running away from the hospital to avoid the operation. The operation is painful, and in the short run there would be a negative impact. So what they have been doing, is postponing the recognition of the disease as a fundamental illness.

I think that gradually the LDP is understanding that postponing will not work; they have to undergo the operation of the financial system. But, at least in the short run, things have to get worse before getting better. We have a big impact on the economy.

So I hope somebody in the LDP can bite the bullet. This is like a hot potato. Major leaders try to pass the hot potato to somebody who is willing to bite the bullet, and we need somebody who can bite the bullet and do a major operation, and probably, within a year or two, the economy will start to recover. But, in the short run, we face a negative impact if they really bite the bullet.

Senator ROCKEFELLER. Thank you.

The CHAIRMAN. Yes, Mr. Makuni?

Mr. MIKUNI. Thank you, Mr. Chairman. I will probably answer two questions at once. In Japan, the Japanese high growth rate of the economy has solved all the problems in the past. As long as our economy is growing very rapidly, there are no complaints at all from the public and the LDP could deliver all the goodies to the voters, and so forth.

So it is quite important to understand that any major policies probably have not really been discussed, publicly, and also in the Diet. Also, the important policies in Japan—could be decided by the bureaucracies. But the results to be delivered, I think probably they would not care at all.

But we are now facing is that, because of the banking crisis and the doldrums which rested so many years, probably we have to see a higher unemployment rate, bankruptcies, and also the problem in the future dates when deposits are going to be written off.

Then voters are going to lose money or have to bear heavy burdens. Then they have to think and they have to act. But, until they have some pains to be feared, I do not think they are going to move.

I think that it is one thing to understand mentally, but it is another thing to act. In order to act, I think that there should be some kind of real big pains or damages to be, so to speak, feared or anticipated. Otherwise, people do not start to move. I think that the last election will probably give, kind of, potential pains to be feared so people will not vote for politicians.

But I do not think they have really chosen whether they are going to lose money on deposits, they are going to pay higher taxes, or whatever. I mean, that decision has to be made in the future by a Lower House election where debate over policy matters may be really done, which has not been done in the past.

The CHAIRMAN. Thank you, Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, I would only comment and say that the very, very honest answers from all three gentlemen paint a profoundly pessimistic picture, because when Mr. Mikuni talks about debate in the Lower House, you and I both know that there really is no debate in the Lower House. Debate is decided between the Ministry of Finance and the LDP Policy Committee.

As we have discussed before, since the end of the second World War there has not been a single budget which has been submitted by the Finance Committee to the Diet in discussion with the LDP Policy Committee which has had a single item changed, even in any 1 year. So, it is a pessimistic situation.

The CHAIRMAN. I would like to call on Senator Moynihan, next.

Senator MOYNIHAN. Well, not to do more than express the extent that I would share Senator Rockefeller's response to your very candid and informative comments. We often find the Japanese difficult to understand; you must often find us difficult to understand.

How would we deal with a problem where what we had to do was to raise unemployment and increase spending? I do not know how you would get that program this committee, or any other. And your unemployment rate is only 4.1 percent, which is full employment, for practical purposes, and I think we would probably agree.

The vote for the Upper House was obviously a protest vote, in some measure. The communist party shared the largest number of gains, with the Democratic party, which is not exactly a vote for change, it is a vote for more of the state capitalism that you had for 50 years. I see Mr. Kanzaki seeming to agree. Could you take home the message that we are scared?

Mr. KANZAKI. Senator, I do not think you have to be scared. As I kept saying, the LDP people should learn from the results of the Upper House election. If they are not going to change, then things will become more serious.

Senator MOYNIHAN. That is our concern.

Mr. KANZAKI. But I am sure that they have learned from this protest from the public.

Senator MOYNIHAN. Well, on that positive note, I thank you all. We have learned a great deal. I have, certainly.

The CHAIRMAN. Well, again, I would like to express the appreciation of the committee for you three gentlemen taking the time, the effort, and the expense of being with us here this morning. I think your very candid comments have been very helpful in enabling us to better understand the situation.

Mr. Kanzaki, I get the feeling you are less pessimistic than the other two gentlemen. I just wonder whether that is generational as to the cause of that difference of opinion. But I do want to emphasize how important the relationship between your country and the United States is, and I think it has been very——

Senator MOYNIHAN. Mr. Chairman, could I note that Mr. Kanzaki is chairman emeritus and has less reason to be anxious about the process? [Laughter.]

The CHAIRMAN. Duly noted.

Gentlemen, thank you very much for being here today. We look forward to continuing the dialogue. I think your willingness to come these long distances has been a very constructive factor in developing a better working relationship. Thank you very much.

Mr. KANZAKI. Thank you.

Mr. MIKUNI. Thank you.

Dr. FUKAO. Thank you, Mr. Chairman.

The CHAIRMAN. Our next panel contains four experts on the financial service industry generally, and on Japan's financial sector in particular.

We are very pleased to welcome as our first witness Mr. William Seidman, who of course is the chief commentator at CNBC Business News, and was the head of the Resolution Trust Corporation.

He will be followed by our good friend Robert Hormats, the vice chairman of Goldman Sachs. Our third witness is Mr. Robert Feldman, the chief economist for Morgan Stanley Dean Witter in Japan.

Our final witness is Mr. Roger Kubarych, the managing member of Kaufman & Kubarych Advisors.

Gentlemen, we are looking forward very much to your testimony. It is, indeed, a pleasure to welcome you, Mr. Seidman. Please proceed.

STATEMENT OF L. WILLIAM SEIDMAN, CHIEF COMMENTATOR, CNBC BUSINESS NEWS; FORMER HEAD OF RESOLUTION TRUST CORPORATION, WASHINGTON, DC

Mr. SEIDMAN. Thank you, Mr. Chairman, Senator Moynihan, Senator Rockefeller. It is a pleasure to be here.

In the spirit of full disclosure, let me say that I have been advising the Japanese Government with respect to some of their banking problems, so you should take that into consideration. And, while I work for CNBC, none of the views that I express are theirs. I do not think they have many views. [Laughter.]

We try to be very neutral.

I am going to address three things: one, the reform of the banking system; second, the monetary policy and the value of the yen; and third, what can the U.S. do in the future. And in 5 minutes, since I did not give you a written summary because, frankly, I just got back and have not had a chance to prepare one. I will try to go through it as rapidly as I possibly can.

First, with respect to the reform of the banking system, it is very clear. I have been going over there for 7 years, and this is the first year in which they have paid any attention, I think, to the kinds of things that I have been suggesting to them. So, I am encouraged by the direction in which they are going.

But I would like to point out these things. First, no one in Japan, I believe, the banks, the supervisors, or the government, knows the size of the problem. There has been no independent audits of the banks and, much like with our S&Ls, we found that what they reported was about half of what the problem really was. We also found that, when they failed, the problem was double. In the Hokkaido Bank which failed, the losses were about double what they were reporting.

So I would say just, fact one is that the evidence is, although no one knows, that the problem of bad loans in the banking system is probably considerably bigger than the number that we have heard, which is around $600 billion.

Second, the problem in Japan is really, they keep talking about bad loans. It is really not bad loans, it is bad banks, of which bad loans are a part of the problem. You cannot fix this problem simply by selling bad loans, you have to do something to fix the banking system, which requires fixing bad banks.

As you know, they have now come forward with a new "Total Plan," of which we have been given a pretty good peek at what they are talking about. I am encouraged by the fact that, under the system and with what Hashimoto was able to accomplish, they now have an independent supervisory agency not under the Ministry of Finance. This is a big step in Japan. They have an independent Deposit Insurance Corporation, independently financed, not under the Ministry of Finance.

Those two agencies are both headed by gentlemen from the Ministry of Justice. That is a big, big difference from what has been happening in Japan. I do not think that Prime Minister Hashimoto really got the credit that he deserves for moving to try to create an independent bureaucracy to deal with this outside of the Ministry of Finance.

As we all know, the Ministry of Finance has been in charge of banking and, therefore, they have much to explain. It is very hard for them to clean up the system, because they were certainly a part of creating the problem.

I went over there, and I have just gotten back. I was over there principally to talk with them about talking the bridge bank method of handling failed institutions.

The bridge bank, in simple terms, is simply a method of taking over the bank by taking over the ownership, without affecting depositors, borrowers, who hardly know that anything has happened because the bank just changed ownership from whoever owned it privately to the Deposit Insurance Corporation. It then runs it and capitalizes it until it can put it back into the private sector.

I think this is what they were looking for as a way to actually fail banks without adversely affecting their economic system by having borrowers with no place to go, depositors wanting money, and so forth.

So I met with all the people. And, as Mr. Kanzaki said, the Diet leaders were the ones who took the leadership in looking at this and deciding what ought to be done. I think that is very encouraging, because they are still there. They were clearly the ones who grabbed this and put it into the plan.

So all of those things, I think, are encouraging. There has been independent financing involved and that, too, will help. So I say, so far, so good. The biggest problem they have in their organization is, they do not have a single board or individual in charge of this clean-up.

They have got four or five different agencies involved. If they do not get some place where the buck stops, it is going to be very easy for all these new mechanisms they have created to do nothing. So, we have to look at that.

I gave them a five-point plan. Point one, was get the facts. Point two, was to put together this bridge bank mechanism. Point five, was get somebody in charge of the clean-up.

I know I do not have much more time, Mr. Chairman.

The CHAIRMAN. You did not volunteer to be that person, did you? [Laughter.]

Mr. SEIDMAN. No, sir. Without any question, that should be a leading Japanese financial expert.

I want to, if I can, make just a couple of more comments. Or do you want me to stop?

The CHAIRMAN. No, that is all right. Please proceed.

Mr. SEIDMAN. With respect to monetary policy and the falling value of the yen, if you will note, the yen really took off downhill about the time the big bang came in, and it is not hard to see why. Fidelity sales are up 65 percent since that came in.

The Japanese are running, not walking, to take their money out of yen and put it into dollars, for obvious reasons. They get 5.5 percent here, they get 1.2 percent there. Any wise and smart individual would like to do that.

We have just seen the start of that. It is going to be an avalanche of money going into dollars and out of yen. The insurance companies will be allowed to do that shortly. Under a situation where you are holding interest rates at a half of 1 percent, you are getting the reaction that you might expect.

Now, they are on the horns of a dilemma. There are two formulas we know. If the economy is bad, lower the interest rate; if your currency is weak, increase interest rates. They have to find a solution between those two problems. Almost any good politician, given that choice, will take the choice of trying to help the economy and forget about the currency, particularly when Japan is a huge export nation.

So, given those circumstances, we can almost certainly predict that the yen value is going to continue to depreciate, and that, of course, means that the trade gap with us and with the world is going to continue to get worse.

Further, this very low interest rate has had the effect, as it did in the United States, of creating a credit crunch in the banking system, because bankers can borrow at a half a percent from the Central Bank and invest it in U.S. Government bonds at 5.5 percent, so they have no real incentive to loan to business.

The same thing happened in the United States. If you make it easy enough for the bankers to make money that way, especially in a dicey economy, it is a great incentive not to make business loans.

So the very low interest rates, half of 1 percent, they were talking about lowering them even lower, which meant they would have to pay you take money if they went much lower.

So if you distort policy the way they have, over a period of time, and with the big bang, they opened it up so all the Japanese could shift out of yen-designated securities and into dollar securities. If you look at the results, you will see it happening. And talk to the people in the securities business, and they will tell you, you ain't seen nothing yet.

Now, a depreciating yen would normally affect the Japanese people in one way very materially, and that is, it would increase the cost of their largest import, which is oil. But during this particular period, the oil price has been going down faster than the yen has been going down, so they have not had any effect of that. So the lower yen has really not resulted in the kind of effect that the average Japanese would react to.

So my bottom line there is, we are going to see a depreciating yen and a bigger trade gap, and it is going to become a huge, I think, political problem in the terms of maintaining open markets.

I will take just one other moment to say that I think, as far as the U.S. is concerned, we are, I think, in no position to try to tell the Japanese Diet or the Party how to operate. My own experience is, they are not particularly pleased with our getting into their political process.

I think they are very interested in learning about how we handled our problems and getting from us the kind of expertise that we developed by making lots of mistakes, of which you all remember, in getting done with our problem.

So I think that the biggest thing that we can do for them is to try to help them move the mechanism for cleaning up the banking system, and then with respect to monetary policy and so forth, I think we will have to continue to comment on it, but they will have to make the decisions.

So the bottom line is, it looks like it is going to get worse before it gets better. I think it will get better. I think you will see some reactions to this among the Japanese people.

If you look at this last election, in the major areas the LDP did not elect any senator. All the high population areas, they did not elect a single candidate. I believe they will read those things to say that the people in the cities are getting mad, finally.

Having been in World War II, I have been engaged with mad gentlemen of Japanese ancestry, and they are tough. So I think they are going to move on this and they will move on the politicians. That is the way it will change. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Seidman.

Dr. Hormats, it is a pleasure.

STATEMENT OF ROBERT HORMATS, VICE CHAIRMAN, GOLDMAN SACHS, NEW YORK, NY

Dr. HORMATS. Thank you, Mr. Chairman. It is a great pleasure to be here with you, Senator Moynihan, Senator Rockefeller, and others on the committee, where I have had the pleasure of testifying a number of times.

What I would like to do, is to discuss the Japan crisis from the point of view of Asia, and also talk a little about the impact on the U.S., and particularly the impact on the U.S. financial services industry, which I have been asked to touch on.

Let me say at the outset, that I think that today the world economy faces a greater danger than at any time since the oil crisis of the 1970's. I say that for three general reasons. One, the problem we have been talking about, recession, a weak yen, and serious banking problems in Japan.

Two, faltering growth, recession, or depression in much of the rest of Asia. I have been advising a number of Asian governments and companies and I am concerned about a growing deterioration of confidence throughout the region, growing unemployment, increased bankruptcies, currencies are under a strong downward pressure, and growth projections all over the region are being sharply downgraded.

In Indonesia, the economy is in a state of collapse. For many other economies, the very measures they need to take to improve their circumstances will mean more unemployment, more uncertainty, and more bankruptcy.

The third general reason for this concern, is sharply lower energy and commodity prices. This is a big benefit for commodity importing countries. In fact, it is the biggest tax cut we have had in the last 20 years, lower oil prices. A great tax windfall for us and for the Japanese.

As Bill said, it has helped to offset the inflationary impact that might have occurred through higher oil prices from the weakening of the yen. But, if you are a commodity exporter like a Saudi Arabia, or as we have seen in the news, a Russia, a Latin America country, or South Africa, this is a huge problem and it is getting worse. Russia's problem is largely internal, but there are certain elements that have to do with commodities.

The second broad point, is I think this is a pivotal period for the world economy during which the crisis countries themselves and the entire international community need to come up with measures to halt the deterioration. Japan's reforms play a central role in this process because it is the second-biggest economy and is by far, as you have pointed out, the biggest economy in Asia.

Japan has, in my judgment, a very short time in which to decide whether to take the additional steps needed to boost growth, strengthen the banking system, and thereby restore confidence in its markets and its currency, thus becoming an important part of the solution to the Asian problem, or continue to put off tough decisions, thereby suffering further erosion of its own economy and posing a growing risk for Asia and for the world economy.

But I think it is also true that Japan's efforts, in themselves, are not sufficient to address Asia's problems. There are a lot of other issues that have to be dealt with, too. I do not have time to deal with that, but I want to say that Japan's problem is central to Asia, but there are a lot of specific country-related concerns that have to be addressed.

One reason the Asian crisis has not had a more severe impact on the United States, is that the American economy is so strong and our exports are very diversified and very quality oriented, so that the exchange rate has not had as big an effect as it did, or would have, 10 or 15 years ago. And we can get into this, but the character of American exports is more diverse and they are very quality oriented and not as price oriented.

I think also we are going to have a wider trade imbalance. That is because our economy is strong relative to other economies, and we should brace ourselves for this.

But I think it is clearly very unhealthy for the United States and the international trading and economic system if a third of the world economy, as it is today, is in recession or experiencing weak growth, or in some cases, in the case of Indonesia and others, really in a depression.

The danger is, if the U.S. or Europe were to suffer an economic downturn in the future with Asia's economy still very, very weak, the global impact would be extremely serious. In addition, high interest rates here, if that were to happen, would have an adverse impact on Asia. If it will still in poor condition, that would pose additional problems for the world economy.

Let me touch, briefly, on Asia and the Japanese crisis and how the two interrelate. First, the point has been made that Japan is clearly the biggest economy in Asia. It is the largest, or second-largest market for virtually every country in the region. It takes about 20 percent of the exports of Indonesia, Malaysia, Philippines, Thailand, Korea, and others. Its recession has, of course, caused a weakness in the exports of these countries to Japan.

Even more damaging to other parts of Asia has been the fall of the yen. That not only increases Japanese competitiveness in bilateral trade, but it also increases Japanese competitiveness vis-a-vis Korea and other countries in third country markets. This is even more important for some of these countries.

For instance, 17 percent of Korean trade is with Japan, but about 30 percent of Korean exports compete head to head with Japanese exports in third markets like the United States. Figures for Taiwan are 19 and 25 percent, respectively.

China is about half and half. It sells about 20 percent of its goods to Japan, 20 percent of its goods compete with Japanese goods elsewhere in the world, which is why the weak yen puts downward pressure on the currencies of other countries in the region and why the Chinese are so concerned, as you pointed out, with the weakening of the yen. This is a big problem. There are other specific issues. Japanese direct investment in Asia is an important factor. That has diminished. Japanese bank lending is extremely important.

Can I take two more minutes?

The CHAIRMAN. Yes, go ahead.

Mr. HORMATS. Japanese bank lending is extremely important to the rest of the area, and weak Japanese banks mean that Japanese credit has contracted in much of the region. A lot of the banks are pulling back from the area.

Now, Japan has done a number of things to help Asia. It has been the single biggest contributor of money to these IMF packages. But the weakness in the Japanese economy and its lack of a sense of direction has really lowered the stature of Japan in the region quite dramatically.

Let me just make one or two points on the impact on the world economy. One, the impact on the world economy, in general, has not been enormous as a result of the Asian crisis, but it has been very big with respect to industrial production.

Industrial production in the OECD countries has suffered more than any other sectors, dropping from about five percent growth last year, to about 2 percent in the current quarter, to about 1 percent by the end of the year.

So, the Asian crisis had a disproportionately large effect on manufactured goods in the rest of the industrialized world, largely because of weakness in Japan and weakness of exports of industrial goods to the Asian region.

Let me comment very briefly on the impact on the U.S. financial sector, because this is one of the points that I have been asked to take up. The central event in deregulation, as has been pointed out earlier, was known as the big bang. We believe, actually, the benefits of the big bang are real and significant, and for the most part are working quite well.

One very important area that Bill Seidman mentioned, and I think he is absolutely right to do so, is the progress that has been made with respect to the April 1 Foreign Exchange Law, which incorporates a number of reforms and makes it a lot easier for Japanese institutions to send money abroad.

I think we saw in the first panel a very interesting chart from Mr. Kanzaki which shows foreign management companies' investment trust business in Japan, which shows a very substantial amount of Japanese investing their money with foreign money managers, and that money going out because it gets a higher rate of return, both with respect to interest returns and the performance of the American stock market.

Big bang has also enhanced scope or innovation and it has improved the asset management because the average Japanese knows he or she has to save for the future. The returns in Japan are so poor, they want to get a higher rate of return on their pension money and American firms investing abroad have done this.

There is one concern that I think I will mention, Dr. Feldman may mention it as well, is the new Securities Investor Protection Fund, which will be established on December 1.

One of our concerns is that the fund, as currently envisaged, which in itself is a very good idea to establish this fund, will make the big, institutionally-oriented firms assume a disproportionately large share of the cost of the liabilities of failed Japanese security firms.

In addition, we think it is very important that Japanese regulators require the segregation of customer assets from member firm assets. There has been a tendency to intermingle those assets. This is one of the reasons these security firms have gotten into trouble. Other places in the OECD do not allow these to be intermingled.

I will simply conclude on one point. Bill Seidman knows the banking issues far better than I and he is very close to it. I will just make a couple of points very briefly about this. That is, first of all, I think that at the heart of the Japanese growth problem is the weakness of the domestic banking system, and at the heart of that weakness are serious problems in the real estate sector.

Japan's banking problems are similar to the problems of the U.S. during the S&L crisis, only greater in magnitude and far broader in scope; as a portion of GDP, they are about five to six times as large as ours.

The banking problem and the real estate problem must be dealt with together. Measures to stabilize the banking system will be useful and constructive, but alone they will not lead to a sustained recovery of the economy because the root of the problem remains lack of recovery and liquidity in the property markets.

That, in turn, requires large-scale workouts, including some loan forgiveness by banks of non-performing real estate assets, so that corporations, real estate developers, and construction companies are no longer constrained by large property-related loans.

The real estate development construction sector employs about 20 percent of the Japanese population, and current problems in that sector are weighing down the rest of the economy.

On that note, let me conclude. Thank you very much.

The CHAIRMAN. Thank you, Dr. Hormats.

[The prepared statement of Dr. Hormats appears in the appendix.]

The CHAIRMAN. Mr. Feldman?

STATEMENT OF ROBERT FELDMAN, CHIEF ECONOMIST, MORGAN STANLEY JAPAN, TOKYO, JAPAN

Mr. FELDMAN. Mr. Chairman and members of the committee, it is a great honor to appear before you today. Let me state at the outset that the opinions I express today are my own and do not necessarily reflect those of my employer, Morgan Stanley Dean Witter.

Since time is limited, let me go directly into the four topics that I believe are most critical. These are: economic prospects for Japan; suggestions for financial sector reform; Japan's role in Asia; and what America can do to improve the outcome.

Unfortunately, Japan's economic prospects are bleak over the next year or two. In fiscal 1997, the year ended in March, the Japanese economy contracted by 0.7 percent. Another contraction is likely in the current fiscal year.

Moreover, the risks are that things will turn out even worse. This sad state of affairs has come about because private demand is so weak. Business investment suffers from low profitability, poor prospects, the slow pace of deregulation, and weak corporate balance sheets in many sectors.

And consumers are suffering from weak income, falling wages, and rising unemployment. In addition, consumer sentiment is plagued by fears about the financial system. Even the largest fiscal package in Japanese history and the lowest interest rates in world history have not been sufficient to offset these headwinds.

There are two ways to address such problems: demand support and supply side reform. In my view, Japan has exhausted the room for maneuver for demand support. Already, the fiscal balance of the general government has been brought from a surplus of 3 percent of GDP in 1991, to a deficit of around 5 percent.

Further major stimulus would, in my view, risk a government debt snowball. Making recent tax cuts permanent is desirable but will by no means solve Japan's long-term economic problems.

However, the second road remains open. There is much room for supply side reform, which I define to mean measures that raise the efficiency of resource allocation.

Let me give some examples. In the industrial sector, there has been much accomplished in deregulation in areas such as retail stores and telecommunications. Domestic long-distance telephone charges are at one-quarter of their level of 1985.

However, vested interests continue to shackle progress in many other areas, such as construction, agriculture, distribution, finance, energy, and pharmaceuticals. Price differentials tell the story. Even at today's undervalued yen exchange rate, spaghetti costs twice as much in Tokyo as it does in New York.

In the labor market, mobility needs to be enhanced by raising pension portability, corporate governance needs to be tightened, and the trend toward big government, which has accelerated in Japan in the last decade, needs to be decisively reversed.

Even if implemented immediately and aggressively, however, supply side reforms will take time to work. Both Japan and the rest of the world will have to live with the hard reality. The Japanese economy will continue to shrink for at least another year, and maybe for several more years.

Japan's financial sector is in critical condition. In my view, there are six hurdles to credible financial reform. First, Japan does not have a reliable and consistent method for assessing the level of non-performing assets.

Second, these levels of non-performing assets must be subject to external checking, with a sharp increase in the capacity of the new Financial Supervisory Agency.

Third, capital adequacy standards at financial institutions need to be tightened, and the regulatory decisions based on those standards must be made automatic.

Fourth, the recirculation of assets seized in the process of cleaning up the financial system must be swift. Fifth, access of borrowers at failed institutions to special bridge credit facilities must be limited in both amount and length.

Finally, these new sets of rules must be applied impartially to everyone in the economy, regardless of their political and bureaucratic connections.

The good news, is that the first steps have been taken in all of these areas. The bad news, is that these are all journeys of a thousand miles each. Japan needs complete transparency, an investor-friendly environment, and the dismantling of the convoy system of financial regulation.

In short, Japan's financial system must take to heart an old saying from my home State of Tennessee, "When you find yourself in a hole, the first thing to do is stop digging."

In Asia, Japan has played four roles. First, Japan has provided markets for Asia, but today Japanese imports are shrinking. Second, until a few years ago, exchange rate movements helped Asian countries expand their manufacturing capacity while Japan moved up the value added chain. Now, with the depreciation of the yen from 80 per U.S. dollar in the spring of 1995 to about 140 recently, Japan has retaken market share from Asian producers.

Third, although the Japanese Government has been generous in support of IMF program, many private Japanese institutions have withdrawn credit from the region.

Finally, Japan has been a model for Asia of how economic reform should not be carried out. I do not foresee quick improvements in any of these areas.

All of this naturally leads to the question of what American can, and should, do to help. First, let me state one thing clearly: a weak Japan is bad for America. A weak Japan means an excessively weak yen, and this means bad resource allocation, higher risks of protectionism, and continued concerns about world financial meltdown.

In addition, many of our joint endeavors with Japan to address the global problems of poverty, pollution, and disease are imperiled by a weak Japan. Nevertheless, it is important for the U.S. not to play savior. We can pressure, cajole, coax, and be brutally frank as only friends can be, but we must realize that lasting reform will only come when the Japanese people themselves decide, design, and implement reform.

Our powers to affect change in a sovereign country are limited to reason and example. Perhaps the best advice came from St. Francis: "Preach the gospel at all times, and use words if necessary." Thank you.

[The prepared statement of Mr. Feldman appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Feldman. We are not getting a very optimistic message today, to put it mildly.

Mr. Kubarych?

STATEMENT OF ROGER KUBARYCH, MANAGING MEMBER AND CHIEF INVESTMENT OFFICER, KAUFMAN & KUBARYCH ADVISORS, LLC, NEW YORK, NY

Mr. KUBARYCH. Yes. I am Roger Kubarych. Henry Kaufman, my partner on the masthead, is someone that I know you are all familiar with. Senator Moynihan has had the occasion to quiz him many times.

The two of you may not know that you have something in common other than being at this outstanding hearing. It has been very educational for me. I think we have all benefitted from our friends from Japan, who are, in fact, old friends of mine and they had excellent presentations.

But you also are custodians of cities with tight hotel markets. I am going to be in Wilmington for a meeting on Thursday. It is just as hard to get a hotel room in Wilmington as it is in New York City.

I will summarize just a handful of points that I think I have heard others make that I think are worth repeating, and a couple of my own, just to lead the way into the question section.

First of all, the Japanese problem is about risk-taking. Savings is something that they do a lot of, risk-taking is something they do not. The household sector holds, as a total share of their financial assets, 60 percent in the form of super-safe assets: deposits, CDs, money funds. In the United States, the same figure for our households is 15 percent.

Americans are looking for opportunities to get higher returns and to participate in an active capitalist system. The Japanese households, by contrast, are worried, anxious about their future, showed that as voters, and do not trust the financial system to provide assets beyond the safest government-guaranteed variety.

Number two, tax reform. Japan has had a rolling tax reform for quite some time. That is because their system was not generating a measure of compliance and of fairness that the country deserved.

One of the reasons that the consumption tax was installed in the first place was to broaden the base and to get a better compliance with paying taxes; clumsily initiated, bad timing, but it speaks to a very important need in Japan. To make the system work for everybody, there has to be much more tax reform that has to support risk-taking.

Number three, financial distress. Yes, as Bob points out, it is largely real estate. Yes, as Bill Seidman points out, you need better bankers, not just fewer bad loans. It is also about an Asian malady that all of these countries has shown is destructive, and that is too much debt and not enough equity. There is not a real functioning equity market in Japan, as there has not been in most Asian countries, and that is needed. The way to get that reform best, is through a total reorganization of corporate governance.

Next, it is about clearing up the legacy of the big bang. This has been hanging around now for 10 years, and we get frustrated that they do not take a more proactive and more rapid solution. But I am personally against the shock therapy. I think that closing down a large number of major Japanese financial institutions would poison consumer and business confidence even further.

This is a case where the U.S. Government has to be supportive of them taking a legitimate amount of time, not another 10 years, but certainly not the next six months, to bring this to a successful conclusion using these devices which, after all, they are adopting from our own background. They are trying to learn the lessons that we learned rather awkwardly ourselves.

We did not solve our banking problem through a shock therapy, we did it with care and a certain amount of selectivity. The result today is, many of the big banks that were under a cloud 8 or 10 years ago are now selling in the stock market in multiples of something like 10 to 15 times better than they did then.

Finally, it is about exchange rates. The major role of the United States in the solving of the Japanese problem is not in terms of engineering a fiscal policy package for them to adopt, they have to do that themselves. Our specific role has to be in the area of exchange rates.

The yen has traversed a tremendous roller coaster over the last 3 years. It has been as low as 80 barely 3 years ago, this morning 141. That is a 75 percent swing in the value of the dollar.

I have a table at the back of my presentation that shows you a bunch of numbers contrasting Japan and the United States in that period of time. The interesting thing about those numbers, is how little they have changed.

The so-called fundamentals that drive exchange rates—and there are many that do so—have not changed as much. They certainly have not changed enough, in my view, to generate a 75 percent swing in the value of the dollar.

Until we get better stability in the dollar/yen relationship, we are going to have immense problems, not only for our trade balance and therefore for our political support for maintaining a liberal, open trading system, but also we are going to see another round of repercussions throughout Asia. It will spread to Russia and China. It will spread to Latin America. We have to stop that before it happens.

Senator MOYNIHAN. Wow. Right on the bell.

[The prepared statement of Mr. Kubarych appears in the appendix.]

The CHAIRMAN. Well, thank you, Mr. Kubarych. It is not a very pretty picture that is being painted, both from the standpoint of where we are and what we can do. As I listen to the testimony, Pat, it seems to me that it is pretty clear that Japan is not going to quickly take the steps that are necessary, at least in our judgment, to reform its economy and develop confidence among the Japanese people.

But it bothers me. Do we just sit here and do nothing? We know that the Japanese economy is 70 percent of Asia, so that recovery in Asia generally is dependent on them. Of course, you gentlemen have pointed out the worldwide implications.

Is there nothing we can do at this time? If we go back to the 1930's, President Roosevelt said we have nothing to fear but fear itself. How do we help build confidence again into the system? What do we do?

I mean, it bothers me to hear, and I agree that the current account deficit is going to increase. We are going to hear louder and more extreme voices on protectionism. I just do not think we can sit here and do nothing. Is this something that should be wrestled with by the G–7, APEC, or do we just let it play itself out? Bill Seidman?

Senator MOYNIHAN. Mr. Chairman, could I just add so our distinguished witnesses will know, we had a hearing about two weeks ago on the trade deficit. Fine economists will say there is nothing to worry about.

But we had a succession of members of Congress saying, we have to do something about it. It is counter-intuitive. The Chairman's question is in a context that is kind of scary here in the Congress.

Mr. SEIDMAN. Well, first, Mr. Chairman, I think a huge trade deficit is definitely something to worry about because, in order to finance that, we have to have the world investing in the United States in the way that they have been doing.

If we saw a change in the general inclination to invest in the United States because our stock market corrects, or something like that, in order to finance that deficit we are going to have to pay very high interest rates and that is going to change the whole economic picture in the United States.

So I certainly think that the trade deficit, which is going to go as high as it appears to be going at the present time, is a major economic problem for the United States.

With respect to your question of, what can we do about it, I would, first, hope the government would organize an experienced team of bank clean-up artists to go over, and the Japanese Government would accept their help in actually doing a job over there. We made all kinds of mistakes, I personally made a lot of them, and we learned from that. So I think there is a tremendous amount we could do to help them.

I am not as pessimistic as some that the Japanese Government will not act in this area. I think this election was a real wake-up call for them. The people that I met with in the Diet were already preparing to take tough steps that they never were willing to take before. So, with our continued help and pressure, I think we can probably be a little more hopeful that they are going to take some of the actions.

My third point of my five points was, they have to close insolvent institutions. That is something the Ministry of Finance said they would never do. They believe in the convoy-theory: every ship is protected, no ships are allowed to sink. That is totally changed in the Diet now. So, I think they are still going to need a lot of help to be able to do that.

My fourth point, was they have to create a market for real estate. To do that, you have to do what we did in the United States, which is offer bargains, show them the waters, get people buying.

We used to say in the RTC, we never met a patriotic American who was still ready to buy our real estate out of a sense of patriotic duty. They wanted a bargain. They are going to have to do the same thing in order to get things going.

The CHAIRMAN. Let me ask you a question then, because as I understand, real estate is now valued at about 20 percent of the top price. How much lower does that have to be?

Mr. SEIDMAN. Well, I think that value is probably somewhere below what real values ought to be. But when you have a market that simply is frozen, and when you know that you are sitting there with billions of dollars worth that are going to be dumped in the market, it is the same problem we had.

Our markets were frozen in exactly the same way. We simply had to go out and say, what will you pay for it? All right, we will sell it to you at that. Once those bargains got out, the bottom fishermen were all around and we ended up with much higher values. I think it takes the courage to take some losses, and the faster they do that, the quicker they will get back.

The CHAIRMAN. Dr. Hormats? Before you start out, just let me point out that one of our Japanese witnesses said the investment banks were helpful in hiding the losses. I thought maybe you might want to comment on that.

Dr. HORMATS. Helped in hiding. Well, I think that was one of the points I wanted to touch on, and I am glad you mentioned it. Let me talk about the question of the trade imbalance for a moment, and then the question of how we can be helpful.

I think it is quite clear that the trade imbalance, as we see it now, is wide and probably is going to get larger. It is large with respect to the crisis economies, and I leave Japan out for the moment. It is large with respect to those countries, not because we have seen a deluge of imports from Malaysia, Korea, or these other countries, it is large because these countries' buying power has collapsed. There is almost no new investment.

I was in Seoul last week, and all these big cranes moving around and making new buildings 5 months ago are just stopped. So, almost no investment is taking place throughout the region.

Consumer purchasing power has collapsed because wealth has collapsed as a result of the stock markets and unemployment. So these countries are just not buying as much and, therefore, the imbalance is widening largely for that reason.

With respect to their ability to export here, they cannot export as much, in part, because they compete with one another, so if one does well, one does less well. They do not so much compete in some of these areas with American producers, but with one another. So, net, the impact has not been as great.

But where there is potential for increased exports, they found it very difficult to get trade financing for exports or trade financing to buy the imported components or machinery required to produce the exports that would ultimately come here. So, there is that problem as well.

It is also very difficult, in a tight credit environment, to shift production, which has been oriented toward your domestic market to foreign markets. It requires, in some cases, adjustment of the production process, that requires new factories or new equipment.

So they really have not increased their exports here very much. But, over a period of time as they begin to gear up, they will and the imbalance will widen. It is certainly very large with Japan, and getting wider with Japan.

The problem, as I see it, is how do we deal with this. I do not think wholesale protectionism is the answer, although I am sure we are going to see a lot more cases before USTR, the Commerce Department, and others. But legislative action, I do not think, is needed.

I think what has been very interesting, is how useful the rules of the World Trade Organization have been in this process. Virtually none of these countries utilizing the counterweight of international rules has resorted to wholesale protectionism. We have not seen that.

In virtually every part of Asia that I have gone to, there has been an understanding that that is not a very good answer for them, and their international rules which would mean that if they did take those actions, there would be retaliation, and they understand this.

In fact, the crisis has, in some cases—I point to Korea and Thailand as very good examples, and to a degree in Indonesia, although it is a little opaque there, it is hard to figure out—there has been more market liberalization during this crisis, in part, urged on by the IMF and the U.S. Treasury, among others.

So the process of trade, we have actually managed to get a little bit more liberalization. The great tragedy would be, if we turned away from trade liberalization at this point, it would give other countries in a worse position an excuse for doing likewise. So that is how I would deal with the trade issue. The key is to encourage more liberalization.

Now, where can the U.S. help? I think Bill Seidman has done a terrific job in helping the Japanese to understand how we dealt with the problems, the kind of mistakes we made and the kind of successes we had.

I think it is also true—I say this with a certain amount of modesty—that the U.S. financial institutions—Morgan Stanley, Goldman Sachs, and others—and the commercial banks have played a very useful role because we have provided innovative new financial techniques, we have helped the Japanese investor and saver to get a higher rate of return.

And, most importantly, I think by being in that market—and I want to compliment the Government of Japan and U.S. negotiators—it is a much more liberal financial services market than it was 5 years ago.

This gives American firms a chance to play a role and it also means there is more competition vis-a-vis the Japanese firms, and some of them are rising to the occasion by developing their own innovative products.

We would like to see further progress. December 1, there will be more liberalization. But I think the financial services area is one way in which foreign firms can help, not just to make profits, although that is not the worst thing in the world, but also to encourage more liberalization among the Japanese financial institutions so they can do better for their own people.

Mr. KUBARYCH. I would like to stress this very great need for foreign equity to go into the Japanese financial sector, but it is also true in Thailand, Korea, and some of the others.

If you go back to our own situation, in the mid-1980's, foreign banking offices operating in the United States had about 7 percent of total banking assets. That tripled in the ensuing dozen years because of all sorts of foreign investments in our banking system, and we benefitted from it.

That happened in many other emerging markets at the same time that have had troubles. Take Argentina, for example, where they had a terrible banking crisis. They have had tremendous foreign investment in it. That stabilized, but there is only one fully Argentine-owned bank right now.

Now, the Japanese banking system needs to be recapitalized and our banks, securities firms, and insurance companies, as well as European, have a very important role to play in this.

Now, what will be holding them back? A variety of bureaucratic red tape, the delays are astonishing and totally unwarranted; some very tricky tax questions; and most of all, the lack of transparency.

The Japanese can fix the lack of transparency overnight, if they choose to. The bureaucratic delays will take a little longer. The tricky tax elements probably cannot be dealt with within a very short period of time.

When that capital investment comes into their system, they have stronger financial institutions. The credit channels will open up. The way I put it, is very simple. In the United States, we have fairly expensive, but plentiful, capital available. Japan has very cheap unavailable credit, and the way to solve that is to recapitalize the system.

Really, the only viable way of doing that in a short period of time is U.S. and European institutions recapitalizing the system. The Japanese authorities have to work night and day to do the things that encourage that inflow.

The CHAIRMAN. Thank you. Dr. Feldman?

Mr. FELDMAN. Thank you. I would like to add a couple of other suggestions to those of my fellow panel members. Mr. Seidman mentioned the possibility of sort of a Peace Corps of accountants and bank examiners to go over to Japan. This is, of course, one way to raise expertise in that area, and I think it is a very, very good idea.

I would also point out, though, that there is a serious problem in cleaning up the real estate sector with organized crime. Many Japanese complain about this. They do not talk about it very openly, but it is very widely believed that that is a serious problem. If there is any advice or help that the authorities in our country could give on how to deal with those sorts of situations, that would be, I think, very welcome and very effective.

The introduction of a new servicer law by the LDP to clean up title to property and get those things moving is a big step forward, and I think the Japanese authorities, particularly the LDP, needs to be congratulated for giving that a high profile. But it is not going to work unless we have some more progress on the organized crime clean-up front.

One other thing, and it relates to a point that Mr. Kubarych mentioned earlier, is the sense of fairness among the Japanese population. I have lived in Japan now almost 13 years out of the last 30, back and forth, straight for the last 9, and in my view, the greatest barrier to a more active reform orientation toward policy is a sense of fairness, that the burdens of aging and the burdens of financial bail-out will be borne fairly among the population.

The biggest objection we hear to the Total Plan that the LDP has put out, is the fear that the system will be highjacked and be used to save the friends of the politicians and bureaucrats in the construction industry at the expense of the banks or the taxpayer.

So I think the first thing that I would recommend, and this is any advice or support we could give, is for the Japanese to introduce a water-tight, indeed, air-tight, taxpayer ID system.

There is no way right now that the tax authorities can trace income, so there is a wholesale evasion in all types of income. Without a taxpayer ID system, I think that there is no hope that a sense of fairness can be generated, which is the essential basis for distributing a burden fairly.

The CHAIRMAN. Thank you. Senator Moynihan?

Senator MOYNIHAN. This is disorienting. Every problem Japan has, we do not, and vice versa. One point, just on the convoy analogy. As an old sailor, may I suggest that the point about convoys is that ships frequently sink in convoys, but the convoy can only move as fast as the slowest ship. It is a little-known detail.

Can I ask, Mr. Kubarych, that fascinating table in the back of your testimony, on the consumer price inflation, the producer price inflation, 3 years ago the Japanese were in a deflationary mode, were they not?

Mr. KUBARYCH. They have been in that deflationary mode now for a very long time, and it continues.

Senator MOYNIHAN. Producer price and consumer price is just over the line.

Mr. KUBARYCH. The only reason the consumer prices are up, to tell you the truth, is because they put the consumption tax higher, and that is picking that up.

So, basically, if you took out the consumption tax, their consumer prices would also be flatter, or negative.

Senator MOYNIHAN. You have us down at 1.36, which I guess is mostly the oil prices.

Mr. KUBARYCH. Oil prices. Yes.

Senator MOYNIHAN. But if you would listen to our economist friends, including the chairman of the Federal Reserve Board, our CPI clearly overstates inflation. I see Mr. Seidman agreeing.

Mr. KUBARYCH. Everything except my cable TV charges, which are going up about 19 times faster than the rate of inflation. But they do not have that in there.

Senator MOYNIHAN. They probably do not have it in there.

Mr. KUBARYCH. Right. So there are distortions on both sides of that equation.

Senator MOYNIHAN. Fine. But we could be edging toward a deflationary moment, could we not?

Mr. KUBARYCH. Well, we certainly would if we had the dollar roaring to 160 or 180 on the Japanese yen. We could temporarily have negative CPI for quite some time.

Senator MOYNIHAN. Yes. Well, I would just like to hear that. It has been 50, 60 years since we have had to think about deflation, and I do not know that we think about it very well.

Dr. Feldman?

Mr. FELDMAN. Actually, there was a very interesting speech given by Chairman Greenspan back in January of this year at the American Economics Association.

Senator MOYNIHAN. Yes, sir. In Chicago.

Mr. FELDMAN. And he pointed out three types of deflation in that speech, and I think it is very important to distinguish which type of deflation we have.

His first, was what he called asset deflation; when land markets or equity markets crash, that kills the demand in the economy and you get deflation. Prices go down, income goes down, too.

A second type, is when you have contractionary policy. That causes the same result. But the important thing, is he mentioned a third type of deflation, is when you have supply-side improvements, such as more open trade, labor market improvements.

Senator MOYNIHAN. And oil prices drop.

Mr. FELDMAN. Oil price is down, technology. My little watch here that cost 3,000 yen can do things that even the most expensive Rolex could never dream of doing a few years ago.

When those technology improvements or other supply-side improvements occur, the supply curve moves outward. That brings prices down, but it brings income up. There have been different phases in the United States and in Japan where we have had different types of deflation at different times.

In the United States right now, there are clearly some demand-side inflationary pressures that are not to be dismissed, hotel rooms being one of them, but there are also some very strong supply-side downward pressures on prices. If the downward pressure on price in the U.S. does, in the end, come from improvements in technology or other areas, then it is not a problem.

Senator MOYNIHAN. You do not have to be concerned.

Mr. FELDMAN. In Japan right now, we have all three, and that is a problem.

Senator MOYNIHAN. Well, thank God you are there. Here.

Dr. HORMATS. To follow that up, I think there is one corollary element that is useful to mention, and that is that the Asian crisis and the lower energy prices have really shifted price-setting power away from the manufacturing sector to the services sector in an interesting sense.

That is, by lowering interest rates, the housing sector and anything related to it has benefitted enormously from that, whereas, if you are in the industrial sector, because of imports and weaker demand, your price-setting capability has been dramatically reduced.

I think there is that shift, and you can see it in the way the curves are in terms of prices of services, which are strengthening in prices of raw materials and manufacturers, which are weakening.

Mr. SEIDMAN. I would just like to add that, because of this deflation, they have moved these extraordinarily low interest rates arbitrarily. If you look at the balance sheet of the Bank of Japan, it is going right straight up now as they are providing the funding.

This policy, this distortion, is going to defeat all the other efforts if something is not done about that. Now, that takes the political courage to raise interest rates when you have a recession. That is not easy to do.

But of all the courageous things they have to do, I would say that that is number one, because with the distortions they are getting from that they simply will lose value in the yen no matter what else happens. It has not provided any incentive for their economy recovery that can be seen, so I would say they tried that and it failed and they had better change that policy.

Dr. HORMATS. Mr. Chairman, can I raise one point that you mentioned earlier? You mentioned G–7, or what kind of group might be constituted to deal with this. I think there is, at least I feel, and I think my colleagues on the panel feel, a sense of urgency about this, and I believe members of the committee as well.

One group that has been very useful that the U.S. actually is responsible for putting together is what is now known as the Group of 22, which is a number of industrialized countries, it includes the G–7, plus a number of Asian economies, particularly the crisis economies, and it deals with emerging markets.

I think at some point it might be useful for the U.S and Japan, or as a co-host, to consider a summit of that group. Now, summits in themselves do not achieve miracles by getting heads of state together and talking.

Sometimes they do not do anything, in many cases. But in this current environment, it seems to me that there are a broad number of issues, a number of them we have focused on are Japan-related. But there are a lot of other problems that the emerging countries are dealing with that are not only Japan-related, but creating some sense of urgency, visibility and movement, sometimes, is something a summit can do.

In the oil crisis, as you both will recall, we did that. We used these meetings to create a sense of urgency for solidarity among the industrialized democracies; here you need a broader group. But it is better than the G–7, because the G–7 does not include these emerging economies.

These countries would use it to put some pressure on Japan, true, but it would also perhaps enable the Japanese who want to move forward with bolder action to use that kind of target as a way of getting more action internally in Japan to fulfill the responsibilities to Asia. Just a thought.

The CHAIRMAN. Mr. Feldman.

Mr. FELDMAN. If I can add, I think there is also a role to be played by parliamentary exchanges, particularly exchanges with some of the opposition parties as well. I think someone pointed out earlier that the importance of political competition is extremely large. That is, when the LDP, for example, faces competition they tend to move a little bit faster.

When the Democratic party began to form in, I think, January of this year, all of a sudden, the LDP started to move a little faster itself. Competition is good for all of us, even though we do not like it. I think that is true in politics as well, certainly in Japanese politics.

So if there could be anything done at the parliamentary level to perhaps give a little support and sympathy and compassion from our side to Japanese legislators on both sides of their aisles, or many aisles, or all sides of their aisles, that would be helpful.

Senator MOYNIHAN. Dr. Feldman, Democrats need sympathy in this country as well. [Laughter.]

The CHAIRMAN. Gentlemen, I hate to turn off this discussion, as I think it has been very helpful. I know that Senator Moynihan joins me in thanking you for being here today. We will continue this dialogue in the future. But, again, thank you for your contribution.

We will now turn to the third panel of American corporations with business interests in Japan. Our first witness is Henson Moore, the former Congressman, Deputy Secretary of the U.S. Department of Energy, who serves currently as the president and CEO of the American Forest and Paper Association. He will be followed by Ambassador Alan F. Holmer, former Deputy USTR, and now president of the Pharmaceutical Research and Manufacturers of America. Our third witness is Peter Walters, the group vice president for Guardian Industries Corporation. The final witness is Brad Smith, the director of International Relations of the American Council of Life Insurance.

Gentlemen, it is a pleasure to have you here. We will start with Ambassador Holmer.

Mr. Holmer?

STATEMENT OF ALAN F. HOLMER, PRESIDENT, PHARMACEUTICAL RESEARCH AND MANUFACTURERS OF AMERICA, WASHINGTON, DC

Mr. HOLMER. Thank you very much, Mr. Chairman. It is a real privilege for me to be back here before the Finance Committee. I represent the research-based pharmaceutical industry, companies like Zeneca from Delaware, from New York, Bristol-Meyer, Squibb, Pfizer, and other companies.

Our industry is clearly the world leader in pharmaceutical innovation. If you look at all pharmaceutical R&D worldwide, our industry from the U.S. has one-third. It is very efficient research and development. With one-third of the R&D, we produce about one-half of all of the new medicines in the world.

The discovery process is very risky. As you may know, it takes about 12 to 15 years and about $500 million in order to bring one new medicine to market. The Japanese market is one that is extremely important to us. It is a total market of about $64 billion per year. Our companies have about 15 percent of that market.

You might ask why, if we discover half of the new medicines worldwide, we just have a 15 percent market share. That is a fair question. Our biggest challenge is a regulatory regime in Japan that denies patients access to our medicines.

According to a study completed by Professor Thomas from the Emory School of Business, since 1991, out of every 10 new medicines launched in the United States and Europe, only 3 are available in Japan. This is an incredible statistics. Seven out of 10 new medicines are not available to Japanese patients.

None of the three leading medicines for depression is available in Japan, nor are major medicines for epilepsy, migraine headaches, prostate disease, or leukemia. This is particularly striking in a wonderful country like Japan that prides itself on being modern.

For those of you who have traveled to Japan, you know that if you want top-quality audio equipment you can go to the Aki Habara section of Tokyo. If you want a powerful super-computer, you can go to Kawasaki. If you want the newest liquid plasma display screen, you go to Osaka. And, for the most part, if you want state-of-the-art pharmaceuticals, you go to Nerita airport, you get on a plane, and you go to Europe or to America.

Part of the problem, is that it takes an average of 40 months to approve a new medicine in Japan, 40 months there, about 15 months here at the FDA.

Another part of the problem, is that the Japanese reimbursement system does not reward innovation. We hope that in their reforms the Japanese will focus on free markets and on choice and competition.

Japanese policy makers are toying with the idea of establishing reference pricing, which would bundle drugs in various therapeutic categories for reimbursement. Basically, what it would do would be to take new innovative drugs, put them together with old copycat drugs, and subject all of them, old and new, to the same reimbursement rate.

If you pay the same price for old drugs as for new drugs, obviously that provides no incentive for innovation. The Germans tried this system several years ago. It virtually stopped innovation in Germany. It denied medicines to German patients. It did not work in Germany, it will not work in Japan.

Fortunately for us in the pharmaceutical industry, we have had amazing support from this committee, certainly from the three of you Senators here at the moment. The Clinton Administration has been listening. The May 15 agreement between Japan and the U.S. reached in Birmingham, England gives us great hope for the future.

Now, I know from my experience as Deputy USTR in the Reagan Administration that there can sometimes be a big gap between a

Japanese governmental commitment and actual implementation of that agreement.

But we are hopeful. We believe that the commitments made by Japan to deregulate the health care sector for medicines will create greater incentives for medical innovation, and that these can create cost savings in health care in the future, and that will assist Japan in moving out of its current recession.

A reform program founded on deregulation in the pharmaceutical sector could serve as a catalyst for Japan in restructuring its hierarchical, bureaucracy-driven business model in order to be able to meet the new global challenges of the 21st century.

But, in summary, Mr. Chairman, Senator Moynihan, and Senator D'Amato, we want two things. We want policies that promote innovation in new drugs through market-based pricing, and second, we want a faster drug approval process that would be in line with the rest of the world so that patients can receive safe and effective medicines that are going to provide cures and treatments for diseases that they face.

This is in the interest, clearly, of the companies that I represent, but it is also very much in Japan's interests. We will do all that we can to move Japanese policy makers in that direction, and we look forward to the leadership of this committee as we fight that battle. Thank you very much.

The CHAIRMAN. Thank you, Ambassador Holmer.

[The prepared statement of Mr. Holmer appears in the appendix.]

The CHAIRMAN. Congressman Moore, it is nice to welcome you back.

STATEMENT OF W. HENSON MOORE, PRESIDENT AND CEO, AMERICAN FOREST AND PAPER ASSOCIATION, WASHINGTON, DC

Mr. MOORE. Thank you, Mr. Chairman. It is good to be back. I want to compliment you and the committee for having a hearing on a very critical subject at a very critical time.

I am the president of the American Forest and Paper Association, which is the trade association of the American forest products industry. As such, we are the largest producers of wood and paper products in the entire world. The next three countries combined do not equal the production of the United States' industry.

We can say that today. I hope we can say that a few years from now, as we are a heavy industry and we are coming into increasing problems in terms of dealing with markets overseas, and that is the reason why we are here today, I think.

Mr. Chairman, so far, the testimony of the panels has dwelt on two provisions of a three-legged stool that I understand is the basis of agreement between the U.S. Government and Japan. We have heard testimony about banking reform, we have heard testimony about the need to do something for economic stimulus.

But the third thing that former Prime Minister Hashimoto agreed to, and this government agreed to in propping up the yen, and it was referred to as late as yesterday in a statement from the White House, was the fact of market liberalization, opening up their markets to our particular products, or products from that part of the world as well.

You asked the question, Mr. Chairman, at the beginning of this hearing, are economic reforms proposed by Japan sufficient? In the case of opening up their markets, woefully insufficient. We can answer your question with a resounding no.

A good example of that, is the progress that is going on with the APEC tariff initiative. There are nine sectors that have been involved in that, and we are one of those sectors.

Recently, at the meeting two weeks ago, or just last month in Kuching, Malaysia, where our trade ministers met, including our own who did an outstanding job in keeping the talks alive, Japan was the only outlier.

Japan is the only country to simply say, no, we are not going to be a part of this. They are arguing to take six of the nine sectors off the table. That has been put off for the time being.

We have one more chance. The trade ministers meet again in September. So something has got to be done between now and September to change this situation or the only tariff negotiations going on right now between the APEC governments will come to an untimely demise.

There are three reasons, basically, in our mind why this ought not happen. One, it is important to our industry and to all industries involved in terms of opening up exports to that part of the world, and also seeing to it that other exports in that part of the world have access to the Japanese market. Currently, 40 percent of the exports of our industry go to the Asian region of the world.

As I have heard Dr. Hormats say a few minutes ago, that he expects the exports to that part of the world from manufactured goods to go down and the imports to go up. I can give you the figures for the first quarter of this year from our industry, which show that in a very dramatic fashion.

Our exports to Asia, 40 percent of our exports, is down 44 percent in wood products in the first quarter of last year, down 31 percent in wood pulp, down 11 percent in paper and paperboard, down 25 percent in newsprint, down 36 percent in printing and writing. Those are exports we are not making, those are jobs now in the United States, some 1.6 million of them, that are now in jeopardy.

In the reverse, looking at the imports coming in from that part of the world by virtue of the devaluation of the currencies, wood products are up over 18 percent over the first quarter of last year, paper and paperboard up 44 percent, printing and writing paper up 138 percent, newsprint up 700 percent.

Now, those are rather dramatic numbers to prove what is happening by virtue of what is going on in that part of the world.

The other countries that are a part of APEC feel like the collapse of their economies are a reason to bring about the reduction in tariffs. Japan is taking just the opposite thinking process. They are using it as an excuse not to do it.

All the other countries harder hit than even Japan, such as Indonesia, Malaysia, and Thailand, are all saying, no, we have got to go into a reduction in tariffs in these nine sectors to really bring about a recovery of the economies of that part of the world.

So the first reason is, it is certainly important to our domestic industry in terms of exports and imports, as we are paying a double jeopardy price at the present time by virtue of what is going on in that part of the world.

Second, it is certainly important to the Japanese consumers. Japanese housing is some of the most expensive in the world. It will go down when they take the tariffs off of building materials and allow us, and others including Malaysia and other parts of the world, to begin furnish building materials into a very sheltered domestic industry, heavily protected by the tariff structure. The same thing is true of paper products going into Japan.

Third, it is critical to the rest of the region. You have heard it said over, and over, and over again by the witnesses this morning that we are really worried about a bigger problem than just Japan's economy, we are worried about that whole part of the world.

Japan is the key to recovery of that part of the world. If they do not open up their markets to products being made in those other countries, then how is it those countries are going to be able to ever really bring themselves back into any kind of profitability or any kind of stability?

I also think it is a little bit unfair to have the United States bear the brunt of this. We support IMF, and we should. At the same time, we are taking the imports from that part of the world by virtue of devalued currencies, Japan is not.

So we are really paying for this twice. It is not really fair to our taxpayers and our workers here to bear the brunt of this. Japan has a duty to step up to the plate, be a leader in that part of the world, and see to it that that part of the world has a chance to begin to increase its exports.

The question has been asked by you, Mr. Chairman, and by Senator Rockefeller, what can be done? A lot can be done. It has been my experience that the Japanese Government moves on these kind of matters when it becomes very critical to the American Government.

Therefore, I think this committee, this Senate, this Congress, and certainly this administration, have to be resolute in dealing with the Japanese Government between now and September in terms of moving forward with trade liberalization. The only thing on the agenda right now in terms of any kind of negotiations are the APEC tariff initiatives. They have got to move forward to endorse that.

We have a number of letters that have been sent to the White House, including letters by you three Senators, 15 Governors, trade unions, all of the businesses in our industry. I would like to ask that those letters be made a part of the record at this point, Mr. Chairman, all asking the President to make this a number one issue in terms of negotiations with the Japanese Government.

The CHAIRMAN. Without objection.

[The letters referred to above were retained in the committee files.]

Mr. MOORE. The time is not to wait. The Japanese Government may say at this point, by virtue of the elections and our Prime Minister resigning, we have got to put this off. We do not have time, Mr. Chairman. The trade negotiations will be over in September.

We do not have time to wait. You have heard from the other witnesses about what is likely to happen in that part of the world if Japan continues to stall and not take the actions that it should.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Moore appears in the appendix.]

The CHAIRMAN. Mr. Smith?

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

Mr. SMITH. Thank you. Mr. Chairman and members of the committee, on behalf of 532 members of the American Council of Life Insurance, I would like to thank you for giving us the opportunity to raise this important issue.

At the beginning of 1998, our International Committee authorized the creation of a new task force to monitor compliance and implementation of current and future insurance trade agreements.

Its first project was to answer USTR's request for industry input on the Japanese Government's implementation of the 1994 and 1996 U.S.-Japan insurance agreements. For U.S. insurers, the Japanese insurance market remains highly restrictive and extremely difficult to penetrate.

At $407 billion a year in annual premium volume, it is the largest life insurance market in the world. Yet the foreign market share in Japan is a mere 3.9 percent. By contrast, the foreign market share of every other G–7 country is at least 10 percent, and in some cases it exceeds 30 percent.

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

However, the overall goals of these agreements are far from being achieved, and until such time as Japan fully implements the commitments it has made to substantially deregulate the primary sectors of its insurance market in a transparent manner, it is obliged to maintain existing protections for foreign firms that have created significant market niches within the so-called third sector.

In terms of liberalizing the primary insurance sector——

Senator MOYNIHAN. Could I ask the third sector, sir?

Mr. SMITH. Certainly. The Japanese market is divided into three sectors. First, is non-life, second is life, and third is anything that does not fall under life or non-life.

Senator MOYNIHAN. Thank you.

Mr. SMITH. In terms of liberalizing the primary insurance sectors, which represent 95 percent of the Japanese market, I have listed the many specific items of noncompliance in my written testimony, although I will be happy to answer any questions you might have.

In sum, this not only means that the Japanese insurance markets remain effectively closed to U.S. insurers, but the Japanese consumers continue to be denied the benefits of a competitive insurance marketplace.

Similarly, we are extremely concerned with the diminution of the third sector safeguards caused by increased activity of Japanese insurance firms and subsidiaries in this segment of the market.

The desire of Japanese business to participate in the third sector provides our negotiators with significant leverage to encourage liberalization of the primary sectors, which was the purpose of the 1994 and 1996 agreements.

Under the 1994 agreement, the Government of Japan pledged to continue longstanding limitations on entry by Japanese insurance companies into the life portion of the third sector, as well as specific restrictions on third sector activities by Japanese life and non-life companies and their subsidiaries.

These limitations must continue until primary sector liberalization has been achieved and a transition period of not less than two and a half years has expired. The purpose being to enable foreign firms—in this case, the U.S.—to establish some toehold in the primary sectors before they face the onslaught in the third sector from large Japanese companies. Without enforcement of this provision, the foreign share of Japan's market, which is already small, may actually fall.

ACLI member companies report that the Ministry of Finance has failed to live up to its key provisions in several critical ways. First, it has allowed the second-largest Japanese non-life company, Yasuda, to create a de facto subsidiary through its partial ownership of INA/Himawari, thus creating a "radical change" in the third sector, a clear violation of both agreements.

This circumvention has created extreme pressure on the Ministry of Finance to allow other large Japanese insurance companies into the third sector. The most egregious case being a cancer insurance product rider done by Tokio-Anshin, the new life subsidiary of Tokio Fire and Marine Insurance Company, which is Japan's largest insurer.

Even as we speak, companies are reporting potential new problems in Japan's third sector. The specific concern is that protected products, such as group, personal accident, or cancer insurance, which represent the largest share of U.S. premium volume in Japan in the third sector, are being offered by Japanese companies under new sales mechanisms, which represent, in our contention, "radical change" in the third sector.

With all of this in mind, we firmly agree with USTR's July 1 conclusion that, as things stand today, the 2½-year countdown to the opening of the third sector should not begin. The countdown should not begin until, as the bilateral agreements require, there is substantial deregulation of the primary sectors, which was the purpose of the agreements.

The objective of the bilateral agreements was to increase American insurance companies' opportunities in the Japanese market by improving market access for foreign companies, improving market competitiveness, and promoting consumer choice.

When Japan lives up to these commitments, the real beneficiaries will be the Japanese consumers, who for the first time will be able to buy innovative and competitively priced products.

I would be pleased to answer any questions you have.

The CHAIRMAN. Thank you, Mr. Smith.

[The prepared statement of Mr. Smith appears in the appendix.]

The CHAIRMAN. Mr. Walters?

STATEMENT OF PETER S. WALTERS, GROUP VICE PRESIDENT, GUARDIAN INDUSTRIES CORPORATION, AUBURN HILLS, MI

Mr. WALTERS. Thank you, Mr. Chairman, and other distinguished committee members. My name is Peter Walters. I am group vice president of Guardian Industries Corporation of Auburn Hills, Michigan.

Guardian is a major worldwide manufacturer of flag glass products used mainly in the construction and automotive sectors.

I would like to tell you of our experiences in the Japan flat glass market.

Guardian Industries has worked for the past decade to achieve access to the Japanese market. Another U.S. competitor, PPG Industries, has been in Japan for over 30 years. Together, we still account for little more than one percent of the Japanese market. In other major countries, Guardian alone typically enjoys a market share of 10 to 20 percent.

Guardian's market entry strategy in Japan was one that has worked well elsewhere: winning customers by providing high-quality glass products at competitive prices.

From the outset, we met a stone wall in Japan. With minor exceptions, neither glass distributors nor glass fabricators would handle our products, despite prices 30 to 50 percent below current market prices.

It became clear that the problem centered on Japan's distribution system. Each of the three Japanese flat glass companies, Asahi Glass, Central Glass, and Nippon Sheet Glass, maintain an exclusive network of distributors that operate as a cartel, maintaining steady market shares of 50, 30, and 20 percent respectively, dating since the early 1950's. There has been literally no change in market share of those three companies in the last 40 years.

Foreign suppliers clearly are not a part of the club. Distributors are discouraged from buying imported glass in a variety of ways, including threats that their domestic sources of supply will be cut off.

Guardian created a sales subsidiary and opened a network of warehouses to provide just-in-time inventory. PPG entered into a joint venture with a Japanese trading company to handle marketing and sales. Neither approach has worked.

In June of 1993, the Japan Fair Trade Commission confirmed the extent of anti-competitive behavior that we found to exist in the flat glass market. However, the JFTC decided not to impose penalties, arguing that the glass companies had already agreed to take reform measures. These industry measures accomplished little.

In recent years, the U.S. Government has worked hard to break down the obstacles to market access in Japan. The Bush Administration was the first to take up the issue. In the 1993 Bush-Miazawa action plan, the Japanese Government undertook to substantially increase market access for competitive foreign firms. Unfortunately, our own election period intervened and the agreement was ignored.

In January of 1995, U.S. Trade Representative Mickey Kantor concluded a bilateral flat glass agreement with then-MITI Minister Hashimoto. The 5-year agreement spelled out the responsibilities for all parties to create an open flat glass market. We believed at the time that this agreement, if properly implemented, would be helpful.

We are now more than half-way through the 5-year life of the flat glass agreement, and I must report that the results have been disappointing. Things looked promising for about 6 months after the agreement took effect, then there was a very pronounced turnabout. Sales rapidly eroded to the pre-agreement levels, where they remain today, and there are no signs of improvement.

A MITI survey released earlier this year found that foreign suppliers still account for only 2.8 percent of the market. Even worse, fully 80 percent of Japanese distributors are not planning to buy imported foreign glass.

The Japanese insist that the market is open because they have declared that it is open. Meanwhile, our salesmen report continuing anti-competitive behavior in the marketplace.

In May, the U.S. Trade Representative and the U.S. Department of Justice proposed that the Japanese flat glass companies adopt anti-monopoly compliance plans patterned after those common here in the U.S.

This proposal was only a procedural one aimed at ensuring full implementation of the bilateral flat glass agreement. It raised no new issues. The Japanese Government flatly rejected the proposal, apparently arguing that Japanese companies must be found guilty of anti-competitive behavior before they can be required to adopt compliance plans.

As an alternative, the Japanese side announced that the JFTC would be taking another look at the flat glass market, but had no specifics on when this study will begin or what its scope will be.

From our point of view, the JFTC study is another delay tactic. We have only 18 more months to run on the current agreement. The JFTC study will easily chew up another year, and while we wait for it, the Japanese will argue that nothing can be done.

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

Comprehensive deregulation is in Japan's interest, as has been stated over and over this morning. The Japanese people are embracing deregulation and change, despite resistance from politicians and bureaucrats. Japanese consumers, not Guardian, would be the main beneficiaries of an open and competitive flat glass market that expands access to new energy-saving technologies, provides incentives for innovation, and provides more choice at competitive prices.

The U.S. Trade Representative's office, our embassy in Tokyo, the Departments of Commerce, Justice, and State have worked hard, and the administration has had the clear and strong support of the Congress.

Despite these efforts, there has been little progress. At a time when trade frictions with the United States are beginning to increase, it should be in Japan's interests to resolve as many outstanding trade issues as possible, and flat glass is certainly resolvable.

I might add that, in a period of a weak yen, is precisely the period when it makes sense to open a market, since the chances of imports damaging domestic industry would be at a minimum.

Mr. Chairman, I believe that market access must be a central issue, along with the reform of the financial system and macroeconomic policy, that should be immediately addressed when Japan's new government is formed. It is especially important that existing market access agreements, such as flat glass, be faithfully implemented. Thank you very much. I would be delighted to answer any questions.

[The prepared statement of Mr. Walters appears in the appendix.]

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I think Mr. Walters made a very good point, that if ever there was a moment when the Japanese could decide to keep their agreements or their undertakings, the currency relationship is such that they are least likely to have an exogenous phenomenon affect the trade. And they do not. This kind of market capitalism does not budge, does it?

Mr. HOLMER, MR. MOORE, MR. SMITH, WE HAVE HAD, WHAT, 43 AGREEMENTS SINCE 1984? YES. Since 1984, we have had 43 trade agreements with the Japanese, and nothing happens.

I think this may have contributed to their problems, and I think we ought to tell them we think it has. Closed economies do not work. We have been trying to teach that to the world since 1934. If we do not get some response, we are going to have the same reactions here. We already are. It is no accident that we have not been able to get fast track renewed.

I think it is time for a measure of indignation. I do not want to be confrontational, but nothing else seems to work, sir. But thank you for first-rate testimony.

The CHAIRMAN. One of the problems, as I understand your testimony, Mr. Smith, is even if you do have an agreement that purportedly is to help open up, the implementation is as difficult as the initial negotiations.

Mr. SMITH. I think, as Senator Moynihan stated, it would seem to be in the Japanese interest at this point for their overall economic stability to increase, in trade parlance, the transparency of their regulation to make it a market-based economy, as opposed to this flee approach, which some of the earlier witnesses were talking about. It is certainly in the interest of Japanese consumers to do the same thing.

It is somewhat ironic that we have two insurance trade agreements, both with the same objective, 2 years apart. The second one was really to get implementation of the first.

Senator MOYNIHAN. Yes.

Mr. MOORE. Mr. Chairman, we have a similar agreement of an agreement that expired last year. Japan has a 4.2 percent import penetration of our products, the lowest in the world. No country in the world imports less paper products than does Japan.

We had an agreement with them from 1992 to 1997. The American penetration was 1.9 percent when the agreement started. By the time the agreement was over with, it was 1.8 percent. They unilaterally canceled the agreement and refused to renew it.

The CHAIRMAN. Senator D'Amato?

Senator D'AMATO. Mr. Chairman, let me just make the observation that I certainly appreciate your holding the hearing. I am sorry I could not be here earlier; we had some other activities.

But it is very startling testimony, coming from different industry sectors, and we hear the same stories. So let me just ask, do any of the panelists believe that the Japanese will change their method of operation as it relates to permitting some kind of competition coming in, legitimate competition? I mean, do any one of you believe that they are going to change?

Mr. MOORE. I do not.

Senator D'AMATO. No. Mr. Holmer?

Mr. HOLMER. I think, on behalf of the pharmaceutical industry, we have not given up yet. I think we may not have had experiences in the past that forest and paper, insurance, or glass my have had. I think we are going to try to go to school on the semiconductor industry. That may be one of the exceptions that proves the rule.

We had an agreement in 1986 on semiconductors. I have not checked the numbers most recently. But you did have a very significant increase in the level of import penetration with respect to semiconductors. That only happened because this committee, the executive branch, and U.S. industry was all over that agreement to make sure that it was implemented in great detail.

We are going to take the same perspective with respect to the agreement that was achieved on May 15. We have an agreement, and we are on a good glide path, I think, with the Japanese at the moment. But just if we get an agreement, we are not going to say, well, that is great, we can now move on to other business. We are going to be vigorous in terms of making sure that the Japanese Government does implement the commitments they undertake.

Senator D'AMATO. Well, that is what you are going to try.

Mr. HOLMER. Yes.

Senator D'AMATO. And you pointed to one example where the U.S. Government became tremendously involved. Lacking that——

Mr. HOLMER. Right. What I hope that we will be able to do, is to persuade the consumers in Japan, the patients in Japan who are denied access to our innovative medicines, that they should not have to put up with that kind of situation, and that the health care costs in Japan are going to go down if they purchase more of our innovative medicines and will allow them to have those costs go down.

Senator D'AMATO. How are you going to get that message to them?

Mr. HOLMER. Well, we are doing it at every avenue that you can imagine, on the ground in Japan, through our excellent embassy in

Tokyo, through our U.S. Government representatives here, through terrific letters that——

Senator D'AMATO. I mean, are you going to buy advertising?

Mr. HOLMER. Are we going to buy it?

Senator D'AMATO. Yes. Do you think they are going to print them? You are saying that Japanese pharmaceuticals are not providing the people of Japan with this level of, let us say, medicine or medical help that you could achieve? You are telling me this, and I see a tremendous commitment from you. You are terrific; I would hire you for anything. But, I mean, you are going to whistle Dixie if you think the embassy is going to get the message out to the Japanese consumers. I mean, come on. That is my observation.

Mr. HOLMER. Right.

Senator D'AMATO. I mean, you are a great, talented guy. We have worked on a lot of issues together. But you are going to try to break that down. You think they are going to try to change on their own?

Mr. HOLMER. No.

Senator D'AMATO. Mr. Smith, what do you think?

Mr. SMITH. I would just say that there are several leverage points for our industry. We have the 1996 agreement, which has the specific provision that the liberalization of the third sector should not occur until two and a half years after the primary sectors are opened.

Senator D'AMATO. What is your penetration?

Mr. SMITH. It is 3.9 percent. The U.S. has the largest share out of any foreign country in the market. Also, Japan bound the bilateral commitments with the United States in the WTO agreement that was signed on December 12 of last year. If we have to, we will do a dispute resolution within the WTO.

I would just say that, as with a lot of these agreements, it is not so much negotiating the agreement, it is following through on the implementation. That is a strong role for USTR and the other U.S. executive branches to play, and for this committee and others to oversee.

Senator D'AMATO. I think the USTR would be spinning its wheels there through my grandchildren's lifetime. There is not going to be any change, not unless we really work this thing the right way to find the pressure points. Mr. Holmer, you know that. You never got anything without it coming down from the President, the Congress, and the threat of serious repercussions. Do you think we are going to get anything without that? Mr. Walters does not. What do you think?

Mr. WALTERS. No, I do not.

Senator D'AMATO. I mean, two out of four of you are in the real world. The other two, first you come and you tell us this horrible story of not being able to get your products in there, then you say, well, but we are not going to give up. Of course you are not going to give up, but do you think it is going to change without there being a real effort from this government, from our administration, or from whatever administration?

Mr. HOLMER. Senator, I agree with you that there will not be an achievement of what we want to have without significant resources of the U.S. Government, and we are going to do everything we can to make sure that that happens.

Senator D'AMATO. I will tell you, I do not know how business people tolerate it. You should really be totally outraged about this and be organizing here. You talk about your efforts over there. Who is going to listen to you? How are you going to carry your message? How are you going to get that message to consumers? I do not see it. You have been working there for years and years, and this fellow over here tells you about the way things never change. Your agreement has almost run out.

Mr. Chairman, again, I want to thank you and commend you for holding the hearing. It is illuminating. I think it is rather appalling and depressing. Very distressful.

The CHAIRMAN. It is very much so. Well, gentlemen, it is 1:00.

Senator MOYNIHAN. We have been here three and a half hours.

The CHAIRMAN. I know all of us feel the pangs of hunger. So I want to thank you for your patience, and for being here today. It has been very helpful. The committee is in recess.

[Whereupon, at 1:05 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. ALFONSE D'AMATO

Mr. Chairman, thank you for holding this important hearing today. The economic state of affairs in Asia, and in particular Japan, is of great interest to me and my state. I have many concerns, and will be following the events in Asia very closely in the days and months ahead.

With regard to the current economic situation in Asia, it is very important to look closely at all the facts and gather as much information as possible. One important consideration Congress must take into account in the upcoming days is to ask ourselves "Is the crisis in Asia a financial crisis or an economic crisis?"

By that I am talking about the difference between a crisis based on a liquidity crisis due to inadequate funds to meet current financial obligations and short term currency inadequacies, or a situation which is far more serious—a solvency crisis resulting from a system of closed banking and capital markets, failed industrial policies, and Chaebols and keiretsu, or conglomerates which consist of intertwined relationships between banks, the government and commercial interests.

If the answer is that the crisis in Asia is a liquidity one, then the IMF loans to Asia will provide a necessary bridge for the economies of Asia to recover. However, if the situation in Asia is the result of a solvency crisis, then the situation is much more desperate and will require much more drastic measures.

If the actions of the International Monetary Fund in Asia are to have any truly lasting and constructive effects, it is essential that the IMF get commitments from foreign governments that the policies that were adhered to in the past will be abandoned immediately, and policies of sound financial practices adopted in their place. The governments of Asia must open up their financial systems to greater transparency, and refrain from government intervention in the markets.

IMF funding must be tied to very strict requirements for recipient countries to reform structurally their financial markets and their economic policies. The reforms must be tailored to each specific Asian country's needs and they must be unwavering in their demands for reform. These reforms must also include improved transparency and bank supervision and the breaking down of the intertwined relationships between the banks, the government and corporate Japan.

If the situation in Asia is to be turned around, the IMF and the Asian governments must encourage capital to return to their economies. The only way to do this is for Asia to embrace sound financial practices and transparency in the financial marketplace. The governments of Asia must end the current capital flight. If this situation is not remedied immediately, the IMF will simply be financing capital flight and currency speculators.

Japan has a fundamental obligation to the region to become the leader in financial reform and assist the Asian economies surrounding it to also reform their economic and financial systems.

Mr. Chairman, I am more concerned now than ever before with the continuing economic roller coaster ride in Asia and the Japanese financial market. The economic indicators used to take the pulse of the Japanese economy all come back unhealthy. Perhaps one of the reasons for this steep economic unrest is the closed, manipulated market system which the Japanese government has chosen to create and protect.

For example, Mr. Chairman, the Japanese government continues to manipulate the way foreign goods are distributed, marketed, and displayed in retail outlets throughout their country. One of the most blatent examples of this predatory market manipulation can be seen in the case of Kodak film.

The Japanese government has erected a series of walls and hurdles that make it impossible for a foreign company to compete on an equal playing field. In effect, the Japanese government simply "privatized" protection, delegating the function of blocking foreign penetration of the market to private industry groupings, and painstakingly guiding the the restructuring of those groupings to maximize the degree of protection achieved. Plain and simple, Fuji has used Japan's lax anti-trust laws and closed market system to erect barriers to free and open competition.

Additionally, the activities of foreign insurance companies in the Japanese market are hampered by a restrictive distribution system of cross-ownership ties, and a complex regulatory regime. Japan is the world's second largest market for insurance with more than $382 billion in total premiums in JFY 1994. While foreign share of other industrialized countries' domestic insurance markets ranges from 10% to 33%, foreign firms' share in Japan was only 3.3%.

Part of the difficulty in penetrating Japan's insurance market arises out of legal requirements which segment the distribution system and product market in a manner that does not allow foreign insurers a clear set of guidelines on how to deal with the Japanese government and stifles their ability to employ many of the innovative and non-traditional products used in other markets which would allow an expansion of their market share. The rules necessary for obtaining a license to do business in Japan are not always clear. They tend to be subjective and allow for considerable bureaucratic discretion.

Market access, Mr. Chairman, is of paramount importance to maintaining tree and open trade. American companies must have the opportunity to bring their products to market. Without truly free access to consumers, U.S. goods and services will never get a fair opportunity to compete, and the United States' trade deficit will surely spiral out of control.

The days ahead will be tough ones for the Asian tigers, and the government of Japan, and I do not envy the governments of those nations as they try to rally their people behind what will surely be very difficult policies. But they must begin the long path and I just hope they find the strength to continue.

PREPARED STATEMENT OF ROBERT ALAN FELDMAN

Mr. Chairman and Members of the Committee, it is a great honor to appear before you today. Let me state at the outset that the opinions that I express today are my own, and do not necessarily reflect those of my employer, Morgan Stanley Dean Witter.

Since time is limited, let me go directly into the four topics that I believe are most critical. These are economic prospects for Japan, suggestions for financial sector reform, Japan's role in Asia, and what America can do to improve the outcome.

JAPANESE ECONOMIC PROSPECTS

Unfortunately, Japan's economic prospects are bleak for the next year or two. In fiscal 1997, the year ended March, the Japanese economy contracted by 0.7%. Another contraction is likely in the current fiscal year. Moreover, there are risks that things will turn out even worse.

This sad state of affairs has come about because the private demand is so weak. Business investment suffers from low profitability, poor prospects, the slow pace of deregulation, and weak corporate balance sheets in many sectors. And consumers are suffering from weak income, falling wages, and rising unemployment. In addition, consumer sentiment is plagued by fears about the financial system. Even the largest fiscal package in Japanese history and the lowest interest rates in world history have not been sufficient to offset these headwinds.

There are two ways to address such problems, demand support and supply side reform. In my view, Japan has exhausted the room for maneuver for demand support. Already the fiscal balance of the general government has been brought from a surplus of 3% of GDP to a deficit of about 5%. Further major stimulus would, in may view, risk a government debt snowball.

However, the second road remains open. There is much room for supply side reform, which I define to mean measures that raise the efficiency of resource allocation. Let me give some examples. In the industrial sector, much has been accomplished in some deregulation areas such as retail stores and telecommunications. Domestic long distance charges are at one quarter of their level of 1985. However, vested interests continue to shackle progress in many other areas such as construction, agriculture, distribution, finance, energy, and pharmaceuticals. Price differentials tell the story. Even at today's undervalued yen exchange rate, spaghetti costs twice as much in Tokyo as in New York. In the labor market, mobility needs to be enhanced by raising pension portability. Corporate governance needs to be tightened. And, the trend toward big government, which has accelerated in Japan in the last decade, needs to be decisively reversed.

Even if implemented immediately and aggressively, however, supply side reforms will take time to work. Both Japan and the rest of the world will have to live with a hard reality: The Japanese economy will continue to shrink for at least another year, and maybe for several more years.

THE FINANCIAL SECTOR

Japan's financial sector is in critical condition. In my view, there are six hurdles to credible financial reform.

First, Japan does not have a reliable and consistent method for assessing the level of nonperforming assets. Second, the levels of nonperforming assets at financial institutions must be subject to external checking, with a sharp increase in the capacity of the new Financial Supervisory Agency. Third, capital adequacy standards at financial institutions need to be tightened, and the regulatory decisions based on those standards must be made automatic. Fourth, recirculation of assets seized in the process of cleaning up the system must be swift. Fifth, access of borrowers at failed institutions to special bridge credit facilities must be limited in both amount and length. Finally, these new sets of rules must be applied impartially to everyone in the economy, regardless of their political and bureaucratic connections.

The good news is that first steps have been taken in all of these areas. The bad news is that these are journeys of a thousand miles. Japan needs complete transparency, an investor-friendly environment, and the dismantling of the convoy system of financial regulation. In short, Japan's financial system must take to heart an old saying from my home state of Tennessee: When you find yourself in a hole, the first thing to do is stop digging.

JAPAN AND ASIA

Japan has played four roles in Asia. First, Japan has provided markets for Asian exports, but today Japanese imports are shrinking. Second, until a few years ago, exchange rate movements helped Asian countries expand their manufacturing capacity while Japan moved up the value-added chain. Now, with the depreciation of the yen from Y80/US$ in spring 1995 to about Y140/US$ recently, Japan has retaken market share from Asian producers. Third, although the Japanese government has been generous in support of IMF programs, many private Japanese institutions have withdrawn credit from the region. Finally, Japan has been a model of how economic reform should NOT be carried out. I do not foresee quick improvements in any of these areas.

WHAT AMERICA CAN DO

All this naturally leads to the question of what America can and should do to help. First, let me make one thing very clear. A weak Japan is bad for America. A weak Japan means an excessively weak yen, and this means bad resource allocation, higher risks of protectionism, and continued concerns about world financial meltdown. In addition, our many joint endeavors with Japan to address the global problems of poverty, pollution, and disease are imperiled by a weak Japan. Nevertheless, it is important that the US not play savior. We can pressure, cajole, and coax, and be brutally frank—as only friends can be. But we must realize that lasting reform will only come when the Japanese people themselves decide, design, and implement reform. Our powers to affect change in a sovereign country are limited to reason and example. Perhaps the best advice came from St. Francis: "Preach the gospel at all times. Use words if necessary."

PREPARED STATEMENT OF MITSUHIRO FUKAO

Mr. Chairman and members of the committee, it is a great honor to appear before you today Since time is limited, let me discuss the most acute problem Japan faces today, the fragility of its financial system.

Japanese banks still suffer from the large amount of bad loans that is the legacy of the bubble economy in the late 1980s. Let me take some 150 commercial banks in Japan that are the core of its financial system.

They had 28.5 trillion yen of equity capital on their balance sheets as of March 1997. On their asset side, they had 65 trillion yen of substandard loans. Because they could usually recover substandard loans until the collapse of the bubble they have not put aside loan-loss reserves against these. However, according to a recent estimate by the Bank of Japan, 3-year cumulative loss rate of substandard loans was as high as 17 percent. If you apply, say 20 percent loss rate for substandard loans. the estimated hidden loss reaches 13 trillion yen, which is close to one half of the equity capital. Some analysts say that even this 20 percent loss estimate is too small because many weaker banks have postponed making provisions against bad loans so as to window-dress their financial statements.

In addition, Japanese banks have too much stock for their weak capital. They have about 48 trillion yen of stock portfolio evaluated at Nikkei index of 16000. At this Nikkei index level, Japanese banks have about 5 trillion yen of unrealized capital gains in their stock portfolio. One thousand point fall in Nikkei index will wipe out 3 trillion yen of banks' stock investment.

Thus, many Japanese banks do not have enough equity capital. At the same times they clearly have too much risky stock on their balance sheets relative to their capital position.

The most important cause of the current turmoil in the Japanese financial system is the lost confidence in the balance sheets of financial institutions.

Hokkaido Takushoku bank showed 300 billion yen of equity capital at the end of March last year and even paid dividend. After its failure in last November, it was found that the bank had a negative equity of more than 1.1 trillion yen. Similarly, Yamaichi Securities hid 270 billion yen of losses in their balance sheets until its collapse last year. Both of them had been examined by the Ministry of Finance and the Bank of Japan. These failures have exacerbated suspicions both at home and abroad regarding financial statements, external auditing and regulatory supervision of Japanese financial institutions.

After these big failures, financial institutions can no longer trust each other. The liquidity of money market dried up and many banks started to keep liquid assets as much as possible. This shortage of liquidity and capital in the banking sector created a sever credit crunch in Japan. In spite of the very low money market interest rates, loan market has been extremely tight since last fall.

Moreover, measures taken by the government to fight bad loan problem have been both ad-hoc and ineffective. First was the denial of the problem. The Ministry of Finance, the Bank of Japan, accountants, and the management of banks have been hiding the seriousness of the problem. Many banks have "amakudari" directors, i.e. former officials of the Ministry and the Bank. This fact may have deterred the Ministry and the Bank to take decisive actions against banks at an earlier stage.

More recent measures are not effective either. For example, when a weak bank agrees to merge with a failed one, the weak one can get a capital injection with public money. Assisted mergers of weak banks are likely to create bigger weak ones. Earlier this year, 21 large banks got across-the-board capital injection by the government. This was done with neither rigorous audit of bank balance sheets nor the strict write off of bad loans. 1.8 trillion yen was thinly distributed to the 21 banks.

In order to regain confidence in Japanese banks, Japanese government has to move quickly and decisively. In the shortrun, the new Finance Supervision Agency should strictly enforce the prompt corrective action on banks so as to regain confidence in their financial statements. Bad banks have to be restructured quickly while avoiding adverse economic impacts.

However, this new agency has four mayor problems. First, they do not have enough man power to conduct massive bank examinations. Including regional offices, the Agency has only 570 bank examiners. This number is only one twentieth of the number of the United States. Second, they do not have enough legal power to apply prompt corrective action vigorously. When bank managers, shareholders or employees of target banks resisted the Agencies' action by law suite, the Agency has to fight court battles. Unlike the supervisory authorities of the United States, the Agency does not enjoy legal immunity on the closure of banks. Moreover, the Agency does not have any specific officials that would handle court battles. Third, most staff of the Agency is from the Ministry of Finance, 373 out of 403. Because about two thirds of banks have some former officials of the Ministry of Finance in their boards, I wonder whether the Agency can really apply prompt corrective action on a fair and impartial basis. Fourth, the most recent measure is the creation of bridge banks. While it is good to have a clear resolution scheme of failing banks, this scheme allows bridge banks to operate for as long as five years. This period is too long and it may create Zombie banks; dead banks that still operate under the protection of government without market discipline. Unless the Zombie banks are privatized or liquidated quickly, healthy banks may start to fail under the unfair competition with Zombie ones.

In the long run, Japan has to setup a better and much improved disclosure and audit system including new accountlug standards, more non-executive board members, and use of market indicators for supervision. I am proposing that banks be required to issue market-traded subordinated bonds so as to allow investors to learn the soundness of banks easily from the market yield of these bonds.

Since a massive restructuring of banking sector is likely to induce failures of financial and non-financial companies, a strong short-run fiscal stimulus is indispensable. Given the fact that the government heavily advertised the future difficulties of budget situations, I doubt if a "permanent" tax cut is really perceived as such. People would suspect that the government would raise tax as soon as the economy recovers. Instead, I would propose having a sharp and temporary cut in consumption tax. Cut consumption tax rate from current 5 percent to 0 percent immediately. Then the government announces that the tax rate will be raised by 2 percentage points every six months until the tax rate reaches 6 percent. This would stimulate the very weak consumption expenditures quite effectively.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, certainly this session has been complicated by Sunday's Upper House election in Japan. As we all know now, the Liberal Democratic Party (LDP) lost control of the House of Councillors. The LDP retains control of the Lower House, or House of Representatives, which is substantially more powerful, and which was not a subject of Sunday's parliamentary races.

But the issue was not control of the parliament; it was Hashimoto himself, whose economic reform, or bailout plan, was soundly rejected by the voters. In parliamentary systems, this type of outcome usually compels the resignation of the Prime Minister himself, as has been done. The election, then, has created many uncertainties:

Who will replace Hashimoto?

Will the new Prime Minister be able to workout economic reforms within his own party, as well as with the many factions outside of the LDP?

What, if any, vestiges of Hashimoto's bailout plan will survive and who will be favorably or unfavorably affected by them, or will we see a new PM undertaking a totally new set of reforms?

Since 75 percent of Total Asian GDP resides in the Japanese economy, there is no question who provides the engine of growth in that region. But how much longer can the rest of Asia await a Japanese recovery before countries like South Korea, Indonesia, and Thailand begin to face economic depression?

These are just a few of the many questions that I and the other members of this committee have. And I regret the absence of Administration witnesses. I understand their reluctance to make comments that would aggravate the Asian crisis further. But there remain serious issues to be addressed by this panel which, in my judgment, demands the presence of USTR and Treasury officials. Without them the appearance is left that they are trying to avoid an open discussion with Congress. I hope I'm wrong.

I'm afraid that much of today's meeting risks getting lost in the political storm created by Sunday's elections. This would detract from the good work the USTR, Treasury and other trade officials of our government has done and continues to do in battering down the barriers to increased market access in Japan. This is an effort that must go on along with our initiatives, and those of the other industrialized nations, to help Japan out of its current economic stalemate.

The way I see it, the Japanese crisis has been eight years in the making, imploding under the weight of its own shaky financial structures. The situation is not unlike Korea in the sense that private companies enjoyed seemingly unfettered access to credit with an ever-declining promise of repayment.

The process worsened as Japanese banks increased their exposure in the region's steadily worsening economic crisis. Nor did the Hashimoto regime manage to put in place a bank reform process, or even a plan, for that matter, that had enough acceptability among LDP leaders to ensure its implementation.

The economic effect seemed as inevitable as Sunday's political outcome—the two were tightly intertwined, in fact. The consequences for Japan's trading partners, however, remain a little less clear.

In Asia, credit starvation probably best characterizes the ability to recover, at least for countries like Indonesia, Thailand and Korea. Not surprisingly, the high exposure of Japan's banks in those countries compelled the Japanese Government to offer generous assistance to the multilateral efforts along side of its own steps taken to bail out these states. Consistent with its role as the regional financial leader, Japan's Finance Minister, Keizo Obuchi, at the September 1997 Hong Kong IMF meeting, proposed a separate $100 billion Asian Monetary Fund to bail out the region. Minister Obuchi, who is among the several rumored successors to Hashimoto, never really presented a working plan for the Asian fund. And the delay was seen as fatal for Japanese influence when the U.S. aggressively stepped in with its own assistance package for these countries late last year.

In my view, this scenario has added to the uncertainty of Japanese reliability as the regional financial leader. Not surprisingly, the very day after the Japanese elections, the Chinese announced that they would be shifting some of their Yen, as well as dollar, hard currency reserves into the new Euro, suggesting an intent to search better returns in the currency futures market. More specifically, the Chinese are betting that the Euro will appreciate against both currencies, especially the Yen.

But it gets worse: Nomura Bank's Research Institute released information on the Japanese economy, just yesterday, Monday, showing how ASEAN economies were "finally normalizing [their currencies] vis-a-vis the Yen." The move by China is almost certain to disrupt this trend.

In fact, while the Nikkei faltered, and then recovered on Monday, other regional stock exchanges were down substantially in Hong Kong, Korea and Bangkok. Sydney's exchange lost 1.07 percent of value while the Singapore market fell by a precipitous 3.41 percent for the Monday session.

Europe was buoyant, however, and the French, German and London exchanges, unlike developments in Asia outside of Japan reflected this attitude, especially in the currency markets.

The point that seems to be missing here is that, without a workable economic recovery plan at home, uncertainty will only increase everywhere, at home and abroad.

But it seems it was the domestic parts of the Japanese recovery plan that received Sunday's vote of no confidence. Hashimoto plan had two categories: managing financial instability, and, on the macroeconomic side, stimulating government and private spending.

The "Total Plan," which was targeted to the financial institutions, never really took hold. It called for a $213 billion fund to recapitalize failing banks while bolstering deposit insurance accounts for depositors.

The economic stimulus package, about a $100 billion, included a plan to dispense about $40 billion on public works projects and about $28 billion on income tax cuts, with still another $40 billion going to other stimulants like corporate tax cuts. This part of the plan was also never implemented.

There remain problems with these schemes. Adding capitalization is not a solution, unless banks are reformed while minimizing the impact on their depositors. Hashimoto did plan to create "bridge banks," or interim institutions that would continue operations while banks targeted for reform underwent restructuring. And, I would add a thought from one of our witnesses, Professor Fukao, who emphasized the need for continuing audits of banks' financial statements to ensure that institutional credibility is maintained. This part of the Hashimoto plan might have worked. It may yet see the light of day.

The parliamentary vote may also have been the public's perception of the tax plan. The overwhelming majority of Japanese citizens pay less than 20 percent income tax, but all pay 5.0 percent consumption taxes. The proposed income tax breaks are seen as a benefit for the wealthy while, just last year, Hashimoto was proposing a consumer tax increase, something that always hits low- and middle-income earners much harder.

Finally, Mr. Chairman, there remains the issue of Japanese cooperation as the domestic financial crisis lingers. On this point the U.S. must remain steadfast. The main point here is that, while Japan's economic situation has lowered imports, its current account and global trade surplus have grown, by 17 percent last year, and is likely to exceed that level this year. We have entered into a cooperative "Framework Agreement" which, since 1993, has been directed toward the elimination of such sectoral trade barriers as tariffs, regulatory obstacles, exclusionary business practices, and others. In addition, we have been targeting these trade distortions through the WTO's Dispute Settlement Mechanisms.

We have a long way to go, I regret to say. Let me elaborate.

In May of this year, the Japanese flatly shut the door on attempts to open their markets to flat glass distribution, placing at great risk the substantial efforts made by such U.S. companies as Guardian and PPG in expanding their distribution facilities there.

The new Deputy USTR, Ambassador Richard Fisher, has also recently reported Japanese unwillingness to implement the 1996 agreement to deregulate the Japanese insurance market, especially in the primary, or life and casualty market, where U.S. participation is marginally less than five percent.

These are just two of the many market sectors awaiting liberalization that will be reported upon today by U.S. companies facing denied or discriminatory access to Japanese markets.

Treasury Secretary Robert Rubin and Deputy Secretary Larry Summers have made a commendable effort to control the effects of worsening Japanese economy, despite the obvious limitations of not controlling Japanese fiscal or monetary decision making. Nevertheless, we must continue to work with the Japanese to restore their economy to the people who, at the electoral level, have said enough is enough.

I thank the chair.

PREPARED STATEMENT OF ALAN F. HOLMER *

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

PhRMA represents America's leading research-based pharmaceutical and biotechnology companies. Our companies are dedicated to developing innovative new medicines that will enable patients in the United States and around the world to live longer, healthier, happier and more productive lives.

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

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

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

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

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

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

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* Mr. Holmer served in the Reagan Administration as Deputy U.S. Trade Representative, with rank of Ambassador.

latory approval process for new medicines, Japan will save lives, while also achieving cost savings.

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

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

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

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

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

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

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

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

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

This lag in the introduction of innovative therapies in Japan has been exacerbated by a general time lag in the introduction of all new drug products in Japan. For example, a recent industry survey in Japan showed that new drugs approved in 1997 had taken an average of nearly 40 months (not including "fast track" approvals for three treatments for HIV and AIDs), compared to 15 months in the U.S.

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

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

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

PREPARED STATEMENT OF ROBERT D. HORMATS

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify this morning on the subject of Japan.

At the outset I would like to make three points:

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

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

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

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

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

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

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

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

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

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

Inevitably East Asian exports to the US will rise. While the US deficit with them is likely to grow, this is a time when the US can afford a large trade imbalance. Strong US economic growth relative to Asia is one reason why the deficit will be large. American policy should aim not at restricting Asian imports to this country, which are one of the few ways that region can overcome the current crisis, but at promoting Asia's recovery and encouraging continued market liberalization there in order to promote increased US exports over the long term as and when Asia recovers.

To the extent that the US has seen an adverse impact from Asia it is not because of increased imports from the region but because of the sharp contraction of demand there and the attendant drop in the sales of many American companies. The weakness in such sales is far from over. But the inflow of capital from Asia, and the decline in goods, energy and commodity prices resulting from weak Asian demand has had an overall benefit for much of the American economy, holding down inflation and interest rates.

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

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

JAPAN AND THE ASIAN FINANCIAL CRISIS

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

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

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

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

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

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

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

IMPACT ON THE WORLD ECONOMY

Largely because of the downgrades in Japan's growth prospects, growth in the OECD area is expected to be 2.5% this year and 2.3% in 1999 compared to 2.7% in 1997. Due largely to broader Asian problems, world GDP is expected to be only 2.4% in 1998 compared to 3.7% last year. Industrial production in the OECD countries has suffered more than other sectors and dropped more rapidly than GDP. Industrial production has already dropped from 5% in mid1997 to 2% in the current quarter, and is likely to be 1% by the end of the year. This setback to industrial production in the OECD region has come largely because the decline in exports to Asia has disproportionately hit the industrial export sector.

The Asian weakness is not likely to be great enough to push the US into a recession, but it is very significantly reducing global price inflation. In the case of the US and KU, the impact of the Asian crisis in cutting inflation has been considerably greater than expected given its relatively modest impact on GDP growth. This is partly the result of its role in lowering energy and commodity prices.

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

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

More deregulation is also planned in areas such as communications, healthcare, distribution and chemicals. This will help companies obtaining input from deregulated industries because of the resulting lower costs. Some of these measures will increase the openness of Japan's economy to foreign competition. Also Japan is moving closer to international accounting standards, including consolidated accounts (scheduled for FY 1999).

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

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

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

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

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

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

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

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

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

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

FISCAL STIMULUS

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

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

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

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

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

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

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

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

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

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

APPROACHES TO THE BANKING/REAL ESTATE PROBLEM

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

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

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

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

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

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

don't the banks do this? To continue the same example, the bank has already written the loan down to 200,000 yen. It must fund this remaining 200,000 yen of the loan. With interest rates of 0.5% the cost is cheap. If the economy recovers, rates will go up only on the 200,000 yen of debt. But if they go up because the economy is recovering, then the value of the real estate is likely to increase and there is a good chance that the bank will make more money by waiting then it would lose in interest expense. In addition, if the bank took the asset over, this would be a bad time to sell it. If it could own and develop the real estate that would be a different matter, but it cannot legally do so. And if the bank did sell the property, it would have little to do with the funds since loan demand is so weak.

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

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

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

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

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

THE FUTURE OUTLOOK

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

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

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

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

On the macro front, two points are worth noting:

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

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

PREPARED STATEMENT OF YASUO KANZAKI

It is the urgent to revitalize the Japanese financial system not only for Japan but also for the sake of the world economy as a whole. The Comprehensive Plan for Financial Revitalization—better known as the Total Plan—has finally been released. (Please see the Background Material accompanying this statement. The first version was announced on June 23 and the second on July 2. My appraisal of the Total Plan is positive; it not only grants the banks what they have demanded as conditions for their decisive action, but gives an opportunity to financial institutions other than banks to participate in the development of the Japanese capital market. Whether the Total Plan is enough to solve longstanding Japanese banking problems and revitalize the country's financial sector will depend on the actions taken by banks' management and the leadership shown by their new supervisors.

THE ESSENCE OF THE TOTAL PLAN

As I see it, the Total Plan has four main objectives.

- First, the plan pushes for a prompt and aggressive disposal of bad loans through establishment of a secondary market in such loans and associated assets.
- Second, it aims to improve transparency and disclosure.
- Third, it also aims to strengthen organizational structure for inspection, surveillance and supervision of the banking industry.
- Fourth, the Total Plan promises at long last to close Japan's "bad banks," while protecting "good borrowers" from loss of credit resulting from the banks' failure.

To win confidence both at home and abroad in Japan's financial institutions, a standard equivalent to that of the Securities and Exchange Commission of the United States has been adopted in Japan for the disclosure of problem loans. Furthermore, the Financial System Reform Law enacted in the last Diet session, mandates, through sanctions, that all financial institutions must fully disclose their problem loans. The Financial Supervisory Agency was newly created on June 22 as a body to perform fair and transparent supervision based on clear rules, ensuring a move away from oversight based on ex ante discretionary guidance to ex post checking based on laws and regulations.

To facilitate the marketing of bad loans by banks, it is necessary to create a liquid secondary market in these loans through the use of such methods as bulk sales and securitization. The law on securitization of specified assets by Special Purpose Companies was approved by the Diet to serve as the legal infrastructure to facilitate the disposal of bad loans by financial institutions.

In a related move, the government is planning to form a body to sort out real estate-related rights and obligations as part of an effort to enhance the liquidity of the real estate and other assets. This body will attempt to settle the complex sets of claims and liabilities associated with bad loans and related collateral real estate. This will stimulate transactions in immobilized assets, enhance efficient utilization of land (including urban renewal), and return to financial markets their proper function of channeling funds. The vague tax treatment for banks giving up their claims has now been improved upon.

The newly created Financial Supervisory Agency will conduct detailed inspection of troubled banks. Weak banks so designated by the FSA will be converted to the bridge bank system and placed under the direction of government-appointed trustees. If such a bank cannot be sold to a healthy bank, then the business of the failed bank will be transferred to the bridge bank. The bridge banks will continue to provide credit to sound borrowers in good faith but bad loans will be sold to a government-subsidized holding company where they could be repackaged or auctioned off. A bridge bank will be either acquired or, if no buyers emerge in one or two years, it can continue to exist for up to three more years. Then such a bank that is not sold after five years will be liquidated.

From the above, I believe we can conclude that the Total Plan—ranging from the disposal of bad loans, more transparency and strengthening of supervisory power, to more efficient utilization of land—is worthy of its name, at least in its intent.

WHY IT IS A GOOD PLAN

As I said earlier, the Total Plan is a good plan but its success will depend on how the banks and financial institutions other than banks—such as securities companies—respond to its challenge. To explain my position, I would like to provide some background on the creation of the plan.

Japan wasted almost seven years to reach public consensus on solving its banking problem. Politicians, bureaucrats bankers—and even investment bankers—all contributed to this delay. The initially-eager politicians burnt their fingers when the government injected 685 billion yen of public money to resolve the bad loan problems of housing loan companies in late 1995 and left this issue in the hands of bureaucrats at the Ministry of Finance. The politicians targeted to revitalize the property market, which was clogged with immobile collateral real estate associated with non-performing loans. While this was a worthy goal based on a desire to restore health to the financial system and the Japanese economy as a whole, the politicians failed to address fundamental issues raised by bankers.

The bureaucrats hoped that the banking problem would go away when the economy turned upward and did not take drastic action. Nor did they tell the public how large and serious this issue had grown.

Meanwhile, the bankers dreamed that property prices would recover eventually and were busy raising capital in the equity market—to beef up the numerator of their capital adequacy ratio. But banks did not try hard to write off bad assets; put another way, the banks did not reduce the denominator of their capital ratio. Instead, all they did was to put aside modest reserves for possible losses in the future.

Securities companies for their part failed to take advantage of the new business opportunities created by the credit crunch in the money markets and by the obvious need to securitize assets held by banks.

The bankers often cited the following reasons for not writing offload loans: 1) No active property market;

(2) Lack of legal framework to securitize bank assets;

(3) Quagmire of conflicting claims and liabilities on collateral real estate;

(4) Cumbersome process of auctioning off problem assets;

(5) Negative economic and social impact of forcing closure of borrowers' business;

(6) Vague tax treatment for writing off assets; and

(7) Possible legal action against bank management for writing offload assets.

All of these reasons were reasonable and justifiable but the banks did not voice them openly for fear of public backlash against their complaints. Public hostility toward banks has been intense in recent years, charging bank managers for not seriously downsizing, instead continuing to rely on protection by the Ministry of Finance and enjoying the comforts accorded by the notorious "convoy system."

The crisis of financial markets in November 1997, together with the ever-worsening Asian turmoil, gave a strong warning to Japanese politicians. Instead of letting the bureaucrats take the lead as in the past, policymakers in the Liberal Democratic Party took the initiative themselves to meet the challenge. Thus the Total Plan for revitalizing Japan's financial sector is the product of the ruling political party. The creation of the bridge bank system was inspired by the experience of Hokkaido, where the failure of the leading bank in the region resulted in liquidity shortage for many healthy borrowers and general economic hardship in Hokkaido. In this and other ways, the plan addresses the concerns earlier expressed by the bankers.

WILL THE BANKS ACT?

As I said at the beginning, whether this plan will restore confidence in the Japanese banking system depends to a great extent on actions taken by banks' management. One lawmaker who was involved in the creation of the Total Plan told me that the new Financial Supervisory Agency, FSA, would send problem banks "to the operation room for surgery," and would not hesitate to close banks that are found to be no longer viable. He further said that some banks would get "blood infusion." It is thus assumed that the new regulators will show leadership.

Another lawmaker believes that banks would indeed take serious action this time. Otherwise, depositors are clever enough to discriminate against such banks and walk off with their deposits, particularly with the legal protection of full deposits coming to and end in March 2001—only two and a half years from now. (There was talk of pushing back this March 2001 deadline, but it was not.) If, however, some banks fail to act quickly, the market will penalize them as it did the Long Term Credit Bank recently. It is no longer possible for banks to be irresponsible with impunity; in future, such banks will surely be punished by depositors and investors. Japanese banks must not only strengthen their balance sheets but also formulate their own strategy to improve productivity, just as the U.S. banks did during the late 1980s and the early 1990s.They must get over the convoy system.

IS THE TOTAL PLAN SUFFICIENT FOR ECONOMIC RECOVERY?

When Japanese banks were penalized by the market for their weak balance sheets and were charged high premiums in recent years, they started to reduce their assets. But instead of disposing of bad loans, the banks tried to reduce outstanding loans. In some cases, the banks withdrew credit even from traditional and sound borrowers. The resulting credit crunch contributed to the economic slowdown. Although it is very difficult to measure the negative impact of the fragile financial industry on growth, our analysts estimate that 25 trillion yen or 5% of GDP was deducted from total output due to the banking problem over 7 years. If the Japanese banking system returned to good health within three years, the GDP may be pushed upward by 1.6% every year simply by eliminating the bad loans problem.

But I doubt that restoring the banking industry will be enough to put Japan on the growth path again, given its massive excess capacity problem. Demand and supply gap now stands at 5% of GDP.

What the government should do now is to restore confidence of the Japanese public in their economy. This, I believe, can be done in two ways. First is the promotion of new business. The government is rightly emphasizing promotion of new business through deregulation and allocation of more research and development budget. But high taxes—notably the 46% corporate income tax and personal income tax with the maximum rate of 65%—discourage entrepreneurs from taking risks of starting new business. Nor is the capital market developed enough to provide ample funds to new enterprises. Furthermore, investors are shy to take on risks of financing new business.

To change all of this, the tax system should be changed to give more incentive both to new businesses and to investors, to start up new ventures. Currently, tax incentive is minor. I am pleased that Prime Minister Hashimoto has pledged to push tax cuts and tax reform to encourage the Japanese to take on the challenge of creating new businesses. Meanwhile, banks should be encouraged to move away from strict insistence on physical collateral in extending loans. This practice has prevented entrepreneurs from acquiring funds. If more new businesses start as a result of reforms, this will create greater job opportunity.

The second way to restore public confidence is to focus consumer confidence. Reducing the maximum tax rate on personal income is one idea. This should encourage those in high-income brackets to spend more money, as they did until 1996 and result in new investment. For people in the medium-income brackets, incentive should be given for housing investment (such as charging the cost of housing investment to their income.) Another idea is to completely revamp the rules government pension schemes. To maintain the viability of the national pension system, the Ministry of Health has recommend either to increase the premiums or to reduce the benefits.

But this certainly discourages middle-aged and younger people, who are afraid that they may not receive enough benefits when they reach retirement age and who thus save more. As much as 70% of contributions of private-sector employees is now transferred to the treasury account of the Ministry of Finance and are channeled to various government programs including public works and government agencies. But the return on investment in the treasury account is only slightly higher than the interest on government bonds.

The Japanese government has not trusted the expertise of local fund managers. Due largely to the lack of competition in the past, the performance of Japanese portfolio mangers was indeed disappointing. But thanks to the on-going deregulation, newly trained fund managers, including those at non-Japanese institutions, are showing better performance. The government should respect the expertise of these professionals and let them manage some of the massive savings of the Japanese people. which are the fruit of their hard work. Japan boasts over 1,200 trillion-yen or about 9 trillion dollars, in individual financial assets, which have not been fully utilized. Using private-sector fund-managing stills is another way in which the Japanese economy can change toward greater market orientation.

Japanese Banking Problem

1) Deficiency of transparency;
2) Lack of policy credibility;
3) Time consuming.

Excuses For Not Writing off Bad Loans.

1) No active property market;
2) Lack of legal framework to securitize bank assets;
3) Quagmire of conflicting claims and liabilities on collateral real estate;
4) Cumbersome process of auctioning off problem assets;
5) Vague treatment for writing off assets;
6) Possible legal action against bank management for rescheduling bad loans;
7) Negative economic and social impact of forcing closure of borrowers' business.

"What are the "Total Plan"

1)Creating systematic framework to promote aggressive disposal of bad loans.

The Law on Securitization of Specified Assets by Special Purpose Companies (SPC) enacted in April 1998 and be enforced from Sep 1 1998.

The Law on the Council for Coordinating Real Estate-Related Rights is submitted at next Diet session.

The Law on Servicer is enacted at next Diet Session.

Tax treatment was straightened up on banks giving up their claims.

Laws to revise part of Civil Law Code to speed up auctions and to strengthen the power of authority to prevent interference are submitted at the next Diet session.

Cooperative Credit Purchasing Co will resume operation for another three years.

2)To Improve Transparency and Disclosure.

Disclosure for bad loans comparative to SEC standard.

The Financial system Reform Law (enacted last Diet)

3) Strengthening Bank Supervision and Prudential Standards

Financial Supervisory Agency was created on June 22 and ordered 19 major banks' to submit self- assessment of asset quality. FSA's inspection will follow. Any bank will be sanctioned under the Article 24 of the Banking Act, should FSA find any false report. Based on the result of the inspection, strict measures are taken, if necessary, according to capital-adequacy ratio, including Prompt Corrective Action.

4) Stabilizing and Strengthening the Financial System

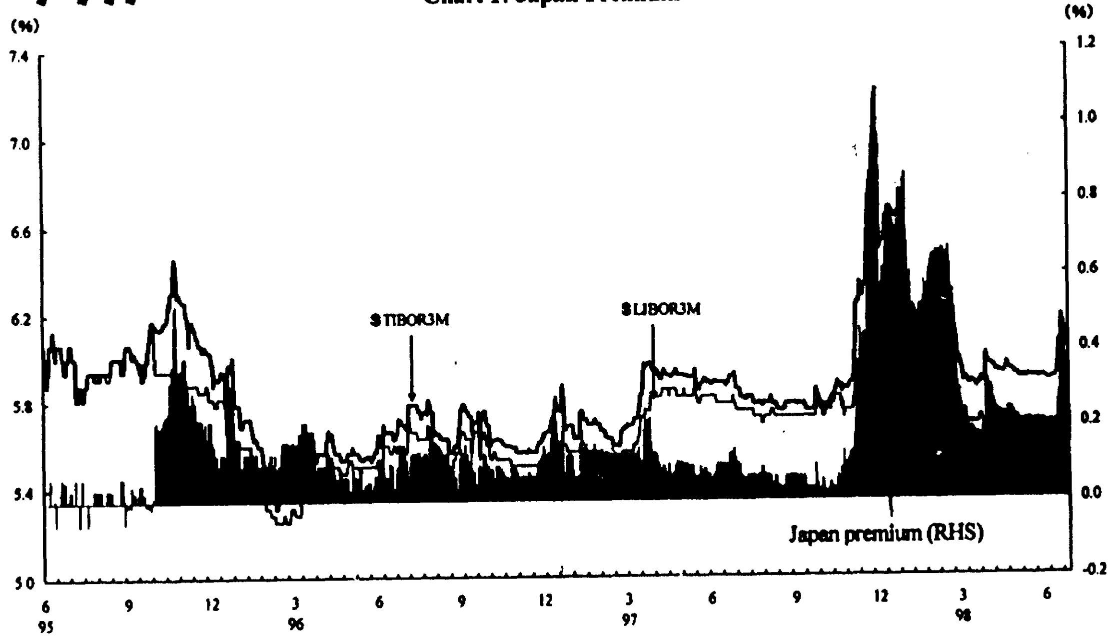
In order to ensure the stability of financial system, an institutional scheme will be introduced for publicly administering the business of failed banks immediately after the failure of the banks. In addition, an institutional framework will be introduced for the bridge bank system.

The scheme is consisted of two stages:

(1) Management of failed banks will be assumed by a financial administrator appointed by FSA. Financial administrator transfer the business of failed banks to private receiver banks or to bridge bank should no private receiving bank accepts such transfer. Legal framework will be put in place for smoothing transfer of business of failed banks.

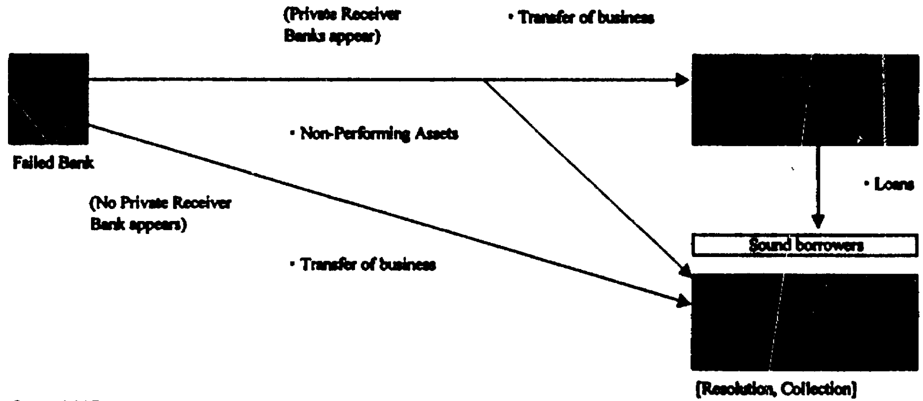
(2) DIC (Deposit Insurance Corporation) will establish the "Heisei Financial Revitalization Corporation" (HFRC) in using public funds already allocated for forming holding company to hold public bridge banks. HFRC assume necessary financial functions of failed banks through public bridge banks in accordance with the decision of the Examination Board of Financial Crisis Management (EBFCM). The Examination and Judgment Committee organized under the EBFCM classify assets of failed banks into loans to sound borrowers in good faith or not. Public bridge banks will assume business with sound borrowers and others will be transferred to Resolution and Collection Bank. Public bridge banks will terminate their operation within two years, with extension of maximum of additional three years, and will be turned to the private sector or be liquidated..

Chart 1: Japan Premium



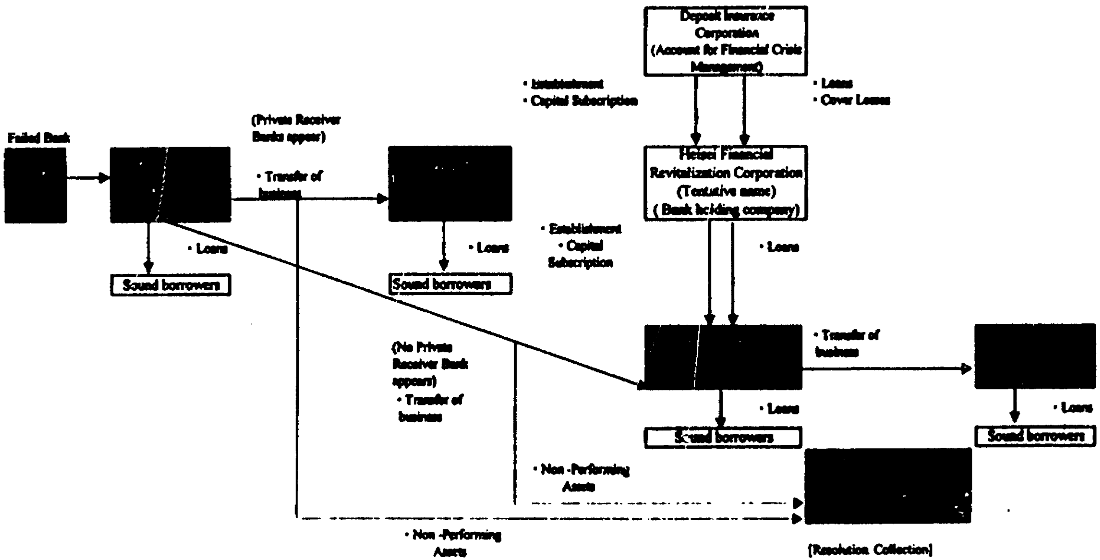
Source : Bloomberg

Diagram 1: The Present System



Source: MOF

Diagram 2: The Bridge Bank Scheme



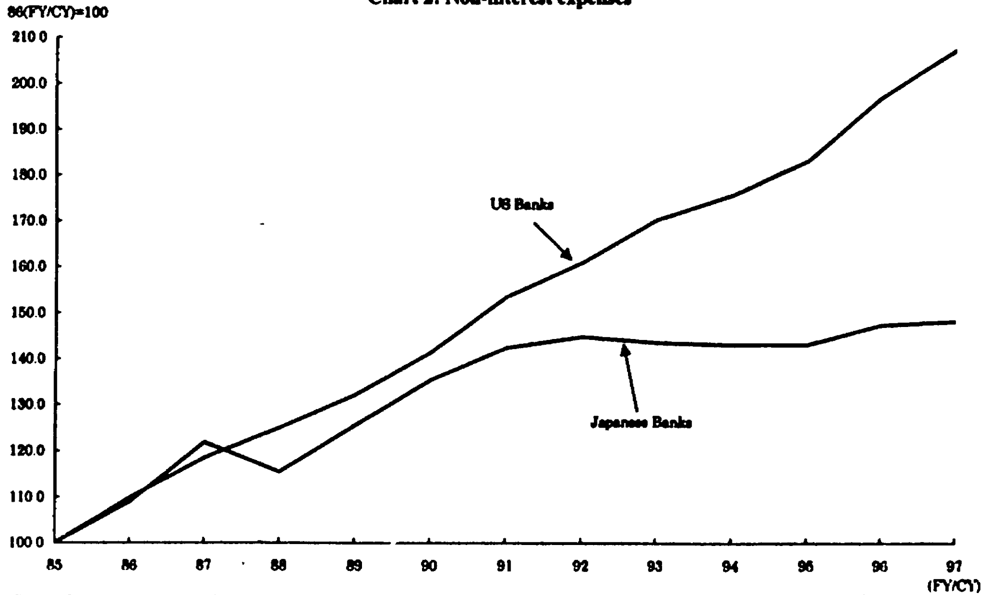
Source MOF

Table 1: US and Japanese banking markets since the 1970s

	US banks	Japanese banks
1970s	Volume oriented toward loans to large-sized corporations and foreign countries	Volume oriented toward loans to large-sized corporations
1980s	Disintermediation • Securitization • Capital Market, Money Market Funds Diversification of High Risk Lending • SL: Land, LBO, LDC Non-Performing Loans	Disintermediation • Securitization • Capital Market Bubble Economy Diversification of Lending to Real Estate
Early 1990s	Restructuring • Writing Off • Reduction Expense, Re-engineering, Restoration Capital Injection of Public Funds to S&L Focus on Retail Business • Consumer Loans, Credit Cards Acceleration of Competition • Non-banks, Mutual Funds	Non-Performing Loans *Ignoring the Problems* Writing Off • Bailout Plan for "Jusen": Housing Loans Companies
Later 1990s	Limits of Growth in Traditional Banking Business • Interest Margin • Credit Quality Consolidation • One Stop Shopping • Conglomerate	Collapse of Convoy System and "Too Big To Fail" Doctrine • Hokkaido Takushoku Bank • Yamaichi Securities Injection of Public Funds to Banks Restructuring & Consolidation • affiliation with Foreign Banks

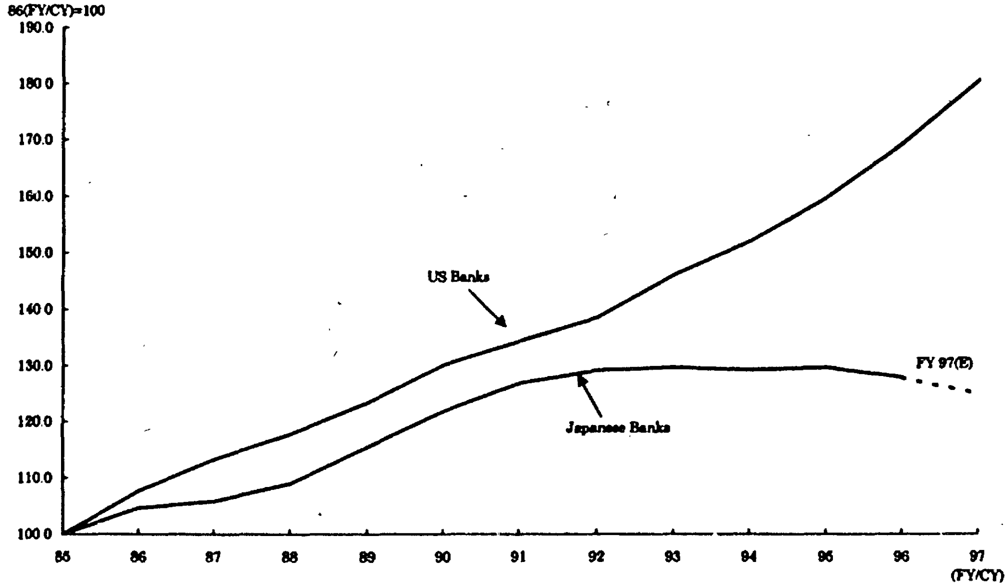
Source: Nikko Research Center

Chart 2: Non-interest expenses



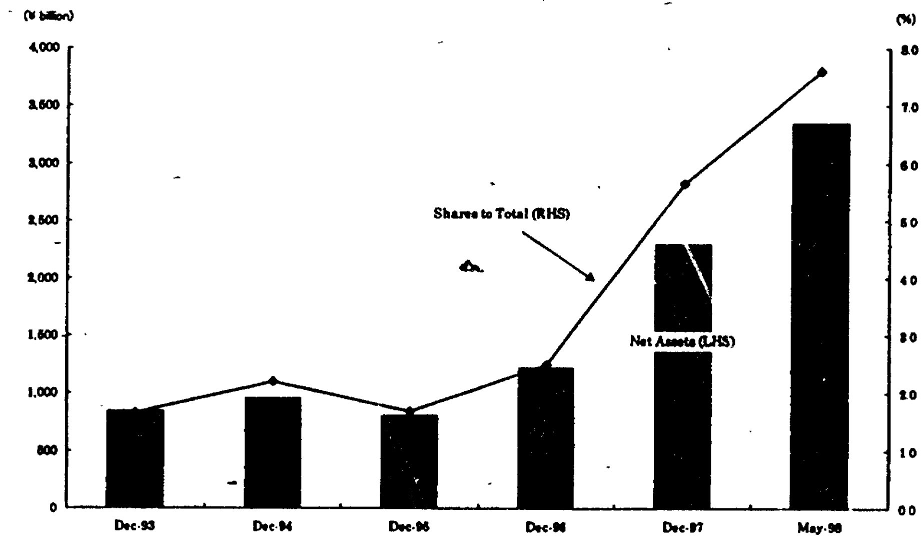
Source : FRB, Federation of Bankers Associations of Japan

Chart 3: Personnel expenses



Source : FRB, Federation of Bankers Associations of Japan

Chart 4: Foreign Management Company's Investment Trusts Business in Japan



Source The Investment Trusts Association

PREPARED STATEMENT OF ROGER M. KUBARYCH

Japan is not playing the kind of dynamic, supportive role in the international trading system that it could be. It is held back by economic and financial infirmities which are perilous, but not untreatable. Ever since the collapse of equity and real estate prices at the beginning of this decade, the economy has labored. The heavy leverage that inflated the financial bubble has left financial institutions of all types—not just banks, but also insurance companies, leasing companies, and other financial intermediaries—with a mountain of bad loans. The financial calamity that engulfed most of Asia last year has made Japan's predicament that much worse. In turn, stagnation in Japan impedes Asian recovery.

I would like to comment on three questions: First, what reforms can the Japanese undertake to solve these problems—and what shouldn't they do? Second, what should the US Government do to encourage them to take the right actions and avoid the wrong ones? Third, what will happen to world financial markets and to our economic prospects if somehow the wrong things are done or if the right things are done but don't work right away?

The Japanese authorities have been tardy in acknowledging the extent and seriousness of the nation's problems. They have announced policy actions that have not been implemented with determination and clarity. For example, taxes were cut by a sizable amount, but the cuts were slated to be only temporary. But both the citizenry and the markets knew instinctively and from long international experience that temporary tax cuts rarely stimulate spending decisively. Even an otherwise highly desirable and laudable initiative, the extensive deregulation of the powers of financial institutions known as Japan's Big Bang, took effect at an awkward moment. Its initial impact is to induce capital to leave Japan. It is fair to say that public confidence in these various policies has been modest, at best.

Now Japan's leaders should act forcefully, and in a non-partisan way, to inject more stimulus before the recession deepens, to reform Japan's tax structure, and to recapitalize its financial system. Japan also needs to liberalize internal markets, but that is easier to accomplish when business conditions are reviving, not during a slump.

Japan is naturally reticent about running an enlarged budget deficit. After all, deficit reduction has been the maxim of the 1990s. But Japan has learned the wrong lesson from our efforts to eliminate the budget deficit (and also from Europe's Maastricht-inspired fiscal restraint). The United States needed to cut the budgetary deficit because we are a low savings country dependent on foreign capital to help finance economic activity and adequate business investment. But Japan is decidedly not a low savings country, and its Government should not be obsessed with fiscal deficits now or any time soon.

What it should be worried about is the absence of significant risk-taking by Japanese households and firms. Consider these data: US households hold barely 15% of their financial assets in what might be called super-safe' form: deposits, CDs, and money funds, assets of certain capital value. They hold well over half of their assets in the form of open market instruments (stocks and bonds) and mutual funds, all of which are exposed to market risk (but provide commensurably higher returns over time). By contrast, Japanese households hold 60% of their assets in super-safe assets but well under a quarter of their financial assets in open market instruments. They own only modest amounts of mutual funds. The anxieties of the ordinary Japanese citizen are further underscored by the 17% plunge in housing starts over the past year—in a country with the lowest interest rates in modern history. In addition, the latest business surveys show that small and medium-sized businesses are planning to drastically slash their investment spending. Encouraging risk-taking has to be a top priority for the Japanese Government, even if that entails a larger budgetary deficit for the time being.

How should the Japanese authorities go about engineering a bold fiscal initiative? It is too easy for Americans, whether inside the Government or outside, to give advice to the Japanese. After all, we can't be sure that their very different system will respond to policy measures as ours would respond. And they, not we, have the accountability. Instead, what I have tried to do is to go back over a number of suggestions that Japanese business and financial leaders themselves have put forward in the past few months and synthesize the gist of what they are proposing. They do not wholeheartedly agree with the emphasis on public expenditure programs in the Japanese Government's fiscal policy, but if that is the policy, they recommend at least getting rid of the long delays that have diluted such initiatives in the past. There is a broad consensus that far-reaching tax reform is essential. On what the composition of tax reform should be, views diverge. Most believe the Japanese Government should permanently lower marginal income tax rates and reduce corporate income tax rates at least to international norms. A smaller number would seek to neutralize the adverse impact of last year's ill-timed increase in the consumption tax, perhaps with a special rebate for low and moderate-income consumers.

In any event, the private sector is less bothered by the prospect of an expansion in the Japanese budget deficit than most officials—and most Japanese media commentators. Personally, I am confident that a bigger deficit can readily be financed. If it is financed through the banks, rather than in the bond market, it can be done at negligible interest rates and with minimal adverse consequences. This would be lousy advice for most countries, but it is appropriate for Japan because of its extraordinary circumstances: a stalled out economy with a big trade and current-account surplus, and prolonged deflation.

Whether in Tokyo, Washington, or New York, all agree that the critical need is to deal with the fragility of the Japanese financial system in order to reactivate normal channels of credit creation. In my judgment, this does not mean rushing to impose some sort of "shock therapy" involving the closure and liquidation of a significant number of major financial institutions. Doing that would threaten to undermine public and market confidence further and could even trigger a financial panic.

Certainly, the United States did not follow such an aggressive approach when a number of our leading banks faced great difficulties in the late 1980s and early 1990s. Let's recall that we started with a long period of floundering about trying to decide what to do about the largely real-estate related lending problems of many financial institutions. After some unpleasant fits and starts, we eventually reached a political compromise on what to do. Thereafter, the US Government and financial regulatory authorities proceeded with great care and selectivity. In the end the cost to the taxpayer, though substantial, was limited mainly to covering the losses of defunct savings and loan institutions. The big banks that might have been closed are now fully recuperated and enjoy lofty stock market valuations.

For Japan, the best course is to move swiftly to support the two essential building blocks for financial reform and rehabilitation: one, changing Japan's tax code, regulatory practices, and judicial biases to institute a free and open market in commercial real estate and to encourage large-scale conversion of existing loans to troubled business enterprises into equity; and two, empowering a public institution to buy bad loans from Japanese banks at an acceptable discount. I think that more emphasis has been placed on the second component, but they are equally important.

It is worth bearing in mind that Japanese financial institutions are in difficulty because their customers are financially distressed. In fact, a good portion of the Japanese business sector suffers from the same malady that is plaguing the rest of Asia: too much debt and too little equity. Existing shareholders understandably don't want to be diluted, so they resist issuing new shares or swapping debt for equity. Creditors don't want to become minority shareholders, who are famously ill-treated by Japan's system of corporate governance. So one of the key reforms is to overhaul corporate governance, Americanize it if needs be, to shift the balance toward outside shareholders and away from insiders. I would put a higher priority on reforms in corporate finance and corporate governance than in closing down a number of over-extended banks.

Once the balance sheets of the major financial institutions have been put in somewhat better shape and the danger of widespread failures of banks and their customers has diminished, the authorities would be wise to encourage the injection of fresh equity capital into Japanese financial institutions. Much of that equity infusion will (and probably should) come from domestic Japanese sources. Some might come from public institutions such as the postal savings system. I would hope that the embryonic Japanese mutual fund industry could also take part as a purchaser of new equity in financial institutions. But a good chunk should also come from outside Japan. US and European banks, securities firms, and insurance companies will be on the look-out for promising opportunities. They will demand full disclosure of the true financial condition of the institutions in which they are considering making an equity infusion. Transparency is unavoidable.

Let me now turn to what the US Government should do to encourage this forthright but measured approach. To begin with, we should always emphasize our common objectives, rather than whatever tactical differences may exist from time to time. One common objective is to protect the safety and soundness of the global financial system, especially the payments mechanism. A second is to restore stability to battered Asian financial markets. Another is to maintain orderly conditions in the all-important foreign currency market for the dollar and the yen. The roller coaster ride from nearly 80 yen per dollar a little over three years ago to today's rate of 141 has done much harm. These swings have distorted competitive relationships between US and Japanese companies, compounded the external problems of many Asian countries, and increased the pressure on the frailest participants in the financial system. The main beneficiaries of this latest bout of excessive volatility are Japanese exporters, many of whom say they are confident of achieving good profitability at a rate of about 110 yen per dollar but who are naturally glad to be able to cash in the proceeds of their foreign sales at 140 or so to the dollar. Our policy should be to oppose excessive medium-term oscillations in such a pivotal exchange rate.

It is often argued that the yen is presently weak because of weak fundamentals' and until those change nothing can be done about the yen, including intervention in the foreign exchange markets. But life is not that simple. There are many fundamentals that potentially influence daily currency fluctuations or expectations of future movements. Which ones matter most? Right now, I appreciate that some of these factors are unequivocally adverse for the yen: for instance, interest rate differentials, relative economic growth rates, and relative stock market performance. But some factors are unequivocally positive for the yen: namely, the current account positions of Japan and the United States and relative inflation rates. Other factors are inconclusive: for example, commodity prices, especially oil (Japan being notoriously dependent on oil imports).

What is instructive, though, is how little many of these fundamental factors have changed from what they were back in early 1995, when the yen was going through the roof. The accompanying Table compares Japan and the US for several fundamental indicators. Yes, some are different. But in my judgment the fundamentals have not changed anywhere near enough to explain a 75% appreciation of the dollar.

What has changed since 1995 are two important considerations which have less to do with economic fundamentals and more to do with policy fundamentals: first, the market's perception of US foreign currency policy and second the general recognition that the Japanese financial predicament was not being brought under control, especially after the Asian crisis escalated.

There is not much the United States can do directly to help the Japanese solve their banking problems, other than perhaps to be historically accurate in describing precisely what we did and did not do in resolving our own banking problems a few years back. But there is an opportunity in terms of foreign exchange policy. We have the ability to shift the focus away from the specific factors that tend to drive near-term movements in currency values and back toward longer term considerations of stability and consistency with industrial competitiveness. We also have the ability to make use of an array of different approaches to official foreign exchange intervention to influence not only day-to-day exchange rate movements but also the evolution of market expectations over a period of time.

Let me conclude by briefly commenting on the final question: what if the wrong things are done or the right things don't work speedily? The answer is that the markets are prepared to drive the dollar significantly higher against the yen. And once the momentum begins to build, there is no obvious resting place. Could the yen-dollar rate reach 160 or 180 or 200? Why not? The Japanese economy is too weak to allow the Bank of Japan to raise interest rates enough to brake such a move. The US economy has too much internally-generated strength to permit the Federal Reserve to dramatically ease monetary policy, notwithstanding the anti-inflationary effects that would accompany such an assumed dollar rise.

The consequences of such a plunging yen would be odious. All the Asian financial markets would thrown back into chaos, their currencies would be driven down, and next time China and Russia would also be compelled to devalue their currencies. The big Latin American countries would hardly be spared, either. In short, we would revisit the type of across the board advance of the dollar that took place in the mid-1980s, with all the unfair consequences that had for many American workers, especially in manufacturing industry. The cries for protection would be inexorable.

This alarming scenario is not the likeliest one, but it is not fanciful, either. It can be averted. But to guard against it, a spirit of collaboration must infuse the US-Japanese economic and financial relationship. It is in the interest of both countries to move in that direction.

Comparison of Japanese and U.S. Economic Indicators

	April 1995		Current	
	Japan	U.S.	Japan	U.S.
Yen-Dollar Exchange Rate	84.33		140.86	
Short-term Interest Rate	1.34%	5.87%	0.40%	5.08%
10 Year Government Bond Yields	3.48%	7.05%	1.62%	5.45%
Change in Stock Prices (over prior six months)	-15.92%	10.57%	3.75%	13.20%
Growth of real GDP (annualized over prior six months)	-1.37%	2.24%	-3.42%	4.48%
Unemployment Rate	3.10%	5.70%	4.10%	4.50%
Consumer Price Inflation (annualized over prior six months)	-1.19%	2.94%	0.98%	1.36%
Producer Price Inflation (annualized over prior six months)	-2.20%	2.86%	-2.00%	-1.37%
Current Account ($ billions, during prior 12 months)	124.80	-130.42	105.54	-165.44
Change in Commodity Prices (over prior six months)	6.25%		-1.04%	

Prepared Statement of Akio Mikuni

JAPAN: PUTTING THE WHEELS BACK ON THE LOCOMOTIVE

Answering the question of how to put Japan on the right track requires a full and frank acknowledgement that today Japan is on the wrong track. To continue with this railroad metaphor, not only is Japan on the wrong track, but it needs a new locomotive. The existing one is outdated. It may have worked well once, but it no longer does so.

Changing locomotives is, of course, a polite way of calling for a revolution in Japan's economic management. Revolutions are usually resisted by entrenched power holders until the bitter end, when it becomes clear to all that no alternative exists. Things have not yet gotten to this state in Tokyo. Admittedly, it is now widely understood that the Japanese economy has fallen into a recession. The extent of Japan's economic difficulties is clear even to those bureaucratic champions of the Japanese system who a few short months ago were telling the public that recovery was right around the corner.

But they still do not appreciate how bad things are going to get. This recession will prove much worse than Japan's economic mandarins expect. The government's recently enacted stimulus package may possibly help the economy bottom out, but the economy will again sink once the effects of the stimulus pass. The economy has been trapped since the beginning of the decade in doldrums that cannot be escaped with one more round of spending on unnecessary public works. For Japan to put these doldrums behind, it requires a full understanding of why and how Japan found itself stuck there for so long.

The seeds of Japan s problems lie with its very success. Back in the 1950s and 1960s, Japan could exploit external markets without affecting them. But Japan is now too large. Of course, economically speaking, Japan can be made "smaller," as it were in relation to its external markets by shrinking the value of the yen. But even here we see the law of unintended consequences in action. The last time the size of the Japanese economy was deliberately shrunk in relation to its external markets occurred back in 1995 when the Japanese authorities cooperated with the U.S. Treasury in moving the yen down from its historical highs. In escaping one crisis, however, Japan unwittingly set the stage for another: the Asian economic crisis. Asian countries, whose currencies were largely tied to the dollar, found their competitiveness across a wide range of industries destroyed by the weak yen. This decline in competitiveness set the stage for the panics that hit one country after another. And in the process, these panics seriously damaged what had become Japan's most important export markets.

Japan's policy makers in the great economic ministries and the leading business bureaucracies do not, however, want to understand what has happened; they do not want to acknowledge that Japan's external markets are no longer limitless and can no longer be taken as givens like the sun rising in the morning or the change of the seasons. Japan's policy makers are in denial. They are in denial because acknowledging the reality of Japan's changed circumstances means acknowledging that their own control over economic decision-making is slipping from their grasp. It means acknowledging that they are being forced to surrender power to markets which they do not understand and cannot trust. But widespread acceptance of the reality of Japan's condition is the only way out of the morass into which the economy has sunk.

I could keep you here until tomorrow with a recital of all the problems that now afflict the Japanese economy. The core of these problems, however, lies with long-established economic policies dating to the war years and earlier that aimed at the maximization of savings. A policy of savings maximization is another way of saying a policy of current account surplus maximization.

These savings were allocated not on the basis of the free play of market forces but rather to those industries that were either politically powerful or deemed essential by Japan's economic mandarins. The savings financed capital expenditures far in excess of those required by the domestic economy. This capital spending made many Japanese companies in a wide range of industries into world leaders at least when measured by technology, costs, or market share. But not by profitability. The beneficiaries of the Japanese system in the great corporations did not need to consider the profitability of their investments. They were engaged only in the expansion of production. Their solvency was the responsibility of their banks and of the government—a government that in turn ensured the solvency of the banks.

The final guarantee of the solvency of Japanese industry lay with Japanese households whose savings financed the economy. And the strength of that guarantee thus directly correlated with the extent of the savings. Thus the entire economic policy apparatus aimed at maximizing those savings.

Those savings took the form overwhelmingly of bank deposits. Under an unwritten social contract, households put their savings into banks or the post office and accepted very low interest rates in return for, at least, an implicit guarantee that the principal would be safe. Since deposits were effectively guaranteed, losses incurred by the banks and industrials who used those deposits to finance their activities could not be written off directly. The only way for the economy as a whole to write off losses, except for a use of tax money, was through general inflation that reduced the actual purchasing power of the deposits. But in the 1990s, the Japanese authorities found that they could no longer engineer inflation—Japan's position as the world's leading net creditor nation made it impossible.

The implicit guarantee given to all deposits was only the first of the policy tools aimed at maximizing savings. Of equal importance was the tax system. Discussion of structural measures to encourage demand in Japan is simply empty talk in the absence of an overhaul of the tax code that would discourage saving and encourage consumption.

Japan's major industrial corporations have engineered rapid growth in productivity that in many cases is the envy of the world. But this impressive performance is nearly invisible in corporate financial statements. Nor is it visible in Japan's macroeconomic numbers. For Japanese companies have retained unnecessary employees either within their own ranks or in their affiliates. And in the Japanese system, major corporations are ultimately responsible for the liabilities of their affiliates, irrespective of their nominal equity stakes. In the past, high economic growth rates made even mediocre operations profitable. But with the combination of slow growth and global competition, many affiliates of Japanese companies have become unprofitable and even insolvent.

The retention of large numbers of unproductive employees by major industrial groups means that productivity gains achieved at the corporate level have not been translated into concomitant gains at the national level. In other words, industrial companies are not making the most productive use possible of the resources available to them. But by hoarding those resources, they make it impossible for the nation as a whole to employ them productively. In a manner of speaking, Japan is refusing to enjoy her economic achievements.

Today, however, the problem goes well beyond a refusal by Japan to enjoy the full fruits of her prosperity. For by failing to dismantle her mercantilist system—and what, after all, is a policy of savings maximization other than mercantilism under another name—Japan runs the danger of seeing the actual destruction of much of what she has achieved.

Let me describe what I mean by this. The Japanese system continues to work so well in extracting savings that savings are running far ahead of domestic investment requirements. This excess flows out of the country where it finances Japanese exports that are not politically welcomed by our trading partners. The day will surely come when some combination of a stronger yen, severe trade frictions and recessions in the economies of our trading partners will force a reduction in Japan's exports. And when that day comes, Japan's low level of domestic consumption will be woefully insufficient to support the entire production apparatus built in my country. The politically engineered suppression of the purchasing power of the Japanese economy will then pull Japan down into a recessionary abyss far deeper than anything seen in this country since 1945.

Japan's policy elite is prepared to condemn the Japanese population to a standard of living far below that which they are capable of earning for themselves and that which they deserve. This, of course, is the price of a mercantilist economy. Japan's industries may be at the cutting edge of late 20th century technology, but socially Japan is still mired in feudalistic thinking and social structures. No social revolution has happened to create full-fledged Japanese citizens, a democratic political system, or a market economy. The policy elite will thwart any serious change as long as it can maintain its instruments of control over the economy, suppress consumption, maximize savings, and rely upon external rather than internally generated demand to keep the Japanese industrial machine going. Thus publicly voiced concerns over a weak yen/dollar rate are little more than crocodile tears. The entire thrust of policy is to keep the exchange rate of the yen as weak as possible despite Japan's ever-rising current account surpluses and continual accumulation of claims on other countries.

Of course, there are plenty of reasons with which market observers and participants justify to themselves today's weak yen regime. The U.S. Treasury is thought to want it too. The United States offers more profitable investment opportunities. Dollar interest rates are higher.

But what all this reasoning ignores is just how dependent the United States is on a continued flow of funds from the rest of the world, most particularly from Japan. The funds keep flowing because of a set of politically determined policies in Japan that have brought about a recession. In a manner of speaking, Japan is deliberately depriving itself so that the United States can enjoy cheap access to foreign credit.

It is important to understand that while the government may have given up its policy of supporting asset prices at astronomical levels, asset prices have not yet fallen to market clearing levels. Excess production capacity has not been shut down. Inventories have not been reduced. And as a result, of course, profits continue to be anemic. In such an environment, lower interest rates do not bring about any increase in borrowing and do not stimulate economic activity. Today, they only produce aggressive purchases of dollars for yen. Not, however, because domestic investors are borrowing low interest yen to buy higher interest dollars. But because the worldwide flight from Japanese banks has forced Japanese banks to fund their dollar assets by purchasing dollar liabilities with yen. So while the Bank of Japan's balance sheet may be exploding, that is not translating into any commensurate increase in loan volume by Japanese banks.

I fear that no economic turnaround in this country is possible until asset prices fall to a level where market players find it profitable to purchase them. Further, unemployment will have to accelerate until it forces the creation of an efficient labor market. Interest rates and the yen will have to rise to the point where unprofitable companies are forced to close their doors. The profitability of those left standing will have to recover sharply.

These events, however, are not compatible with continued bureaucratic control of the economy. But, Japan's economic mandarins will not voluntarily give up their control. Loss of control will only be forced upon them by economic distress that will make today's bad economic news seem only like a prelude. Such distress could, however, be ultimately constructive.

There remains, it is true, a very slight chance of reform prior to financial catastrophe stemming from Japan's nominal political leadership. Part of Japan's legislature is now elected via a single-seat system which could theoretically provide one party with a landslide victory. Under the old proportional representation system together with pork-barrel political machines, vested interests were bought off by public construction works, subsides, and public employment in return for votes. This has become too expensive with Japan's enormous fiscal deficits.

Policy elites continue to be confident, however, that Japan's journalists will protect them from the scrutiny of policy analysis. Japan's establishment media still operates to a very large extent under the wartime system, reporting what the elite deems will serve the national interest. Japanese newspapers do not discuss competing policy visions during campaign periods, meaning that vote-buying machines can work without being disturbed by the genuine cut and thrust of policy debate.

Assuming we do get that debate—a dubious assumption—and assuming it leads to an electoral takeover by the current opposition, it may be helpful at this point to ask ourselves what this new government would need to do in order to restart the Japanese economy.

The overriding policy goal must be the reversal of the traditional aims of maximizing production and savings by suppressing consumption, maximizing the current account surplus by driving up the dollar, and socializing all market risks through the support of stock prices and land prices, the suppression of interest rates, and the blurring of credit risk. These must be replaced by an entirely different program.

First, in order to maximize consumption and minimize savings—thereby reducing the current account surplus—the consumption tax must be eliminated. Interest income should be taxed as ordinary income. Both mortgage interest payments and property taxes should be deductible from taxable income.

To end the socialization of risk, to establish a clear link between risk and reward, today's almost completely intermediated financial system should be replaced with disintermediated securities markets as the primary source of corporate finance. For properly functioning securities markets would force elimination of the great drag on the Japanese economy—unprofitable production capacity. City banks must not be allowed to interfere with the necessary purging. They will have to be prohibited from supporting large companies; in other words, their role as "main banks" must end.

The government's attempts to control all financial risks should be abandoned. The government has a huge war chest that it uses for this purpose. It is the Trust Fund Bureau of the Ministry of Finance and it is funded with postal savings, postal insurance, and government pension funds. The bureau should be shut down. The government should tap personal savings through private intermediaries at market driven rates of interest rather than unloading JGB's on the Trust Fund Bureau.

The Temporary Interest Rate Adjustment Law, which exempts financial institutions from anti-trust requirements and permits administered, cartelized interest rates on both lending and deposits, should be repealed so that interest rates are determined by market forces.

The core of the MOFs licensing system should be changed. This system, by which the MOF licenses financial institutions to do business, gives the MOF immense power over credit allocation, leaving banks as little more than deposit gatherers. Both the risks and rewards of credit allocation should rest entirely with bankers who would thus be forced finally to understand real credit analysis.

With the flow of funds in the economy finally freed from government control, the next most important reform must be the creation of a genuine labor market. Today, we have essentially a one-window market. It opens for young people on finishing their education and then promptly closes. Company employees are expected to work for 30 years, or most of their productive lives, for single employers during which time wages rise according to seniority but not according to contributions. Japanese workers are underpaid for their contributions during their younger years; as they age, the situation is reversed. This system can only work, however, for bureaucracies and companies that can promise incoming recruits their jobs will be safe for 30 years. Only companies that are free of the risk of bankruptcy, those protected by the government and the main-bank system, can make this promise. Bankruptcies of those protected entities like Yamaichi result in serious breaches of the social contract. Smaller firms, whose viability is not protected, cannot therefore compete for high-quality white-collar and engineering recruits.

Finally, reform depends vitally on building an infrastructure of accountability. It is no longer possible for the Japanese government to compensate everyone, to allocate losses and burdens while fulfilling all of the implied social contracts. For loss-allocation to be carried out in a manner that is perceived as just and fair, Japan needs transparent, impartial accounting standards and universally followed judicial procedures. The number of accountants and lawyers in Japan is minuscule in proportion to the size of the economy. This must change and measures instituted to build the accounting and legal infrastructures necessary to a mature economy governed by market forces.

PREPARED STATEMENT OF W. HENSON MOORE

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

Export sales are critical to the future growth and, ultimately, the survival of our industry. Access to the Japanese market is a critical part of this equation. After the U.S., Japan ranks as the second largest market for paper products and the number one export destination for solid wood products. Japan is a high cost producer of both wood and paper products. The competitive price and high quality of U.S. forest products should command for our companies a strong position in the Japanese market. But this is not the case:

JAPAN MARKET ACCESS

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

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

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

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

JAPAN'S ROLE

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

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

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

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

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

- the bridge banking plan has been found seriously deficient by world financial markets; and
- reliance on outdated public spending techniques, and conflicting signals on possible tax cuts, has failed to stimulate domestic spending.

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

APEC

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

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

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

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

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

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

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

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

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

NEXT STEPS

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

The urgency of the situation in Asia will not allow us to wait until the LDP chooses a successor to Mr. Hashimoto. Japan's political leadership has failed to face up to the realities of the economic crisis to a degree that has baffled observers and, ultimately cost the LDP dearly in this weekend's election. Clearly, Prime Minister Hashimoto paid the price for committing to reform without making any true structural changes.

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

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

PREPARED STATEMENT OF KENICHI OHMAE

Chairman Roth and esteemed members of the Finance Committee:

It is a special privilege for me to be invited to the US Senate to offer my views on the fragile state of the Japanese markets and what can be done about it.

As a management consultant for more than 26 years, I have long been a student of both large organizations and the global economy. What we have in Japan today is not a unique phenomenon: the collapse of property markets in major cities due to an oversupply of commercial buildings. This phenomenon is not different from what we saw during the past 15 years in Houston, Los Angeles, New York, Melbourne, and London. What is different, however, is the magnitude of the problem, as well as the way in which the Japanese Government and, more recently, the US Government, have tried to handle it. As a result, the situation is now so explosive that any "normalization" process could well have a profound impact on markets far beyond Japan.

In this testimony, I shall call this unique problem the "Crash of Tokyo"—or COT—because it is basically a direct consequence of Tokyo's commercial property prices having fallen to one-fifth of their peak level in 1989. More detailed descriptions of the COT can be found in the many articles and books on this subject that I have published both in Japanese and English. Leaving the details to these references, let me here describe the major descriptions of Japan's current financial crisis:

1. The Japanese Government has never used the full range of existing laws to prevent or reduce the effects of COT. For example, the protection of savings accounts in troubled institutions, according to the law, is guaranteed up to ten million yen per account. In 1996, however, the Japanese Government promised to protect ALL savings in ALL financial institutions through March 31, 2001. This unlawful promise has made the recovery slower and more expensive than it had to be. It has also caused a chain reaction of moral hazard. When push comes to shove, borrowers and lenders have learned to ask the government for—and the government has learned to provide—inventive new forms of temporary pain relief, not a real solution to the problem, which only grows over time. Indeed, seven years of pushing the COT problem away have now "grown" it to something on the order of a couple of trillion dollars.

2. US government, industry, and individual consumers have long been the beneficiaries of the moral hazard resulting from COT. The loss of confidence in Japanese financial institutions and in the Japanese economic system, has, ironically, driven Japanese investors to mostly off-shore, dollar-based instruments that support the economy of the United States and, more specifically, Wall Street. In the 80's, the Japanese financial institutions financed one-third of the American budget deficit through the purchase of US Government notes and bonds. More recently, Japanese banks have been the providers of much of the capital requirements of major financial deals in the US.

3. The American private sector knows first-hand the fundamental ills of the Japanese system at issue in COT. Major American accounting firms, for example, have been retained by many large Japanese multinationals. This means that these firms know—or should be in a position to know—how deep the problem is. When a Japanese bank goes bankrupt, the bad debts discovered later are often between three and twenty times the size reported in the audited accounts. So, the best point of success for your Committee to size up the COT problem is the American accounting firms.

4. Likewise, the major American investment banks have for many years helped their Japanese clients hide liabilities in off-shore havens and/or in derivatives that may look good on the books today but turn into hidden liabilities over time. In effect, these banks have been engaged in the lucrative business of helping the Japanese COT problem survive well past it time. In recent months, we have begun to see the casualties resulting from this type of malpractice—the bankruptcies of Nissan Life and Toshoku, for instance, as well as the 700 million dollar loss now visible in Yakult's accounting book. I expect to see dozens of corporate casualties resulting from derivative and off-balance sheet liabilities coming due over the next two years. Again, the best place to begin to size up the magnitude of the problem is to ask the top US investment banks.

5. The American experience in the 80's, while useful to know, is not relevant here. In fact, relying on it as precedent is quite dangerous. A number of American consultants have been helping the Japanese Government put together a "Total Financial Restructuring Plan" with advice on things like a "Bridge Bank," a Japanese RTC, and securitization. None of these approaches will work in Japan. I would go one step further. if and when these ideas are implemented, the crash, which everyone is trying to avoid, will inevitably take place.

Few outsiders understand the nature of the current Japanese financial markets, let alone the likely side-effect of proposed solution for COT. Consider securitization, for example. First, there is a huge gap between market and book value. Japanese accounting, unlike that in the US, is not based on reporting assets at current market value. The result: many "invisibly" over-extended corporations. If, however, the properties now collateralized by lenders were securitization, their real value would become visible, triggering a crash not only of properties themselves, but of the whole stock market.

There is also a problem with the bond market: we do not have a workable bond market in Japan. The Government normally buys virtually all public bonds, using Postal Savings and Public Insurance money. So, if there were a broad move toward securitization, the bond market would have to be able to handle at least 100-200 billion dollars of activity. This seems extremely difficult, unless the bond market grows at the expense of stock market, or Postal Savings, or both, which would then likely trigger a crash.

Another serious problem with securitization is the lack of cash flow in the Japanese properties which have been collateralized by the banks. Most of them are greenfield investments, i.e., empty lands, which in themselves do not produce cash flow. So, unless new buyers pump in fresh capital and build something to generate the necessary revenue, these will be only a negative cash flow. Today, the net present value of most of these collateralized assets is negative, which is vastly different from the US situation in the 80's.

These are just a few of the reasons why the American experience, now having copied by the Japanese Government, would not work, and, in fact, would do more harm than good.

6. The danger we are faced with now is the imminent failure of the ENTIRE Japanese financial system. So far, we have been able to handle, albeit with great difficulty, bankruptcies one-by-one. With the fate of the Hokkaido Takushoku Bank, the smallest of Japan's money center banks, still unsettled and with the LTCB lying in the intensive care unit, the damage is spreading very rapidly throughout the corporate sector. The "Total Restructuring Plan" that the Japanese Government announced on July 2 is worse than inadequate. It does not begin to address the crux of the issue—namely the SYSTEMIC nature of what can and will go wrong.

The "Bridge Bank" concept contained in the Government plan, for example, works for regional banks at best. But the real threat is the fall of major banks—most likely, several of them simultaneously. Japanese banks have a rather complex interbank relationships in almost all major financial deals and projects. There are no good banks and bad banks. They will all become bad if a major part of the system goes bad. Hence the $220 billion (30 trillion) in funds the Government claims to have for the Bridge Bank and The Rehabilitation Bank will simply not be enough once the system starts to melt down.

We need, therefore, to create a SYSTEMIC response, and an organizational solution, independent of the Ministry of Finance and The Bank of Japan. We need to create an "Emergency Room" with access to ALL of the credit facilities on which Japan can draw. Only this magnitude of credit line can avoid panic when the inevitable crash arrives. This credit facility will have to have unlimited access to all national assets, both tangible and intangible, and be able to allocate credit to the threatened. At this stage, however, no one in Japan knows exactly how big Japan's national assets are. My estimate is that they are no smaller than a few trillion dollars.

The credit facility also needs to be independent of the Ministry of Finance and the Bank of Japan. They have created these problems and, despite the many warnings given them both privately and publicly, they have not done anything fundamental to prepare a remedy for COT. They cannot think of cut the hux. They ARE the problem, not the solution. And they have to be removed from the new and, I hope, final operations described above.

7. Many American officials and businesspeople are aware of all this. Still, they continue to think and talk as if it is strictly a problem of, for, and about Japan. Nothing could be further from reality. In today's inter-linked economy, COT is as much an American or global problem as Japanese. It is, therefore, time for the leadership of the US to internalize the COT problem and work together with the Japanese to design and implement the best possible solutions. It is their—your—best interest to do so. In due course, it will probably be necessary for you to help administer our turnaround operations. And American investors will have to bear with us during these turbulent times. Remember, many Japanese financial institutions played a critical role during the American turnaround operations of the 80's and even in the 90's. It is time to trade places and work together, so as not to make a bad situation worse.

Thank you for your attention.

Prepared Statement of Brad Smith

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

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

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

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

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

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

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

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

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

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

In sum, this not only means that the Japanese market remains effectively closed to U.S. insurers, but that Japanese consumers continue to be denied the benefits of a competitive marketplace.

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

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

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

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

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

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

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

I would be pleased to answer any questions.

AMERICAN COUNCIL OF LIFE INSURANCE,
CARROLL A. CAMPBELL, JR.,
President & Chief Executive Officer, April 24, 1998.

Hon. RICHARD FISHER,
Deputy U.S. Trade Representative,
600 17th Street, NW,
Washington, DC 20508

Dear Ambassador Fisher: Thank you very much for the recent meeting with members of our *Insurance Trade Agreement Compliance Monitoring Task Force.* Attached as you requested is our analysis of the current status of Japan's implementation of the 1994 and 1996 Insurance Agreements, which tracks exactly with the problems we had identified and have been providing your staff technical details on since the beginning of the year. With less than three months remaining until the July 1st trigger date requiring USTR determination of Japanese compliance with primary sector liberalization measures, please note the substantial highlighted sections where the Government of Japan has failed to live up to its promises in fundamental areas of these agreements.

Japan is now the world's largest insurance market, but foreign market share is still by far the lowest of any OECD member country. Full and good faith implementation of these agreements represents the only way U.S. insurance companies will be able to fairly compete, and reap the benefits of what on paper IS a very good agreement. USTR must continue to vigorously stress to the Japanese that agreements must be fully implemented, anything else is unacceptable.

We look forward to working with you to provide for a broad based consensus industry determination on this matter, and promise tO continue our strong support for your advocacy efforts in the week's to come. We look forward to a report on the trip to Japan by Assistant USTR for Japan, Wendy Cutler, that will hopefully make clear how the Japanese Government will comply with all required measures before July 1. We hope the attached analysis will provide a blueprint for determining the real status of implementation.

Thank you for your continuing review of this matter.

Sincerely,

CARROLL CAMPBELL.

* * *

STATUS REPORT ON IMPLEMENTATION OF U.S.-JAPAN INSURANCE AGREEMENTS; FAILURE BY GOVERNMENT OF JAPAN TO COMPLY WITH OBLIGATIONS

INTRODUCTION

In 1994 and 1996 the Government of Japan undertook two agreements with the Government of the United States designed to promote transparency and deregulation of the Japanese insurance market and to open it to meaningful foreign participation. The U.S. insurance industry recognizes that some limited progress has occurred since 1996. However, the overall goals of these agreements are far from being achieved. Until such time as Japan fully implements the commitments it has made to substantially deregulate the primary sector areas of its insurance market in a transparent manner, it is obligated to maintain existing protections for foreign firms that have created significant market niches within the so-called third sector.

Taking in to account the following review of all the key implementation issues, the U.S. insurance industry believes there is no basis for USTR to allow the Ministry of Finance to begin to run off the 2 tie: year clock as of July 1998 as set forth in the 1996 agreement. USTR should establish a firm date now, well in advance of July 1, with the MOF to review all pending issues and obtain agreement on what actions are necessary to justify the start of the 2 t/2 year clock.

BACKGROUND

For U.S. insurers, the Japanese insurance market remains highly restrictive and extremely difficult to penetrate. At $4 trillion, it is the largest insurance market in the world. Yet the foreign share of Japan's market is a mere 3.9%. By contrast, the foreign market share of every other G7 country is at least 10% and in some cases exceeds 30%.

In the 1994 agreement (Measures by the Government of Japan and the Government of the United States Regarding Insurance), the text states clearly that the purposes of the agreement are:

"Substantially to increase access and sales of competitive foreign . . . services" and to "address reform of relevant government laws, regulations and guidance which have the effect of substantially impeding market access for competitive foreign . . . services, and [to provide] significant improvement in market access for competitive foreign insurance providers and intermediaries".

As with all agreements negotiated under the Clinton Administration's U.S.-Japan Framework, the insurance agreement was designed to be "results-oriented." The agreement contains general and specific quantitative and qualitative criteria to determine whether the above goals have been achieved.

The 1996 (Supplementary Measures Agreement) sets out a date specific time frame for the introduction of insurance liberalization measures by Japan, including the July 1st USTR determination regarding implementation of all primary sector measures. The 1996 agreement represents the lever by which the 1994 agreement will liberalize the Japanese insurance market. Without vigorous monitoring of Japanese implementation and appropriate advocacy by USTR about non-compliance, neither agreement are worth the paper they are printed on.

CURRENT STATUS

USTR provided the following assessment of Japan's implementation of its insurance obligations in the recently released 1998 Foreign Trade Barriers report:

> "In January 1998, the U.S. and Japan conducted the most recent biannual review of Japan's implementation of its commitments under the insurance agreements. The U.S. raised serious concerns with the lack of transparency of Japan's insurance reform process. In particular, foreign firms have not been given a meaningful voice in the discussions to reform the rating organizations. A similar disturbing lack of transparency is seen in the process to establish a Payment Guarantee System, revise rates for personal accident insurance, reallocate premiums of the Housing Loan Corporation among insurance providers, and in the approval process for new products and rates. Similarly, the United States is extremely concerned with the diminution of the third sector safeguards caused by increased activity of the part of Japanese insurance firms and subsidiaries in this segment of the market. The United States is actively pursuing these issues at senior levels with Japan so as to ensure full and faithful implementation of the insurance agreements."

The U.S. insurance industry fully shares USTR's view that Japan has thus far failed to comply with numerous critical elements of the 1994 and 1996 agreements.

KEY IMPLEMENTATION ISSUES:

Below is the status of compliance with key provisions of the 1994 and 1996 insurance agreements:

1. Third Sector Protections

The "third sector" is comprised of specialty insurance products such as personal accident, medical and cancer insurance. It is distinguished from the primary sectors of Japan's insurance market of life (first sector) and property/casualty (second sector). Arguably, the third Sector is the core issue in both the 1994 and 1996 agreements. The USTR successfully linked future domestic Japanese industry access to this area (representing some 5% of the overall market) only if Japan implements substantial deregulation of the primary areas of life and non-life insurance (95% of the market).

Requirements: Under the 1994 Agreement, the GOJ pledged to continue long-standing restrictions on entry by Japan's large insurance companies into the life portion of the third sector, as well as specific restrictions on third sector activities by life and non-life companies and their subsidiaries. These limitations on entry by large domestic companies and their subsidiaries must continue until primary sector liberalization has been achieved, and a transition period (2-1/2 years) has expired. Without enforcement of this provision, the foreign share of Japan's market may actually fall. Its purpose is to enable foreign firms to establish some toehold in the primary sectors before they face an onslaught in the third sector from large Japanese insurers.

Status: The Ministry of Finance has failed to live up to this key provision in several critical ways. First it has allowed the second largest Japanese non-life company (Yasuda) to circumvent the agreement by allowing Yasuda to establish a de facto subsidiary through its partial ownership of INA/Himawari. This circumvention has created "radical change" in the third sector—a clear violation of the 1994 and 1996 agreements. Further, the Yasuda circumvention has created pressure on the Ministry of Finance to allow other large Japanese companies to enter the third sector, specifically by approving a cancer insurance rider product for Tokio-Anshin, the new life subsidiary of the Tokio Fire and Marine, Japan's largest non-life company. Japanese industry sources also indicates two more Japanese companies are considering similar applications to enter into this restricted area..

US Industry Comment: The MOF must stop the Yasuda violation of this agreement immediately. Under no circumstances should the USTR allow the two and one-half year ("reasonable period") start date to begin on July 1. The damage done to U.S. industry interests by Yasuda in the third sector is incalculable. The 1996 agreements terms have been violated now for sixteen months. Even if all their primary sector deregulation commitments are fulfilled by July 1 (about which we have serious doubts) the July 1 date should be postponed until after the Yasuda matter is addressed for at least the same amount of time Yasuda has been in violation.

2. Rating Bureau Reform

Requirements: Under the 1994 agreement, the MOF is obligated to implement reforms allowing insurers to differentiate on the basis of the risk insured, the rates and form of insurance products, and the means by which they are distributed, and to eliminate the requirement for insurers to use rates calculated by the insurance Rating Organizations.

Status: A bill to revise the Rating Organization Law is currently pending before the Diet. However, given the vagueness of proposed law, future roles of Rating Organization and MOF remain unclear, and may continue to significantly constrain ability of foreign firms to create new products and set rates on basis of risk insured.

U.S. Industry Comment: The Rating Bureau reforms must be consistent with the terms of the agreement. Necessary legal changes should embrace all regulatory and administrative measures as required before July 1. Expense data should not be collected: we want to increase the likelihood of broader pricing flexibility/differentiation/competition in the marketplace. Current methodology for review of Personal Accident (PA) rates and MOF oversight must be maintained until at least 2001 to prevent radical change even after RB is reformed. USTR should insist that it be allowed to comment on draft ordinances and regulations before they are finalized. USTR should have verifiable evidence that MOF will approve new rate applications without regard to whether such applications use data calculated by the Rating Organization. Additionally the recent modification of OTA rates was a blatant attempt by the RO to introduce its own rate revisions before the obligation to use their rates was removed.

3. Approval of Product Applications within 90 Days

Requirements: Unless specifically rejected, MOF examiners must approve within a standard 90 day processing period application of new products.

Status: MOF concedes that they continue to not approve all product applications within 90 days, and compliance rate has fallen recently. Both life and non-life products exceed 90 day requirement by from 2 weeks to several months. Increased staffing needed to process increased application volume. Possible MOF is withholding foreign approvals to prevent foreign firms from gaining lead over domestic firms. MOF continues to encourage uniformity of product design and pricing, which both reduces workload and minimizes differentiation between foreign and domestic firms.

MOF also has not changed its long-standing practice of requiring companies to engage in lengthy pre-application discussions.

U.S. Industry Comment. Delays in the approval process are contrary to the terms of the 1996 agreement. Foreign firms continue to suffer from the MOF's attempt to prevent meaningful competition. MOF should undertake an overall review of its product process to ensure micromanagement approach is eliminated.

4. Notification System

Requirements: The MOF is required to allow the marketing of listed products within 90 days unless company notifications are specifically rejected.

Status: MOF has established notification procedures for required products, although further efforts to streamline approval process are necessary.

U.S. Industry Comment: Continuing concern about whether MOF has actually changed its longstanding prior approval approach to product applications.

5. Payment Guarantee System

Requirements: The 1994 and 1996 agreements call for MOF consultation with US insurers in Japan on the development on insurance regulations both generally and those dealing specifically with liberalization measurers. The PGS has dramatic effects on both current foreign insurers in Japan, as well as foreign insurers considering entry into the Japanese market. A non-transparent or bias PGS would cause severe negative impact on the financial status of US companies with current operations, and on the chances for entry by new US players.

Status: The Japanese Diet is currently considering PGS regulation adoption. Some U.S. insurers in Japan were consulted in the formulation the PGS, but not all, and many legitimate concerns were not included in the final proposal.

U.S. Industry Comment: Foreign insurers should be given seats and allowed equal representation on the soon to be formed Establishment Committee, which will finalize the Articles of Incorporation for the PGS. Important forward looking considerations include that the future governing body of the PGS include full and equal participation by foreign insurers, and that USTR focus on monitoring that the establishment of the Policyholder Protection Organization (PPO) is fair, transparent, and consistent with or clearly takes into account the views of foreign insurers regarding the formula for contributions, the degree of protection given, and the operation of the fund.

The new PGS should not be biased against foreign insurers. Insurers that do not write high risk products should not be unduly burdened by failures in those product lines. Currently, the PGS proposal does not distinguish between different product lines with different risk factors. By failing to respect such a distinction, the validity of the PGS proposal and related regulatory issues are raised. The solvency and reserve requirements are very different between the risks inherent for insurers specializing in speculative asset accumulation products (i.e., annuities, GICS, etc.) as opposed to those who sell more actuarially predictable insurance products such as life or certain categories of health insurance. In the U.S., an individual insurance company must pay according to the premium written by product line. While the U.S. guaranty system looks to all insurers to contribute to the guaranty system, it is carefully structured so as to require companies engaged in "like product lines" to take initial and primary responsibility for contributing to the fund.

In the absence of product risk sub-accounts, the formulae to be applied should increase the weighting on reserves, thus appropriately reducing the pressures on companies which underwrite selectively and soundly. Because the proposed PGS will be guaranteeing 90% based on liability reserves, it is therefore logical for the contribution formula to be more strongly weighted on the reserves. Under the proposed nonlife PGS, the formula for contributions for insurers is 70% on premiums and 30% on reserves. The 70% premiums—30% reserves disproportionately impacts foreign insurers. Domestic insurers have a 1 to 2.4 premium to reserve ratio. Foreign insurers have a 2 to 1 premium reserve ratio. From the ACLI member perspective, a formula that weighted 100% on reserves would be ideal. Realistically, 70% on reserves would likely be more viable. At a minimum, the contribution formula should be 50% reserves of only those products/lines of business covered by the PGS and 50% written premiums for only those product lines of business covered by the PGS. This inherently requires that there is a strong and effective regulatory early warning system with solvency margin standards in place and enforced. If so, there will be no opportunity for financially unsound insurers to hide inadequate reserves or underreport their reserves. This is essential to a well structured regulatory system.

In its current form, foreign insurers would be "at the mercy" of the PGS. Consequently, it is imperative that management of the PGS be "independent" i.e., not a management structure of all insurers with little voice for non-Japanese insurers.

The management structure already followed by the JNLIA and the Rating Organization would not be appropriate. The MOF must commit to monitor the market with rigorous application of early corrective measures to avoid, or at least limit, the number and size of insurance failures.

We also believe that the Japanese government should share the burden in financing insurance companies that are already in poor financial health; there should be limits on the assessments made on healthy insurers, and there should be responsible maximum limits for policyholders benefits in the case of insolvency. To do otherwise would be to promote irresponsible consumer and company activity while abandoning the significant work already done to promote a healthy market with transparent regulatory oversight.

6. Transparency

Requirements: Under both the 1994 and 1996 agreements, the Government of Japan committed to consult with the U.S. Government and industry on all relevant implementation measures, including formulation of new regulations.

Status: As expressed in the majority of issues raised in this analysis, the Government of Japan has: Not consulted with the totality of U.S. industry on many important issues; Not incorporated relevant prudential recommendations of US industry in the formulation of new regulations; and Not required Japanese companies to adhere to liberalization measures as required in the agreements.

U.S. Industry Comment: Transparence is key to true liberalization of the Japanese market. As long as the current closed system exists, entrenched powers will prevail in maintaining a uncompetitive insurance marketplace. The U. S. Government should advocate for a clear and transparent regulatory and decision making process which incorporates the views of U.S. insurance companies to the same extent as Japanese domestic companies.

7. Staffing of MOF Insurance Sections

Requirements: Numerous obligations under the 1994 and 1996 agreements can only be implemented if MOF has sufficient resources to adequately evaluate new product proposals and review applications. The 1994 Agreement specifically states that MOF is to "take immediate steps to increase the number of staff in charge of processing applications."

Status: MOF insurance operations continue to be seriously undermanned. There is increasing evidence that overburdened staff is falling further behind in managing increased responsibilities. Staff resources under the new Financial Supervisory Agency will be even more constrained. Failure to adequately staff these functions will undermine efforts at fundamental reforms.

U.S. Industry Comment: There is every indication that the MOF staffing situation is worse, not better (as required by the 1994 agreement). A much more serious bottleneck can be anticipated after Rating Bureau reforms go into effect if the MOF continues to exercise de facto prior approval for all new product applications. Delays will become even longer.

Conclusion: Overall, the ACLI member companies have serious concerns as to whether Japan will be able to live up to its commitments by July 1. The USTR should insist on a postponement of the 2+ year start date until the MOF has satisfied all elements of what would reasonably be considered substantial deregulation. Once the clock starts ticking, all leverage is gone to affect change in the primary sectors of the Japanese insurance market.

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

Prepared Statement of Peter S. Walters

INTRODUCTION

Mr. Chairman and other distinguished committee members. Thank you for the opportunity to appear before you today to discuss Japan trade issues. This is an especially timely hearing in light of the visit next week of Japanese Prime Minister Hashimoto.

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

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

BACKGROUND

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

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

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

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

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

EFFORTS TO OPEN THE MARKET

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

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

- Japanese flat glass manufacturers and distributors released public statements that the market was open on a non-discriminatory basis for competition by all suppliers, foreign and domestic alike.
- The Government of Japan endorsed these statements and agreed to survey the industry annually to ensure that the goal is being met. The data required to be collected in the annual survey is spelled out in great detail in the agreement.
- The Japanese Government also agreed to strengthen building standards to require greater use of energy-efficient glass products and safety glass.
- U.S. suppliers agreed to continue to work hard, with the support of the U.S. government, to take advantage of new market opportunities.

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

THE CURRENT SITUATION

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

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

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

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

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

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

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

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

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

Mr. Chairman, market access must be a central issue—along with reform of the financial system and macro-economic policy—when Prime Minister Hashimoto visits Washington next week. It is especially important that existing market access agreements—such as flat glass—be faithfully implemented. We expect President Clinton to raise the issue in a firm and clear way. We urge you also to press the issue in your contacts with Prime Minister Hashimoto and his delegation. It is important for Japan to know that the Congress believes Japan must take prompt action to address market access issues with the United States.

Thank you for the opportunity to appear before you today. I would be pleased to respond to any questions you may have.

COMMUNICATIONS

AMERICAN CHAMBER OF COMMERCE IN JAPAN,
July 23, 1998.

SENATOR WILLIAM V. ROTH, JR.,
Chairman, Senate Finance Committee,
215 Dirksen Senate Office Building,
Washington, DC.

Dear Senator Roth: As President of the American Chamber of Commerce in Japan, which represents almost 3000 individuals and companies in the manufacturing, retail, and finance industries, I would like to thank you for holding the recent hearing on Japan's international economic role and current internal reform efforts. Your hearing brought attention to an important bilateral economic relationship and raised many issues of direct concern to U.S. companies doing business in Japan.

I would also like respectfully to submit the attached ACCJ position papers for the record. They outline some important areas of concern we have identified in the banking and financial services areas and should be considered together with our five recent position papers on insurance issues, which I understand have already been submitted into the record.

Again, on behalf of the ACCJ, thank you for holding your July 14 hearing and for your continuing interest in U.S.-Japan relations.

Sincerely,

GLEN S. FUKUSHIMA, *President.*

* * *

THE AMERICAN CHAMBER OF COMMERCE IN JAPAN SECURITIES INVESTOR PROTECTION FUND VIEWPOINT

BACKGROUND AND ISSUES:

The ACCJ welcomes the establishment of an Investor Protection Fund (Fund) to raise investor confidence in the securities industry (Industry). We believe the Fund is a necessary element of the Big Bang reforms and, consistent with the Government of Japan's stated policies, should be established in a "free, fair and global" (i.e., transparent) manner.

The ACCJ is concerned, however, that the Fund is being designed without input from concerned parties in the Industry and without scrutiny by the Japanese public and international financial community. We do not believe that the Fund can achieve its objectives if the views of interested parties are overlooked at its inception.

The greatest contribution that the Fund can make to the stability of the Industry is not providing money but rather promoting stricter requirements for procedural safeguards such as the segregation of customer assets and raised fiduciary standards of financial intermediaries in the Industry (Members). Without such requirements, there is little incentive for Members of the Industry to reform their own internal practices and no guarantee that the mistakes of the past will not be repeated again.

Various proposals to finance the Fund with premiums calculated based on trading volume require close examination and consideration by the Industry in a fully transparent manner. The eventual formulation decided upon must be fair to both newcomers and existing Members and should not be merely designed to create a pool of money which can be used to compensate for and cover up historic inefficiencies in the system.

RECOMMENDATIONS:

The ACCJ advocates that the Fund be established and operated on a basis consistent with the following 6 fundamental principles:

1. *The Fund Must Represent the Interests of its Members.* The Fund must be given appropriate legal standing to represent the interests of its members independently of Industry supervisors. The Fund's charter should set out the powers of the Fund and the standards and requirements for membership clearly and unambiguously.

2. *Fund Administration Must Be Transparent.* All the procedures of the Fund should be detailed explicitly in the charter and adhered to faithfully, and all its activities should be reported to the Financial Supervisory Agency (FSA), the Fund membership, and the public at large. The old Investor Protection Fund (old Fund) should be held up to the same standards of transparency before the Fund takes over any of its outstanding obligations.

3. *Beneficiaries and Covered Assets Should Be Defined Inclusively, Not Exclusively.* It appears that the class of beneficiaries will be defined to exclude "professional investors." Given the unavoidable difficulties in identifying all the parties to be excluded, we urge that the "general investors" who will comprise the class of beneficiaries be defined specifically by which parties are included. The same argument applies to the definition of the class of assets to be covered. Only such an approach is consistent with the Government's commitment to a free, fair and open financial system in Japan.

4. *Membership Qualification Should Require Confirmation of Compliance.*

—*Asset Segregation.* The crucial importance of the segregation of assets is recognized in the proposed Financial System Reform Act (FSRA). If Members are allowed to draw from the Fund before complying with asset segregation requirements, the Fund will be drained to protect the assets of members instead of the assets of customers, subverting the essential aims of the Fund.

—*Compliance with Solvency Ratios.* Industry regulators have paid insufficient attention to the enforcement of solvency ratios. To maintain both investor confidence and the integrity of the Fund, the Fund should take the lead by requiring compliance as a prerequisite for membership and suspending the membership of non-compliant members. Capital adequacy should be reported and monitored on a daily basis and made available to the public on at least a monthly basis.

—*Transparency of Basic Member Information.* Basic Member information, including information regarding asset segregation and solvency should be independently confirmed and available as a matter of public record.

5. *Public Funds Should Be Provided From the Outset.* Given the importance of Industry stability to the public interest, as well as the extent of government involvement in Industry regulation and the mandatory nature of the contributions to the Fund, we feel that the Fund should seek matching and capping public funds from its inception. Such inclusion is essential to ensure accountability of Fund administrators to the public and transparency in the Fund's operation.

6. *Both Contributions and Representation Should Be Proportionate to Size.* Fairness demands that contributions made to the Fund be proportionate to benefits received. Fairness also demands that voting rights on issues affecting the Fund be proportionate to contributions made. The size of customer assets held as a custodian or fiduciary, or some derivative thereof, would provide the best measure of the benefits derived from membership in the Fund. Approaches to calculating Fund contributions on the basis of transaction volume are not only biased (i.e., not "fair"), but also they treat all transactions as equally risky and ignore the basic concept of asset risk weighting which has become widely recognized as being critical to the determination of solvency and investor protection. An approach which imposes fees based on transaction volume and treats all transactions equally for such purposes would reward exactly the type of imprudent conduct by Members which has led to the existing problems with the Old Fund.

We are hopeful that a new Investor Protection Fund, designed with maximum opportunity for input from all concerned parties, will play a useful role in restoring investor confidence and reforming Industry practices in Japan. The ACCJ would welcome the opportunity to provide further input with respect to the proposed structuring and creation of the Fund.

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THE AMERICAN CHAMBER OF COMMERCE IN JAPAN
THE INTRODUCTION OF A LOAN SERVICER ACT VIEWPOINT

BACKGROUND:

The Liberal Democratic Party has recently issued an outline of a proposed law (the "Servicer Act") to allow third-party servicing companies ("Servicers") to service loans, installment receivables and other forms of indebtedness ("Loans") originated by certain financial institutions. Such a law could facilitate the development of a liquid secondary market for non-performing Loans ("NPLs") in Japan by fostering the growth of a healthy receivables servicing industry. It is anticipated that the bill will be adopted in the upcoming Diet session.

ISSUES:

Unfortunately, existing drafts of the proposed bill would impose unnecessary requirements and limitations on Servicers including the following:

1. Requiring prior approval to become a Servicer,
2. Requiring Servicers to appoint a lawyer to their Board of Directors,
3. Prohibiting non-Japanese financial institutions from servicing Loans,
4. Limiting the types of Loans that might be serviced; and
5. Prohibiting Servicers from engaging in related businesses.

RECOMMENDATIONS:

1. *Exempt Qualified Companies from Onerous Prior Approval Procedures.* Approval procedures may be needed to keep undesirable elements from entering the Servicer industry and taking advantage of loan recovery and foreclosure situations. However, companies which possess proper financial qualifications and have no record of criminal activity or ties with organized crime should not be subjected to the same level of scrutiny. Imposing a prior approval requirement will slow down unnecessarily the process of resolving Japan's NPLs problem and is unlikely to be effective in eliminating such influences (which in all economics are better address through strong transparency regulations). The following types of companies should not need prior approval to act, or to provide services related to, this activity as Servicers (or should be entitled to a simple and expedited licensing procedure):

   a. Companies listed, or controlled by a company listed, on a major international stock exchanges; or

   b. Professional services firms (e.g., major international accounting and consulting firms); or

   c. Companies specializing, or controlled by a company specializing, in loan servicing, and rated average or better by an internationally recognized Rating Agency.

2. *Require Lawyers for Court Appearances but not for Company Management.* Legal action to recover delinquent Loans necessarily involves lawyers, but the day-to-day management of a company does not. Non-lawyers should not be allowed to participate in the Japanese legal process, but scarce legal resources in Japan should not be wasted on the management of companies. Other countries do not have similar requirements for Boards or staff of Servicers, and neither should Japan.

3. *Treat Japanese and Non-Japanese Companies Equally.* Requiring non-Japanese companies to meet more restrictive criteria for licensing or entry into the servicing business is economically inefficient and runs counter to the government's stated goal of making Japan's financial economy free, fair and global.

4. *Open the Field to Include All Types of Debt Assets.* The types of Loans identified in the proposed bill include most of the non-performing receivables that present acute problems today. However, artificial restrictions on the types of Loans and debt assets that may be serviced is inconsistent with the concept of a free and global financial services industry and will unnecessarily hamper the future development of the Servicer industry in Japan. Servicers in other countries routinely handle all kinds of debt assets, and they should be allowed to do so in Japan as well. Japan should seek consistency with, not differentiation from, other major OECD legal and regulatory systems (i.e., regulatory convergence, not divergence).

5. *Continue to Allow the Same Companies to Both Originate and Service Debts.* Placing limitations on the scope of business which a Servicer may handle restricts the transfer of expertise to and from related areas. There has never been a distinction between originators and Servicers of Loans in Japan or in other OECD countries, and there is no need or justification for erecting a new barrier now. Certainly,

those Servicers who meet the highest standards of qualification (as set forth in point 1 above) should be allowed to continue both originating and servicing Loans.

6. *Transparency*. The best safeguard for the protection of Japanese consumers is an open and fair loan origination, processing and servicing industry. All Servicers should be required to be publicly audited in accordance with international standards (or comply with international professional service firms' standards) and required to make public the backgrounds of their officers and directors. License applications and renewals should be a matter of public record freely available for inspection, and procedures to handle consumer complaints regarding Servicers should be established as part of the law, or in related fair credit practices legislation. Such an approach to enactment and implementation of law and regulation have proved the most effective in eliminating criminal influences in other jurisdictions.

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ACCJ VIEWPOINT

TRANSPARENT LICENSING AND SUPERVISORY PRACTICES

BACKGROUND AND ISSUES

The ACCJ has for many years pressed for increased transparency and the elimination of anomalies in the Japanese regulatory process which sometimes result from the application of the undocumented and non-transparent system of "administrative guidance" to regulate Japan's financial markets. In that connection, the ACCJ welcomed the Government of Japan's recent enactment of the Administrative Procedure Act and its statements of intention to bring greater transparency to Japan's administrative procedures. However, the ACCJ believes that the continuation of the existing system of "administrative guidance" will make it increasingly difficult for the Government of Japan to implement the financial reform proposals announced by Prime Minister Ryutaro Hashimoto on November 11, 1996. The ACCJ is issuing this Viewpoint in order to clarify its views as to the essential elements of a regulatory system which will be perceived as ensuring procedural transparency and equal treatment of licensees.

RECOMMENDATIONS

The ACCJ urges the Government of Japan to consider implementation of the following "10 Principles of Transparent Licensing and Supervision" in the regulatory reform process which will accompany Japan's "Big Bang" reforms:

(i) Public Benefit Purpose. No licensing requirement should be imposed on a party unless the requirement is rationally related to some public good and such public good is expressly identified and explained in the relevant legislation or rule making proceeding.

(ii) Public Comment. Except in emergency conditions or where national security concerns exist, no new regulation should be adopted or imposed on licensees without such regulation being made available for public comment (by way of public hearings or opportunity for written comment) for a reasonable period.

(iii) Public Hearings and Review. All formal and informal hearings by regulatory authorities and/or any government sponsored (funded) advisory organs and councils concerning the issuance of new regulations (or changes to existing regulations) should be open to the public or, where such public proceedings are not feasible, transcripts of such proceedings should be made available to the public upon request.

(iv) Access to Internal Supervisory Manuals. Except where national security, public health or safety, or licensee confidentiality considerations are involved, members of the public should be furnished reasonable access, upon request (and at reasonable cost), to the principal internal manuals, memoranda, instructions and similar documentation used by Japanese government officials in carrying out their prescribed duties so as to ensure that licensees may fully understand the standard to which they are to be held.

(v) Public Inspection. All non-confidential applications for licenses should be available for inspection and duplication by any member of the public at reasonable times and cost.

(vi) Review Limited to Disclosed Criteria. All regulations or related explanatory materials governing the consideration and issuance of licenses should be reduced to writing and made available to potential applicants upon request. No license should be denied to a licensee on the basis of any factor not identified in such written regulations or explanations.

(vii) Prompt Review. No application for a license made in good faith may be refused filing for action by the relevant regulator and action should be taken on all applications received within a reasonable period.

(viii) Written Explanation of Denials. Any total or partial denial of any application for a license should be accompanied by a statement of explanation from the relevant regulatory authority detailing the manner in which the applicant has failed to satisfy the requirements of the regulations governing the issuance of these licenses.

(ix) Appeals. License applicants should be afforded meaningful access to administrative or judicial appeal of a license denial (or failure to act on an application) without prejudice (whether formal or informal) to the ability of the licensee to file additional or supplementary applications for licenses.

(x) Relationship of Licensees and Regulators. Care should be taken through appropriate measures to ensure that the relationship between regulatory authorities and licensees is maintained at arm's length and is not subject to influences unrelated to the protection of the public interests which the licensing process is intended to protect.

The ACCJ hopes that the legislation implementing the Big Bang reforms will include elements intended to address the above concerns, that the Japanese financial system will thereby become more transparent to the international financial community, and that Tokyo in turn will achieve its full potential as a major international financial center.

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ACCJ VIEWPOINT

APPROVAL OF DIFFERENTIATED PRODUCTS AND RATES WITHIN THE STANDARD PROCESSING PERIOD OF 90 DAYS

BACKGROUND

The 1994 US-Japan Insurance Framework Agreement includes the provision that the Ministry of Finance ("MOF") will give *"medium to small and foreign insurers . . . sufficient opportunity to compete on equal terms in major product categories in the life and non-life sectors through the flexibility to differentiate, on the basis of the risk insured, the rates, forms and distribution of products."* This provision was given specificity in the 1996 Supplementary Measures ("Agreement") and is a criteria for judging MOF compliance with the Agreement. A reasonable period was defined as two-and-a-half years and would commence July 1, 1998, but only if MOF approved applications for differentiated products or rates within the standard processing period of 90 days.

The ACCJ has evaluated the approval process and found that some progress has been made in approving differentiated products, such as non-smoker life insurance. However, MOF still engages companies in lengthy "pre-screening" discussions, for the majority of product applications. Pre-screening of applications renders the 90 day review period pro forma because accepted applications are predestined for approval. Only when these negotiations are complete and all issues resolved to MOF's satisfaction, will MOF formally accept an application, after which it is approved in a matter of days. In those instances when MOF accepts an application when submitted the first time, the sheer volume of work still required in the approval process has prohibited the examiners from completing the application review within the prescribed processing period of 90 days.

Apart from the Agreement, a standard processing period is outlined in MOF ministerial notification and is defined as 90 days for product approvals. The vague ministerial notification provides great leeway for extension of the processing period while companies add, revise or correct a product application. The notification also creates an exception to its 90 day standard period based on conditions within MOF. MOF is attempting to claim compliance with the Agreement by referring to its ability to "stop the clock" on the running of the 90 days period in its own notification.

The ACCJ has concluded that MOF is unable to meet the 90 day processing period in the Agreement. This is supported by the Government's own policy statement that recommends streamlining the approval process that was endorsed by the Cabinet on March 31, 1998. Until such time as MOF streamlines the approval process, or dramatically increases its level of staffing for these functions, it will be impossible for applications to be processed within the standard processing period of 90 days required by the Agreement. The ACCJ therefore recommends that the two-and-a-half year clock not begin July 1, 1998, but instead be delayed until a new streamlined approval process is introduced.

ISSUES

Product Approvals Exceed the Standard Processing Period of 90 Days

MOF examiners are conscientious and hardworking, but examinations often result in arbitrary rulings by inexperienced staff with little time in the job before rotation. There are numerous reasons for delay, most of which do not relate to correcting, revising or adding to the product application. These reasons include:

- Examiners are often too busy to meet and appointments are delayed or canceled;
- The examiners are not qualified actuaries with accumulated experience, so time is spent educating the examiners, particularly if a product is new to Japan;
- Delays are even longer after the annual MOF staff rotation; Product changes are often requested by MOF to encourage more uniformity in themarket, not because of an inherent design problem.

Even if consideration is given for the time required to make "legitimate" revisions to a product application, the standard processing period of 90 days is still being exceeded.

Substantial Deregulation has not Occurred in the Primary Life and Non-Life Sectors

As long as companies cannot introduce products in a timely manner, they do not have the flexibility to differentiate on the basis of product, price and distribution. As a result, substantial deregulation will not have occurred and the two-and-a-half-year-clock should not begin from July 1, 1998. Foreign companies are actively attempting to introduce new and innovative products, pricing and distribution to the insurance market. However, at this time, the approval process is still far too onerous to introduce differentiated products to the market. Just because a policy or benefit is different is not a reason for MOF anguish, rejection or prolonged examination. Differentiation is the essence of innovation.

RECOMMENDATIONS

MOF is engaging in after-the-fact re-definition of the standard 90 day processing period to claim it is in compliance with the criteria in the Agreement. Furthermore, it appears that compliance with the agreement is in the hands of MOF examiners. The ACCJ recommends implementation of the following measures, before it can be determined that MOF has complied with the Agreement.

- Senior level MOF officials (i.e., Director General) need to be engaged in actively monitoring the approval process on an ongoing basis;
- These officials need to provide a statement of policy and operating guidelines for the approval process;
- MOF examiners should be required to maintain a log to record meeting dates and the time required for each product approval, commencing from the start of presentation of the new product to MOF, regardless of any arbitrary distinctions between informal and formal review. This actual information should be reported to MOF senior officials and US Government representatives;
- There need to be official determinations on when the approval process can be extended beyond 90 days and reasons provided; prolongation should only be in extreme, rare occasions, not on a case-by-case basis;
- As per its commitment in the Agreement, MOF must act *"to achieve broad primary sector deregulation and will take immediate steps to increase the number of staff in charge of processing applications."*

The ACCJ also urges MOF to introduce, as soon as possible, proposals to relax the regulations for approving products that were called for by the Three-Year Deregulation Promotion Plan and were approved by the Cabinet on March 31, 1998. These proposals should include measures for liberalization of the approval process. Fundamentally, the industry should be supervised through prudential measures and not though the micro management of the approval process, especially if there are limited MOF resources available.

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ACCJ VIEWPOINT

UPDATE ON THE PAYMENT GUARANTEE SYSTEM

BACKGROUND

Prior to the submission of the Financial Services Reform legislative bill to the Diet, members of the ACCJ Insurance Subcommittee provided their Response to Recent Developments ("Response") in the Proposal for the Payment Guarantee System ("PGS"). The Response includes specific recommendations on several issues: moral hazard (self-responsibility, investment risks), transparency (solvency margins and early warning system), assessment formulae (differentiated business lines, premium vs. reserve ratios, pre-existing insurer formula), and other proposals to enhance the functionality of the PGS. The MOF did not incorporate in the PGS legislation the majority of these recommendations. As the MOF prepares to implement the PGS, the ACCJ offers this May 1998 Viewpoint on the PGS for consideration in the preparation of applicable ministerial ordinances.

ISSUES

The PPO should be independent, and equally represent the interests of all members

The Payment Protection Organization ("PPO") will be established to implement and manage the provisions and articles of the PGS. The PPO will have a board of directors, an organizational/operating committee, and an asset-assessment committee. A system managed by all the insurers would not provide any meaningful representation for foreign insurers. The Marine and Fire Insurance Association of Japan and the Foreign Non-Life Insurance Association are presently discussing several potential categories for the PPO representation: large insurers, medium insurers, small insurers, non-life insurance subsidiaries of life insurers, and foreign insurers.

The Proposed PGS Should Weigh Contributions According to Lines of Business

The proposed PGS makes flat assessments without regard to the type of insurance product of either the failed insurer or the PGS-contributing insurers. A flat assessment without differentiation for lines of business ultimately weakens the system by failing to recognize the economics of insurance. (i.e., Some products, like group annuities, have more risk than others.) Insurance products with greater risk, resulting from interest rate assumptions and policy duration risk, should have a higher risk-based factor in the PGS assessment formula. The PGS should assess charges to insurers in relation to the risk profile of the business being written. Moreover, it is unfair for the PGS to include foreign insurers in the bail-out of insolvent Japanese insurers for certain business lines from which foreign insurers have historically been excluded.

Public funds should be used to pay directly any debt in excess of a 10-year PGS fund ceiling

The PGS plans to make annual assessments over a 10 year period and plans to make public funds available under "appropriate circumstances." For example, public funds may be made available as PPO/PGS loan guarantees, if the 10-year fund is insufficient to cover the policyholders. Without any overall limit to assessments, very large insolvencies or a series of insolvencies may overwhelm the remaining insurers who must continue to pay.

An effective early warning system with accurate solvency margin disclosure is needed

A PGS should be viewed as an avenue of last resort. The goal of insurance regulators should be to create an environment in which the PGS is rarely, if ever, used. Primarily, the PGS should exist to provide the insurance buyer with a level of comfort that the market is watchful of his or her interests. A transparent and effective early warning system with solvency margin disclosure is one of the most important mechanisms for policyholder protection. Recently, the MOF has crystallized its plans to introduce an early warning/correction system, and the insurance industry is preparing to release standards for public disclosure of member companies' solvency margins.

However, the solvency margin formula does not fully reflect the risks undertaken by a company, including asset risk, underwriting risk and credit risk. For example, the formula should exclude unrealized appreciation of real estate and the use of subordinated loans to enhance surplus. These devices only give the false appearance of additional capital. If the solvency margin standards are to be an effective tool in triggering supervisory intervention, the formula should be exercised in a uniform and consistent fashion. Furthermore, the early warning system must be exercised in a rigorous fashion to limit the impact of an insolvency on the public and the entire industry.

RECOMMENDATIONS

- The ACCJ recommends that for both the life and non-life insurance industries: 1) the PPO structure apply due process principles to prevent the voice of dominating members from summarily over-riding or bullying any valuable minority opinions; 2) foreign insurers have meaningful representation in the development of the PPO provisions and articles, and; 3) foreign insurers are included on the board of directors and all PPO committees.
- The ACCJ recommends that the PGS assessment formula differentiate between different level of risk for different product categories. Furthermore, foreign insurers should NOT be charged for a particular product line, to the extent that foreign insurers were not allowed effective access to the market for that particular product line at any time.
- The ACCJ recommends that the PGS contain a cap or limit on insurance company assessments. Moreover, in the event of any shortfall beyond the 10-year assessment fund, public funds should not be used as mere loan guarantees. Rather, public funds should be used directly to cover any shortfall.
- The ACCJ recommends that the solvency margin formula accurately reflect all risks and that the early warning system be applied rigorously to prevent the continuing operations of an insurance company that is already in financial trouble.

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ACCJ VIEWPOINT

RADICAL CHANGE TO PA AND OTA RATES

BACKGROUND

The 1994 US—Japan Insurance Framework Agreement and 1996 Supplementary Measures (collectively, the "Agreements") provide that no radical change may occur in the third sector insurance market until the first and second sector markets are liberalized and US companies have a period of open access to those sectors. The 1994 Agreement established this mutually agreed principle of no radical change in the third sector until liberalization had first been instituted in the much larger first and second sectors. The 1996 Agreement specified certain criteria the Government of Japan would meet to achieve greater openness in the first and second sectors and recognized that the prohibition on radical change would continue for two and a half years after those criteria were met.

Personal Accident Insurance ("PA") and Overseas Travel Assurance Account ("OTA") are third sector products that US companies pioneered and on which they are reliant for a large portion of their revenues. These two third sector products are clearly covered within the mutually agreed restriction on radical change established by the Agreements. Prior to July 1, 1998, full PA and OTA premium rates are set uniformly by the Property and Casualty Rating Insurance Organization (the "RO") for all companies. In accordance with the Agreements, after that date the RO will give up this function and will produce only pure premium rates based on loss data that the RO collects[1]. Full premium rates which include loss, administration and acquisition costs, plus a margin for profit, will be set by the companies independently and competitively, subject to the Ministry of Finance's ("MOF") approval.

ISSUES

Changes to OTA Rates

In the final months before the RO gives up its function of fixing full rates, the RO has proposed and MOF is expected to accept changes that affect the premium rates for PA and OTA products. The OTA rate changes do not follow the historical practices of the RO and cause radical change in the third sector. Historically, the RO has adjusted profit margins (referred to as "fund revision") if (1) actual fund results are more than 10% above the products' designated 5% profit margin for the prior year or (2) actual fund results are more than 5% above the products' designated 5% profit margin for three consecutive prior years. While the PA rate revisions follow these criteria, the revisions in the OTA rates notified to MOF are not based on these criteria. MOF acceptance of OTA rates not supported by historical practice would be radical change and further would raise a concern that MOF intends to allow other radical change in the future.

In addition, the timing of the changes raises issues. A great deal of expense will be incurred in amending solicitation material and policy documents to reflect the new rates. This is despite the fact that insurance companies will be able to set their own rates and not follow the RO rates beginning July 1, 1998, soon after the RO's new rates go into effect.

Unlimited Discretion to Determine Rates Could Lead to Radical Change

After July 1, 1998, insurance companies may continue to use the full rates fixed by the RO for up to two years. Before the end of that two year transition period, insurance companies will be required to file their own full rates for PA and OTA with MOF. Currently, MOF has not given any indication that it intends to place any restrictions on the ability of insurers to file for and receive new rates for their PA and OTA products after the RO is reformed. This is in sharp contrast to Differentiated Auto Insurance ("DAI"), a second sector product which the Agreements specifically targeted for deregulation and in which US and foreign companies are actively interested. The ability of insurance companies to set rates for DAI has not yet been deregulated and continue to be restricted by guidelines issued by MOF.

The ACCJ Insurance Sub Committee is concerned that, prior to expiration of the two and a half year period for continuation of the prohibition on radical change, MOF will approve changes to the PA and OTA premium rates filed with MOF by large Japanese non-life companies that will constitute radical change from the rates fixed by the RO in the past.

RECOMMENDATION

After July, 1998 when the RO is due to be reformed, MOF should not allow changes to the PA and OTA premium rates of large domestic non-life insurance companies that deviate from historical practices, as that would also constitute radical change. The purpose of the Agreements would be contravened if unbridled competition were allowed in PA and OTA in the third sector while at the same time MOF continued restrictions in the form of guidelines on the ability of US companies to innovate in DAI in the second sector. ACCJ recommends that MOF adopt written guidelines for PA and OTA rates based on the historical practices previously followed by the RO as described above under the first Issue for the full period as mutually agreed in the Agreements. At the same time, the existing DAI guidance should be relaxed, or totally abolished, to allow for further differentiation in the primary auto insurance.

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ACCJ VIEWPOINT

TOKIO MARINE LIFE INSURANCE COMPANY'S CANCER RIDER LICENSE

BACKGROUND

When the 1994 US-Japan Insurance Framework Agreement and 1996 Supplementary Measures (collectively, the "Agreements") were concluded, there already existed long-standing practices regarding companies that were licensed to sell cancer insurance riders and the level of benefits offered. The Agreements captured all the understandings of the two Governments on this subject and are the only basis for evaluating compliance.

MOF committed to maintain these market practices in the Agreements by avoiding radical change in the business environment. Furthermore, it was understood that insurance companies could not circumvent the Agreements by using newly created subsidiaries to introduce products not allowed to be sold by the parent company. Accordingly, the eleven life subsidiaries of domestic non-life companies were not allowed to sell cancer riders when they began sales operations in October 1996.

However, in late 1997, MOF granted Tokio Marine Life Insurance Company ("Tokai Anshin") a license to sell cancer riders with a whole life or term base policy. This rider is a clear departure from prior market practices and violates the radical change provision in the Agreements. The benefits in the Tokai Anshin rider are more generous and radically different from other cancer riders in the market approved by MOF. The result is a package that very closely resembles a standalone third sector cancer product rather than a rider.

ISSUES

Tokai Anshin Has Replicated a Standalone Cancer Product.

In a word, Tokai Anshin's cancer rider and base policy package is highly competitive and is directly comparable to a standalone cancer product. Like the new generation of standalone cancer products, Tokai Anshin's rider focuses on benefits payable to the policyholder while alive. Therefore, cancer diagnosis and hospitalization benefits have high limits. Death benefit coverage is provided in the base policy. Premiums for the combined package come very close to that of a standalone product, especially when Tokai Anshin begins sales with a term product.

Tokai Anshin's Cancer Rider is Radically Different from Riders Sold by Other Insurers.

When the Agreements were concluded, market practice excluded the top five life insurers from selling cancer riders. Four mid-sized insurers sold a very basic rider, with large death benefits in the rider and/or base policy. Small insurers sold cancer riders as an additional benefit to the more important standalone FIH and cancer product. Market practice originally dictated that Tokai Anshin, backed by 81,000 Tokio Marine & Fire agents, be treated the same as the top five life insurers and not licensed to sell this rider.

However, MOF has now introduced radical change to the third sector when these clear past MOF market practices were ignored and Tokai Anshin was licensed to sell a rider that has more benefits and higher limits than riders sold by mid-sized insurers. Tokai Anshin's rider includes cancer diagnosis benefit, recuperation benefit and a hospitalization benefit, but without the hospitalization benefit maximums included in the riders of other insurers. Furthermore, Tokai Anshin has designed the product so that premiums are far lower than those already in the market.

Tokai Anshin's Cancer Rider Does Not Maintain the Ratio of Rider to Base Policy Benefits.

The ratio of hospitalization rider benefit to base policy benefit that was in practice before implementation of the new Insurance Business Law was set at 1:1,000 for mid-sized insurers. In the 1996 Agreements, MOF committed to maintain this ratio in order to avoid radical change in the business environment of the third sector. Tokai Anshin, however, is now selling a rider with a hospitalization benefit that is sold in the ratio of 3:1,000 to the base policy. The result is a very competitive product—in terms of price and level of benefits—and a violation of the radical change provision.

RECOMMENDATIONS

MOF permission for Tokai Anshin to launch this rider is a direct unraveling of a specific trade agreement between the governments of Japan and the US. This license is already encouraging other companies, both life subsidiaries and major life companies, to consider filing for similar applications. This development is a steady departure from the letter and intent of the Insurance Agreement and must to brought to an end. Tokai Anshin is poised to begin sales of a very competitive cancer rider and term base policy package. This product combination should be halted immediately. Furthermore, Tokai Anshin's cancer rider license should be suspended, or marketing activities curtailed, in order to limit the potential for further damage to foreign insurers operating in the third sector from any such radical change during the period as specifically mandated by the Agreements.

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ACCJ VIEWPOINT

REFORM OF RATING ORGANIZATIONS

BACKGROUND

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

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

Under the proposed revisions to the RO Law, the obligation of members of the Non-Life Rating Organization and the Automobile Insurance Rating Organizations (the "ROs") to adhere to standard, total premium rates calculated by the ROs will be substantially reduced. With two exceptions, the ROs will calculate only pure premium rates [2] for referential use by the ROs' members for all the fire, personal accident and automobile insurance lines covered by the two ROs. The two exceptions are compulsory automobile liability insurance ("CALI") and household earthquake insurance, which are government-mandated programs.

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

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

ISSUES

Ministerial Ordinances

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

Lack of transparency

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

Expense data

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

Directors

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

Quasi-Government Organization

In discussions with member companies regarding the ROs proposed new organizational structure and scope and mode of operation, it is clear that the ROs still consider themselves quasi-government organizations with little accountability to their member companies.

Recommendations from foreign members to combine the ROs into one organization and streamline its operations have been ignored. As long as the ROs are not market-driven service providers, they will continue to hamper industry efforts to innovate and differentiate themselves in the market.

RECOMMENDATIONS

- The draft Ministerial Ordinances should be revised and medical expense insurance and nursing care insurance deleted as lines of business for which the ROs will calculate pure premium rates.
- Certification that the RO Law has been fundamentally reformed should be delayed until such time as the current debate about the functions and the scope of the activities of the ROs is concluded. Until then it cannot be confirmed that fundamental reform has been carried through in the cabinet orders and ministerial ordinances and the RO's articles of incorporation and internal regulations.
- The collection of expense data intended by the ROs is included in their proposed new articles of incorporation. As the articles of incorporation of the ROs are subject to the prior approval of the Financial Supervisory Agency ("Agency"), the ACCJ recommends that the Agency not allow collection of expense data as this is likely to restrain competition.
- The number of directors is also included in the provisions of the ROs' articles of incorporation. The ACCJ recommends restructuring the configuration of the directors by the Agency. The non-member directors should be eliminated or their numbers substantially reduced.
- The ACCJ recommends that the two ROs be combined into one and duplicate administrative functions eliminated. Additionally, the RO should charge member companies only for basic services (calculation of pure premium rates) with all other services charged on a usage basis.

ENDNOTES

[1]: Pure premium rates are strictly the cost of losses, which is one element of the total premium.

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

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