

Future Directions for U.S. Economic Policy Toward Japan

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FOREWORD

During the last ten years, Japan has faced a difficult period of economic stagnation. Only now is the country showing preliminary signs of emerging from its economic slowdown. In response to its difficulties, Japan is gradually making changes to its traditional financial system. These changes are driven by Japan's desire to catch up with technological innovation and to resuscitate its economy. However, many of these reforms are controversial within Japan since they aim at the heart of traditional Japanese business practices. There are people both inside and outside Japan who perceive the reforms as happening too slowly. Others, however, fear the disruption and social dislocation of current and anticipated changes to the status quo.

These differing views have resulted in a domestic tension that permeates Japan's ongoing process of structural reforms. Although the controversy may cause the pace of reform to slow, the Council's Independent Task Force on Japan says that it also offers the United States an opportunity to seize the initiative in its economic policy toward Japan. Washington can now base its policies on the forces for change already at work within the Japanese economy, including technological development, globalization, increased mergers and acquisitions, and growing foreign direct investment.

The Task Force met for the first time in May 1999 and decided to examine structural reforms under way in the Japanese economy to determine whether they were fundamentally changing the way that business was being done in Japan.

In assessing developments in the Japanese economy, the Task Force came to three broad conclusions for U.S. economic policy toward Japan. First, the reforms that have already occurred within Japan's financial system are in keeping with the interests and goals of U.S. businesses. The United States should continue its current shift toward focusing its substantive policy agenda to support those reforms coming from within the Japanese marketplace, and that will in due course enable foreign entrants greater participation.

Second, the Task Force found that the United States could do an even better job in fostering market liberalization in Japan by shifting its priorities from traditional and controversial bilateral trade targets to more multilateral processes. Such a shift would acknowledge that Japan's internal structures are changing, as well as permit Washington to step back from a policy of constant public pressure on Japan for

reform. It would also allow the United States to continue recent efforts to focus on Japan's external behavior, more appropriate in this new era of globalization.

Third, the Task Force recommended that the United States adopt a fresh approach in its economic negotiations with Japan to match the changes in the economic environment worldwide. The Task Force concluded that the United States should concentrate on economic issues that enable new ventures to bring value to the Japanese market. While the role of government in both Japan and the United States has been pivotal in the bilateral economic relationship, corporate sector entrepreneurs and investors now must take the lead in forging the path for the future of the bilateral economic relationship. Both governments should do what they can to assist this process.

We were fortunate to have Laura D'Andrea Tyson, BankAmerica Dean at the Haas School of Business, University of California, Berkeley, chair the Task Force. She presided over the group's discussions with great skill and leadership. She brought her extensive expertise to the project but also solicited and incorporated the diverse views and experience of the members of the Task Force into this final report. Happily as well, Diana Newton, a former Council International Affairs Fellow, brought her considerable skills and knowledge to the Task Force effort.

- Leslie H. Gelb, President, Council on Foreign Relations

ACKNOWLEDGMENTS

I am enormously grateful to the chairwoman of the Task Force, Dean Laura D'Andrea Tyson, for being so generous with her time and energy throughout this project. In addition to bringing her experience as a former U.S official to the table, Laura kept the Task Force focused on the key issues and was tremendously effective in forging consensus out of diverse perspectives.

We would also like to extend our thanks to everyone who served on the Task Force, giving generously of their time at our various meetings and in reading various drafts of this report. Tracey Dunn and Chong-Lim Lee worked tirelessly providing important research and administrative assistance throughout the process. Les Gelb, Mike Peters, and Jan Murray at the Council were extremely supportive and offered excellent guidance throughout the process. Publication of the report is made possible by generous support from the Arthur Ross Foundation, for which we are all most grateful.

- M. Diana H. Newton, Project Director

EXECUTIVE SUMMARY

THE CHANGING ECONOMIC LANDSCAPE IN JAPAN

Japan's economy is emerging from more than a decade of stagnation, but its recovery remains painfully slow and subject to considerable downside risk. Weak balance sheets and bad debt pervade its banking and insurance sectors, a huge stock of outstanding government debt constrains its fiscal choices, and many of its firms require substantial restructuring to regain profitability and meet global competition. Despite the macroeconomic risks posed by these difficulties, there are reasons for optimism. Japan's economy has enjoyed positive albeit anemic growth for more than a year. Even more significant for Japan's long-run position are the

growing indicators that its prolonged malaise has finally sparked a process of real restructuring and meaningful economic reforms.

During the last few years, there have been some dramatic illustrations of how economic necessity is driving changes in the Japanese economy. In the last three years, the Japanese government has introduced new policies and new federal resources to stem the crisis in its banking system. Two of Japan's largest, most distressed banks have been sold to "outsiders," one to a foreign consortium led by American investors and the other to a Japanese consortium led by Softbank. Such transactions were unimaginable just a few years ago. In another break with tradition, several other Japanese banks are merging. During the last half-year two major Japanese companies-Sogo, a well-known retail chain, and Chiyoda, one of Japan's largest insurance companies-have been forced to declare bankruptcy after the Japanese government failed to find stronger domestic firms willing to acquire them. These bankruptcies signal the death knell of a distinctive feature of the Japanese economy known as convoy capitalism-the expectation that firms encountering serious financial difficulties would be rescued by stronger firms or banks.

Signs of significant change extend beyond the sales of distressed assets to unlikely buyers and the bankruptcy of major corporations. Japan's financial markets are becoming more open and competitive as a result of significant deregulation and changes in accounting and taxation. Venture capital and private equity firms are appearing in Japan, some arriving from the rest of the world, others sprouting on home ground. New start-ups are emerging in information technology industries. And older Japanese firms are merging with one another or with foreign firms to restructure their operations.

Significant increases in both foreign direct investment flows and the volume of mergers and acquisitions, most often executed with the help of foreign financial firms, reflect the painful changes taking place. Many of these changes go to the heart of Japan's traditional economic system-the preferential bank lending, supply, distribution, and cross-shareholding relationships among groups of firms and banks. Such relationships have impeded competition from both foreign firms and domestic new entrants. They have also insulated Japanese firms from the pressures for disclosure, transparency, and profitability characteristic of competitive financial firms. Many of these traditional features of Japan's economic system are exactly those that have been identified by American and other firms as structural barriers to Japan's markets. Driven by both necessity and the opportunities afforded by new information technologies, these impediments are finally breaking down.

But the process of structural change and reform, while real, is moving in fits and starts and remains painfully slow. And the dangers of backsliding are strong. There are deep tensions within Japan's political and business leadership between those who embrace such changes and those who steadfastly oppose them. The strength of the opposition should not be underestimated. It took the Japanese government nearly a decade to muster the political capability and will to address the banking crisis. Meaningful policies to stem the related crisis in the insurance sector have yet to be taken. Amid the dramatic examples of change there are signs that traditional approaches to Japan's economic difficulties still enjoy substantial support. The government's share of total fiscal investment and lending remains at an historic high, and new government programs to bolster Japan's semiconductor, biotechnology, and information technology industries have been introduced. Despite a decade of negative returns, so far the majority of Japanese households have chosen to keep their savings in low-risk, low-earning accounts with banks or the Postal Savings System. In addition to political, cultural, and bureaucratic reasons to resist change,

many Japanese are also concerned that if reforms and restructuring occur too rapidly, they could undermine confidence, reduce demand, and throw the economy into another macroeconomic tailspin. Given the fragility of Japan's current recovery, this is an understandable concern.

CONCLUSIONS

The members of the Council on Foreign Relations Independent Task Force on Japan believe that ongoing changes within Japan's economy provide both American policymakers and American businesses with opportunities to craft a new economic relationship between Japan and the United States. Task force members agree that this relationship must rest on the premise that a healthy Japanese economy serves America's economic and geopolitical interests. Despite its decade-long stagnation, Japan remains the largest economy in Asia, America's third-largest trading partner, and its major ally in the Asia-Pacific region.

The Task Force also believes that the structural reforms and changes now under way in Japan are essential to revitalizing its economy in the long run. At the same time, however, Task Force members are cognizant of opposition to such changes within Japan. Moreover, they are aware that America's leverage for influencing the telecommunications market following lengthy, sometimes contentious negotiations between American and Japanese officials suggests that the American government can hasten reforms at least when they are supported by powerful Japanese business interests. But as-or rather if-Japan continues to open its doors to foreign direct investment, American companies are likely to have many more opportunities to foster structural changes through their ongoing operations in Japan than the American government is likely to have through bilateral negotiations.

RECOMMENDATIONS

Although recognizing that Japan continues to confront significant macroeconomic challenges and risks, the Task Force decided not to address macroeconomic policy questions on the grounds that it had little to add to an already broad discussion of such questions by both American and Japanese scholars and policymakers. Instead, the Task Force decided to focus its attention on the structural changes in Japan, their likely effects on Japan's long-term economic performance, and their implications for the course of U.S.-Japan economic relations during the next administration.

The Task Force recommendations reflect this focus and fall into three main categories: recommendations about the appropriate substance, form, and tone of U.S. economic policies with Japan.

Recommendations about the Substance of U.S. Economic Policies with Japan

1. Two broad areas of reform should be a major focus of economic dialogue between the American and Japanese governments during the next several years-reforms that improve the climate for foreign direct investment and financial-market reforms affecting how capital is raised and allocated. The development of modern equity-based financial markets in Japan will ultimately affect the structure and performance of the rest of its economy. And foreign direct investment by American and other companies will be a powerful catalyst for change. In addition, since a country's imports and its stock of foreign direct investment tend to be positively related, the continued growth of such investment by American firms is likely to increase Japan's imports, defusing trade tensions between the two nations to some extent.

2. These two broad policy priorities indicate that the U.S. government should focus its dialogue with the Japanese government on policies affecting financial markets and the investment climate in Japan, including accounting and reporting standards, taxation, mergers and acquisitions, and antitrust/competition policies.

3. Japan introduced consolidated accounting for listed companies in April of this year, making it easier for Japanese companies to divest non-core business interests and to consolidate. Such reforms provide more transparent accounts of Japanese companies to potential domestic and foreign investors, thereby enabling troubled Japanese businesses to command a higher price for their distressed assets by reducing the risks involved in requiring them. But the Japanese government, under pressure from the Ministry of Finance, has delayed implementation of consolidated taxation reforms based on the OECD practices to an indefinite future date. The absence of such reforms impeded purchases and sales of troubled Japanese companies, slowing the pace of restructuring and foreign direct investment. The U.S. government should continue to urge the Japanese government to enact consolidated taxation reforms quickly. Taken together, consolidated accounting and taxation reforms will make it considerably easier for U.S. companies to invest in Japan.

4. Japan's Commercial Code is nearly a century old and has many provisions that affect shareholder rights and corporate governance and that impede modern financial transactions such as company issuance and redemption of stock, stock splits, stock options, and pension portability. The Ministry of Justice has announced plans to update the Code's rules and regulations. Implementation of these plans through a timely and transparent process that allows foreign companies and legal experts to comment on proposed modifications of the Code should be a goal of U.S. economic dialogue with Japan.

5. The U.S.-Japan Income Tax Treaty was last amended in 1971. American businesses and the U.S. government have already expressed interest in renegotiating this treaty to deal with a wide range of issues including transfer pricing, venture capital investment, stock-for-stock exchanges of foreign company shares, and withholding rates on various kinds of income. Two of Japan's major trading partners have negotiated tax treaties with Japan that include lower withholding rates than the current U.S.-Japan treaty. To supplement the ongoing informal talks between the two countries, the U.S. government should prepare a detailed alternative to the current treaty, after extensive pre-negotiation and consultations with the Japanese government and with business representatives from both the United States and Japan.

6. The rise of new-economy activities in both the United States and Japan and the spread of cross-national mergers and acquisitions pose new challenges for antitrust policy. Recently, the United States and Japan concluded a new bilateral antitrust agreement. The next administration should monitor the enforcement of this agreement to strengthen consultation and cooperation between the antitrust authorities of both countries. During the last few years, the antitrust authorities in the United States and the European Community have consulted and cooperated on a number of high-profile cases affecting both markets. There may be lessons from these experiences that can be applied to U.S. relations with Japan in the antitrust arena.

7. The U.S. government should consider fostering an officially mandated dialogue on new-economy issues between American and Japanese business

leaders. (Such a dialogue could be part of the U.S.-Japan Business Roundtable or could be established as a separate entity.) Economic changes triggered by the diffusion of new information technologies are posing new policy challenges for both the U.S. and Japanese governments in such areas as telecommunications deregulation, Internet taxation and privacy, intellectual property protection, and competition policy. A dialogue on such issues could provide useful insights for both governments and could head off policy friction between them. In addition, much of the internal impetus for change within Japan is coming from firms in emerging Information Technology areas. Such a dialogue could yield mutually beneficial reform recommendations and act as an additional channel of pressure on the Japanese government from Japanese business leaders. The U.S. government should also explore the desirability and feasibility of establishing a tripartite dialogue among U.S., Japanese, and European officials and business leaders on new-economy issues.

8. Service sectors, including both financial services and telecommunications and Internet services, are areas in which American firms enjoy strong competitive advantages and in which regulation in Japan remains pervasive. Deregulation in these activities is likely to provide significant benefits for Japan's consumers and for American companies as well. It should be a continued focus in bilateral economic discussions between the United States and Japan. Within the telecommunications sector, a key issue remains the dominance of the Nippon Telegraph and Telephone Corp.: the recent reduction in NTT access charges, although important, is only a first step toward significant deregulation. The disruptive nature of the Internet and wireless technologies is weakening NTT's dominance and creating opportunities for new entrants into Japan's telecommunications market.

Recommendations about the Form of U.S. Economic Policies with Japan

1. Efforts by the U.S. government to encourage structural reform in Japan's economy or to resolve trade and other economic disputes with Japan should be rooted whenever possible in the framework of multilateral organizations, including the World Trade Organization (WTO), the Organization for Economic Cooperation and Development (OECD), the G8, and Asian-Pacific Economic Cooperation (APEC). The U.S. government should continue to rely on the WTO as the first step to resolving trade disputes with Japan. Additional WTO cases will help develop multilateral precedents about what comprises a "government" measure and how that term should be applied to actions involving a mix of government and business participants.

2. The next administration should support international efforts to restart a new round of multilateral trade negotiations and should seek fast-track authority from the U.S. Congress. In the long run, strengthening the WTO and broadening its coverage to areas currently excluded from its rules and dispute settlement processes will prove to be the most effective ways for addressing trade disputes with America's trading partners, including Japan. As it did to develop support for a global agreement to liberalize trade in information technology products, the U.S. government should also continue to use regional organizations such as APEC to encourage sectoral trade-liberalization agreements that can later be championed at the multilateral level.

3. During the past two decades, relations between the United States and Japan have frequently been strained by contentious bilateral trade talks focusing on structural barriers to Japan's markets. As these impediments begin to crumble in response to economic reforms, the impetus behind such talks is likely to dissipate. This is not to say that bilateral trade disputes between the United States and Japan will disappear altogether. After all, the United States continues to have heated trade disputes with Europe and Canada, economies much more like the United States than Japan in addition to being economies in which American companies hold far more direct investment than they hold in Japan. But sectoral trade disputes are likely to become the exception rather than the rule in U.S.-Japan economic relations as they were during much of the last twenty years. As reforms break down the structural barriers to Japan's market, Japan should begin to emerge as a more "normal" trading partner, and U.S. policy should adjust accordingly.

4. New regional agreements on monetary cooperation and subregional agreements on trade are now under negotiation in Asia, and Japan is playing a leadership role in both. Japan is seeking to negotiate bilateral trade deals with Singapore and South Korea and to promote a network of currency swaps to protect the Asian economies from speculative attacks. It is too early to tell whether such agreements will reinforce the multilateral system or compete with it; that is, whether such agreements will prove to be outward-looking or inward-looking. Both the United States and Japan share an interest in a well-functioning global economic system, and regional agreements can be useful ways to explore solutions that can ultimately be applied on a global basis. Regional arrangements to prevent currency crises and contain their contagion effects could prove to be a useful addition to multilateral arrangements. And subregional trade agreements could reenergize the global trading system. The U.S. government should work with Japan to make sure that such regional agreements are consistent with the WTO and reinforce rather than weaken the multilateral financial system.

5. Overall, the United States should encourage Japan's role as a partner in the Asia-Pacific region and should work with Japan to promote regional standards on issues of common interest such as the environment, rules for information technology industries, and infrastructure development.

Recommendations about the Tone of U.S. Economic Policies with Japan

1. American policymakers and business leaders should take advantage of the economic changes under way in Japan to foster a more collaborative and friendly tone in their relationships with their Japanese counterparts. As domestic pro-reform forces gain strength in Japan, they can take the place of *gaiatsu*, or foreign pressure, to open Japan's markets to foreign competitors. Then the balance in the tone of U.S.-Japan relations can shift from one of conflict and contention toward one of consultation and cooperation.
2. While remaining vigilant for signs of backsliding, the U.S. government should recognize and applaud Japan's progress in implementing meaningful economic reforms and continue to offer technical assistance to design and implement such reforms through bilateral and multilateral channels.
3. The U.S. government must continue to strive for a unified consistent economic message in its relations with the Japanese government. Public differences

- among government agencies on the appropriate course of U.S.-Japan relations undermine the ability of the U.S. government to achieve its goals.
4. Improved bilateral relationships and greater understanding among legislators and administration officials in both the United States and Japan will enhance the ability of the U.S. government to achieve its priorities in its relations with Japan. The next administration should explore the possibility of introducing a formal parliamentary exchange between the United States and Japan. The United States has such formal exchanges with Canada, Mexico, the United Kingdom, and the North Atlantic Assembly.
 5. Given the significance and breadth of economic relations between the United States and Japan, the U.S. government should devote more resources to agencies responsible for overseeing them. An increase in the number of government officials with experience or expertise in U.S.-Japan economic relations and knowledge of the Japanese language would help the U.S. government achieve its objectives.

TASK FORCE REPORT

THE CHANGING ECONOMIC LANDSCAPE IN JAPAN

The Japanese economy is slowly emerging from more than a decade of recession and stagnation, although in fits and starts. Recovery is taking hold, and signs of sustainable growth are spreading. Japan's current struggle has been compared to what the United States confronted in the 1970s and 1980s—a systemic restructuring triggered by macroeconomic difficulties, deregulation, and technological innovation. As change takes root in Japan's economic structure, the potential for Japan's recovery is enormous. Ken Courtis of Goldman Sachs stated this point succinctly when he said, "No major economy is further behind. No major economy has a bigger opportunity to catch up."^[1] This is especially true given Japan's inherent competitive strengths, evidenced in its work ethic, design capabilities, and technical expertise.

After years of economic malaise, necessity has become the mother of invention, spurring reforms in traditional economic structures and adjustments in economic policies. The impetus behind these changes is a complicated mix of long-term and short-term economic difficulties that have surfaced during the past decade. Several of the distinctive features of Japan's economic system, including the preferential lending, supply, distribution, and cross-shareholding relationships among groups of firms and banks, are beginning to evince signs of change. Many of these traditional features of Japan's economic system are exactly those that have been identified by American firms as structural barriers to Japan's markets. Driven by both necessity and the opportunities afforded by new information technologies, these impediments are finally breaking down. And the threat of impending bankruptcy or the necessity of massive restructuring has driven a growing number of Japanese firms and financial institutions to seek foreign capital and expertise, creating new and unusual opportunities for foreign companies.

Despite the fact that meaningful systemic reforms and foreign business practices are welcomed by some in Japan, not everyone agrees that opening the market to more competition is the best answer to Japan's economic challenges. There is a deep tension between those who embrace reforms and those who steadfastly resist them.

As a result, backsliding and inertia are recurrent problems, and the process of structural change and reform, while real, remains painfully slow. Although some of the opposition to reform is inspired by fear of change or fear of losing power within the status quo, some is justifiably motivated by the macroeconomic vulnerabilities of the Japanese economy. There is valid disagreement, both in Japan and in the United States, over the appropriate speed and direction of structural and policy reforms because of understandable concerns about the sustainability of Japan's macroeconomic recovery.

The members of this Task Force agree that several interrelated macroeconomic challenges pose serious risks to Japan's continued economic recovery. These challenges include a large federal debt, huge losses and nonperforming loans in the banking and insurance sectors, and weak consumer demand. We also agree that deregulation and systemic reforms that hasten the necessary restructuring of Japan's banks and companies could aggravate macroeconomic difficulties by undermining confidence, reducing domestic demand, and increasing unemployment. And we recognize that mistakes in macroeconomic policy, such as a premature return to positive real interest rates triggered by monetary tightening, could derail the economy's recovery. Our report, nonetheless, focuses on the structural reforms taking place in Japan, their likely effects on Japan's long-term economic performance, and their implications for the course of U.S.-Japan economic relations. Given the weight of Japan's economy in the global economy, we agree that the U.S. government has a legitimate interest in Japan's macroeconomic stability and should therefore continue to engage in discussions with Japan about appropriate policies to address its macroeconomic challenges. But we do not provide macroeconomic policy recommendations in this report. (Some of the comments of individual Task Force members at the end of the full report consider macroeconomic policy options for Japan in greater detail. One of these comments concludes that negotiating pressure by the U.S. government helped Japan avert a major macroeconomic collapse during the last several years.)

AMERICA'S INTEREST IN A STRONG JAPANESE ECONOMY

The ongoing changes within Japan's economy provide both American policymakers and businesses with opportunities to craft a new economic relationship between Japan and the United States. Task Force members agree that this relationship must rest on the premise that a healthy Japanese economy serves America's economic and geopolitical interests. Despite its decade-long stagnation, Japan remains the largest economy in Asia, America's third-largest trading partner, and its major ally in the Asia-Pacific region.

Although Japan's economic performance has been weak during most of the last decade, this situation will not last forever. America's business leaders and policymakers must look ahead to a time when Japan regains solid economic growth consistent with its potential. Just a decade ago, many Americans considered Japan a formidable competitive threat. Now many Americans dismiss Japan as economically unimportant. Both of these views present a highly distorted and misleading image of reality.

Despite anemic growth for more than a decade, Japan's economy today accounts for 11 percent of global GDP and three-fourths of economic output in Asia. Japan retains its status as the second-largest economy in the world and America's third-largest trading partner. Furthermore, Japanese companies are globally competitive in several industries including information technology, machinery, automobiles, and

consumer electronics, and they can and will continue to challenge their foreign counterparts. Overall, Japan remains the single largest economy and democracy in Asia with intimate and intensifying business and financial relations with U.S. markets and firms.

Given these strengths, some fear that a revitalized Japan could reduce U.S. influence and market share around the world, and that it could undermine American economic and geopolitical goals in the Asia-Pacific region. Such fears have led some to argue that a sustained economic recovery in Japan based on meaningful economic reforms is not in the U.S. interest. The members of this Task Force think this perspective is wrong. A healthy and prosperous Japan will be a more attractive trading partner and a stronger geopolitical ally.

While Task Force members agree that sustained economic recovery in Japan will benefit the United States, they also agree that America's ability to influence the pace and direction of reform in Japan is limited. The recent reduction in access charges in Japan's telecommunications market following lengthy and sometimes contentious negotiations between American and Japanese officials suggests that the American government can hasten reforms at least when they are supported by powerful Japanese business interests. But as-or rather if-Japan continues to open its doors to foreign direct investment, American companies are likely to have many more opportunities to foster structural changes through their ongoing operations in Japan than the American government is likely to have through bilateral negotiations. That is why the Task Force believes that reforms which improve the climate for foreign direct investment in Japan should continue to be a major focus of discussion between the United States and Japan.

JAPAN'S RECORD OF REFORM

Japan's postwar industrial structure centered on the keiretsu system, which linked several companies from different sectors with one another and with a main bank that was the dominant source of their funding. These preferential links limited both imports and foreign direct investment in Japan, as reflected by low ratios of imports and foreign direct investment in Japan's GDP as compared to the same ratios for other advanced industrial countries. At the same time, by providing an implicit guarantee against bankruptcy, the keiretsu system reduced the sensitivity of business actors to risk and encouraged excessive investment. Japanese firms encountering serious financial difficulties expected that they would be rescued by stronger firms in their group or by their main bank—a hallmark of the Japanese economy known as "convoy capitalism." In addition, most Japanese firms relied mainly on bank loans and cross-shareholding for their financing needs. Debt-equity ratios were relatively high, and Japan's capital markets remained substantially underdeveloped, although a halting process of financial deregulation finally got under way in the 1980s, largely at U.S. insistence. Consequently, Japanese firms were insulated from the pressures for disclosure or profitability characteristic of competitive equity markets. Moreover, the cost of capital to Japanese companies remained relatively low as a result of Japan's high savings rate and bank-dominated financial system, which directed saving into low-risk, low-return deposits rather than high-risk, high-return equities.

The distinctive features of Japan's financial markets provided fertile ground for the speculative and excessive investments that led to bubbles in Japan's real estate and equity markets in the late 1980s. When these bubbles burst, several major banks found themselves with huge portfolios of bad loans secured by real estate and equity

collateral whose values had plummeted. Throughout the first half of the 1990s, the government failed to address the mounting bad loans of Japan's banks, hoping that once the economy recovered in response to expansionary monetary and fiscal policy, asset values would be restored, solving much of the problem. But even when the economy began to recover in the mid-1990s, asset values remained depressed and bank balance sheets remained troubled. After the ill-advised consumption tax hike of 1997, the ensuing economic slowdown threatened to trigger a full-fledged banking crisis. To avert such a crisis, the government of Japan, with behind-the-scenes urging by the American government, was forced to increase the capital of major banks, to require write-offs of bad loans, and to enhance bank supervision. (See comments from Posen et al. at the end of this report for more detail on the role of the U.S. government.) These steps coincided with implementation of the Big Bang reform initiatives championed by then Prime Minister Ryutaro Hashimoto to liberalize access to Japan's insurance and securities industries, to reduce tax disincentives to financial transactions, and to curb the power of the Ministry of Finance. The Japanese government also established the Financial Reconstruction Commission and the Financial Supervisory Agency and strengthened the independence of the Bank of Japan. Both measures were intended to help unwind the banking crisis and to oversee the implementation of the Big Bang reforms.

Some in the Japanese bureaucracy welcomed foreign purchases of bad bank loans at discounted prices to ease the banking crisis. And as foreign capital was attracted for this purpose, foreign direct investment flows into Japan began to increase. Recent high-profile cases of such investment include: Ripplewood's purchase of the Long-Term Credit Bank of Japan (LTCB); Merrill Lynch's purchase of part of Yamaichi Securities; Citigroup's merger with Nikko Securities; GE Capital's investments in Japan Leasing and Toho Life Insurance; Nissan's joint venture with Renault; Cable and Wireless's acquisition of International Digital Communications (IDC); and Daimler-Chrysler's partnership with Mitsubishi Motors.

Perhaps the most remarkable of these transactions is the sale of the LTCB to Ripplewood Holdings LLP, an American-led partnership of foreign investors. The government of Japan established the LTCB during the early postwar period as the linchpin of its preferential allocation system for directing long-term loans to various industries. No one, especially the bank's employees, imagined that the government would allow such an important bank to fail, but the Japanese government ultimately had no choice. Once it became clear that the bank was no longer viable, the government nationalized its assets in the fall of 1998. The government then began a long and complicated process of restructuring the bank's balance sheet and searching for a private-sector buyer. When no domestic buyers came forward, the government was compelled to sell what had been a jewel in Japan's crown of banks to a foreign bidder. Although there was significant internal disagreement over this decision among Japanese government officials, the newly created Financial Reconstruction Commission (FRC) had primary authority. The head of the FRC, Hakuo Yanagisawa, favored the sale, arguing that the LTCB needed both foreign capital and foreign expertise to become a modern financial institution. After a year of labored negotiations, the sale was finally completed, and the newly named Shinsei Bank now serves as a dramatic example of how necessity has triggered economic changes unimaginable just a few years ago.

As the LTCB example illustrates, however, there is hardly consensus among Japanese government officials regarding the pluses and minuses of selling distressed Japanese companies to American and other foreign institutions. Such sales have occurred out of necessity. Japanese firms have been forced to choose infusions of foreign capital and business practices over shutting down operations and firing

employees. The resulting growth of foreign investment has intensified the pressures for reform in Japanese business practices and government policies. Japanese companies seeking foreign capital or capital outside the main banking system have been compelled to implement restructuring plans to attract new investors. Other Japanese companies have taken steps to emulate the business plans of successful foreign competitors. Some companies have been forced to accede to pressure from foreign shareholders for more transparent and open communications regarding management and corporate strategy. To help Japanese companies meet these new demands, the Japanese government recently implemented a 10 percent cut in income taxes for Japanese corporations and promulgated a new Industrial Revitalization Law making it easier for them to divest subsidiaries, to transfer goodwill, to swap debt, and to do in-kind investment transfers.

The recent increase in inward foreign direct investment (FDI), while relatively small compared to levels in other developed nations, is dramatic by Japanese standards. According to data from the Ministry of Finance, inward foreign investment increased from about \$10 billion in FY1998 to about \$22 billion in FY1999. Because they net out repatriated funds, the estimates of FDI activity are somewhat smaller in Japan's balance-of-payments accounts-about \$4 billion in FY1998 rising to about \$17 billion in FY1999. According to the Ministry of Finance data, the dollar amount of FDI has nearly tripled during the last three years; starting from its lower base of \$4 billion, the percentage increase of FDI in the balance-of-payments accounts is much larger. Between April 1998 and March 1999, 1,542 cases of foreign direct investment with a total value of \$13.46 billion occurred, according to Ministry of Finance data. Between April 1999 and March 2000, the comparable figures were 1,705 cases of foreign direct investment with a total value of \$23.99 billion. (See Graph 1.) Although American companies claimed the record at 60 percent for the highest share of foreign funds invested in Japan between April 1998 and March 1999, European companies took first place between April 1999 and March 2000, accounting for 58.9 percent of the total. During the same year, American firms accounted for only 10.4 percent of such investment, but this decrease in share mainly reflected a decline in the dollar amount invested rather than a decline in the number of FDI transactions involving American companies. Overall the increase in foreign direct investment flows in Japan is good news for Japan's trading partners. Since imports and the stock of inward foreign direct investment tend to be positively correlated, the expansion of FDI in Japan should increase its openness to imports over time.

In addition to opening the door to foreign direct investment, the collapse of major banks, securities firms, and insurance companies, as well as the uncertain business environment, have resulted in a profound reevaluation of credit risk by both borrowers and lenders in Japan. The reluctance of lenders to make loans that may not be repaid and the reluctance of borrowers to take on the risk of foreclosure if they cannot repay their loans have tightened capital availability in Japan. The heightened sensitivity to financial risk has sparked two unintended but beneficial developments.

First, companies have been encouraged to implement restructuring plans to prove that they merit additional financing from either foreign or domestic lenders. A few companies, such as Nissan-Renault and Sony, have announced dramatic plans that offer immediate restructuring. Others have adopted plans that allow for incremental reductions in pay, personnel, and excess capacity over several years.

Second, to ease the credit crunch on small and non-mainstream businesses, the Japanese government approved the creation of a new equity market last year and another this year. The Tokyo Stock Exchange (TSE) opened MOTHERS (Market of the

High-Growth and Emerging Stocks) in December 1999, with plans to list approximately thirty relatively young, unproven companies by the end of 2000. By summer 2000, however, MOTHERS had not done as well as anticipated. Only ten companies had listed, and seven of them were trading below their Initial Purchase Offer prices. Critics of the exchange charge that its listing standards are too loose, its shares too illiquid, and the prospects for its listed companies too poor. A second market, NASDAQ Japan, a joint venture of NASDAQ and Softbank, opened its doors in June 2000 with eight companies listed. The hope is that NASDAQ Japan's more stringent disclosure requirements, comparable to those in the United States, will build confidence in Japan's new equity markets and spur MOTHERS and other rival markets to match them.

Japan's equity markets are also enjoying larger inflows of funds from American venture capital and private equity firms. The interest of such firms in offshore opportunities is growing, and Japan stands to be a major beneficiary. Several American firms, including Chase, Warburg Pincus, GE Capital, and Goldman Sachs, have already set up venture capital funds to invest in Japan. A recent joint venture between Sumitomo Bank and GE Capital has established a buy-out fund to invest in Japanese divestitures, new technology start-ups, and other opportunities. Financial sector liberalization and the emergence of high-tech start-ups in Japan have provided an opportunity for the U.S. venture capital industry to marry its financial and managerial strength with Japanese Internet and high-tech ventures.

Another indicator of change in Japan is the growing number of consolidations among Japanese companies—a relatively rare occurrence until the last few years. Some of the most recent partnerships have even crossed keiretsu lines. Among the most publicized and prominent of these deals are the Sumitomo-Sakura bank merger and the merger of Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan into the newly christened Mizuho Bank. The Asahi-Tokai-Sanwa bank merger faltered when Asahi dropped out, but Tokai and Sanwa still plan to merge, albeit with weaker keiretsu relationships. The number of merger and acquisition (M&A) cases in Japan has more than doubled since 1995, and the 1,204 cases of M&A activity recorded from January through September 2000 already surpasses the 1,169 mergers and acquisitions completed in 1999. (See Graph 2.) The projected figures for total M&A activity in 2000 suggest 12 percent of that activity will be cross-border transactions, down only one point from last year's 13 percent. Despite recent growth, however, M&A activity remains far less important in Japan than in either the United States or Europe. M&A activity as a share of market capitalization climbed only to about 6 percent in Japan, compared to 13 percent in the United States and 18 percent in Europe.

As Japanese companies come to terms with the need to consolidate and reduce overhead and labor costs, they are also beginning to examine business deals on the basis of profitability and balance sheet effects rather than on the basis of traditional corporate connections. For the first time, M&A flow in 1999 reflected a shift from distressed sales to strategic investments. For example, the Japanese shareholders of International Digital Communications (IDC) put profits above connections when they voted to accept the bid from the Britain's Cable & Wireless over that of Nippon Telephone and Telegraph (NTT). The recent trend toward joint ventures has led to more competition and the breakdown of the old relationship-based capital system. These changes have trickled down to the supply-chain system as well. The pressure that companies exert on suppliers to lower their prices in times of a downturn has lasted far longer and been far more intensive now than in previous business cycles. The first wave of compression within the distribution chain began in the early 1990s, when retailers tried to cut out some of the costs associated with the multiple

wholesaler levels common in Japan. Now, companies like Nissan-Renault are trimming supplier relationships to become more profitable.

The Internet is also providing additional opportunities for companies to cut production and distribution costs even further, either through additional access to multiple suppliers or through e-retail channels that reduce brick and mortar costs. By increasing information about prices and alternative sources of supply, the Internet is forcing changes in Japan's antiquated and inefficient distribution system. In Japan, as in the United States, the lion's share of productivity increases resulting from business-to-business Internet applications is likely to show up not in the manufacturing sector but in the wholesale and retail distribution sectors, where productivity in Japan lags the most. For example, e-STEEL, an American company, has just concluded a joint venture with two major competing trading companies, Mitsui & Co. and Mitsubishi Corp., to sell steel via the Internet. This partnership will enable Mitsui and Mitsubishi to trade 5 million tons of steel annually in the Japanese market and allows for the possibility of future access by Japanese companies to e-STEEL's global economic platform.

The more intense pressure for profits has also led to a reduction in cross-shareholding among related companies. As companies focus on competitiveness through restructuring plans, they have begun to sell each other's shares. As these shares enter the market, companies find themselves with an array of options. Public companies can offer their shares for sale on the Tokyo Stock Exchange and can use them to purchase assets under the newly legalized stock-swap mechanism passed in August 1999 by the Diet, Japan's legislature. If, as promised, the Japanese government reforms its consolidated taxation system, Japanese companies will also be able to use their shares to reduce their underfunded pension liabilities and to compensate and reward employees for performance.

As corporate structure evolves, so too does the management-employee relationship. The erosion of employment guarantees and seniority-based pay structures in big companies has accelerated with the economic stagnation of the 1990s. Even healthy companies no longer automatically guarantee that they will employ workers until retirement. Many companies are paying employees to take early retirement and have developed restructuring plans that rely on attrition and a freeze on new hires to reduce employment levels. But outright termination of employment in large Japanese firms is still relatively rare. Japanese companies have also begun to reevaluate their seniority-based pay systems, and a small but growing number of companies have increased the role of merit-based pay systems including stock options and other incentives. This is especially true in the financial sector, in the high-tech sector, and in young growth companies, although even some old-economy corporations have begun to experiment with such approaches to employee compensation.

In addition, companies will soon be able to offer defined investment pension plans that allow employees to choose among alternative investments. Once the government of Japan passes the enabling legislation, expected sometime next year, 401(k)-type direct investment pension funds for employees will permit Japanese savers to take a more active role in deciding where and how to invest their retirement funds. Since equity investments will offer higher rates of return than the low interest rates available at banks and the Postal Savings System, this reform might well attract a growing portion of household savings into the stock market.

This expected change in pension investment vehicles will come on the heels of payments by the Postal Savings System to depositors of maturing ten-year accounts. These payments commenced in April 2000. The accounts involved were earning 6 to 7 percent interest but will earn only 0.2 percent if they are reinvested in the Postal

Savings System (assuming they are under the 10-million-yen limit and can be reinvested). Such low returns should encourage Japanese investors to transfer their money into alternative investment vehicles, but the evidence thus far has not been convincing. Analysts predicted that approximately one-quarter to one-third of the 106-trillion-yen maturing in the Postal Savings System over the next two years would be invested in alternative higher yield, though riskier, assets. To date, however, investors have shied away from equities, choosing to reinvest most of maturing funds in other types of accounts in the Postal Savings System or at other banks.

Foreign financial institutions are working hard to educate Japanese investors about the rates of return they can expect by investing in equities, and they hope that the need for retirement savings will entice Japanese investors to put a much larger fraction of their savings in the stock market over time. Large U.S. institutions like

Goldman Sachs, Merrill Lynch, and Fidelity are using sophisticated advertising, including weekly television shows, to attract Japanese investors. Most foreign firms have teamed up with Japanese partners to take advantage of their extensive access to clients. Fidelity initially planned to tackle the Japanese market alone but entered into partnerships with both the Bank of Tokyo-Mitsubishi and Nomura-Sumitomo Bank to market its funds to Japanese clients. Merrill Lynch went one step further by purchasing part of the failed Yamaichi Securities in hopes of making it profitable by offering U.S.-type investment services to Japanese consumers. Many Japanese securities companies are also gearing up to offer such services and have already launched new investment trusts or mutual funds.

SIGNS OF BACKSLIDING AND FEAR OF COMMITMENT

Although the structural changes and reforms described above are real and significant, the overall pace of reform remains slow and the dangers of backsliding remain strong. The strength of resistance to change should not be underestimated. It took the Japanese government nearly a decade to muster the political capability and will to address the crisis in the banking system. And meaningful reforms in the insurance system are yet to be undertaken. As an illustration, Chiyoda, one of Japan's largest insurance companies, was recently forced to declare bankruptcy, but only after the failure of efforts by the Japanese government to find a domestic buyer for the firm. Moreover, the government has yet to pass legislation protecting thousands of policyholders at risk as a result of bankruptcies in the insurance industry.

There are numerous other signs of the cultural, political, bureaucratic, and economic impediments to change in Japan. The ratio of lending and fiscal investment by the government as a share of total investment remains at an historic high. The government has announced new programs to bolster Japan's semiconductor, biotechnology, and information technology industries. As already noted, the majority of Japanese savers have chosen to reinvest their savings in low-risk, low-return accounts in the Postal Saving System or other banks. Japanese companies have been slow to implement the mark-to-market accounting rules required by the Big Bang reforms. As a result of resistance to reform of Japan's commercial code, mergers and acquisitions are proceeding slowly, delaying the rationalization of personnel and business strategies. And the government dragged its feet on reducing NTT access fees, reaching an agreement with the U.S. government in July 2000 only after years of negotiating.

Even critically important financial sector reforms have lagged, in part because of concerns about their effects on Japan's macroeconomic situation. For example, the Japanese government has postponed implementation of its decision to abolish government guarantees for bank loans to small and medium businesses from 2000 to 2001, and it has put off enforcement of bank deposit guarantees from 2001 to 2002. The government has also delayed introducing tax incentives for employees investing in 401(k)-style pension plans. Although the government did implement consolidated accounting standards as of April 1, 2000, it has delayed indefinitely the implementation of new consolidated taxation standards. Nor has there been any government action in response to pressures to reform the pension system to stem further growth in unfunded liabilities or to reduce capital gains taxes governing the purchase or sale of real estate.

The late Prime Minister Keizo Obuchi replaced an aggressive supervisor of the Financial Reconstruction Commission, Hakuo Yanagisawa, with a party loyalist, Michio Ochi, who encouraged local banks to come to him if they felt too much pressure to reform. Ochi was ultimately fired for such behavior, but the two administrators who have followed him in the job have not exhibited any more interest in pursuing vigorous banking reforms than he did. The force of the initial Big Bang initiatives to redistribute influence from the Ministry of Finance to other financial agencies and the Bank of Japan has weakened in response to pressure from traditional political-business alliances. Prime Minister Obuchi's sudden illness and death resulted in a shift in Liberal Democratic Party (LDP) leadership to Prime Minister Yoshiro Mori, but the prospects for speeding up reform have not changed significantly since the June 2000 election. The Tax Authority within the Ministry of Finance has proven the most intractable of all government offices, blocking reforms that would encroach on sources of revenue, including the consolidated tax reforms and the harmonization of tax incidence to international norms for corporate reorganizations.

A TALE OF TWO ECONOMIES

The reforms, the backsliding, and the stonewalling reveal Japan's growing economic dichotomy. Japanese businesses, government officials, and the public at large are now grappling with the transition from the old structure of the industrial economy to the new structure of the global economy and its domestic manifestations. As this transition proceeds, a dichotomy has emerged within the Japanese economy. Even in the heyday of the old economy in Japan, there were significant productivity and performance differences between export-oriented, globally competitive firms, primarily in the manufacturing sector, and domestic-oriented, protected firms, primarily in the service sector. Now another divide has appeared between old-guard companies that want to restructure as slowly and painlessly as possible, and start-up, risk-taking enterprises that want Japan to move rapidly toward a more competitive policy environment.

Those who fear reforms strongly resist further changes to Japan's traditional state-led economic structure. Japan's continued macroeconomic difficulties have strengthened their calls for slowing the reform process. More than a hundred Diet members have formed an anti-reform group to study the disadvantages of deregulation. Their membership includes more than half of the current LDP members of the Diet, and until recently Prime Minister Mori was a member. This self-professed anti-deregulation group has successfully blocked enhanced competition in taxis, liquor, tobacco, and other economic activities of special importance to small or family-owned businesses. Ministry bureaucrats tied to Japan's traditionally dominant

industries are trying to resist any changes that will diminish their power or their resources. Many politicians in the Diet are doing the same.

On the other hand, some people and institutions within Japan are pushing the government to take additional steps to ensure Japan's economic recovery and longer-run economic revitalization. A growing number of entrepreneurs want to take advantage of new opportunities to start businesses and obtain capital. Innovative high-tech start-ups are attracting foreign venture capital, and taking advantage of a new law permitting firms to own the intellectual property rights gained through government-funded research. Young employees or college graduates are sacrificing job security in large domestic firms in favor of positions at foreign companies or

Internet start-ups. Some young Diet members are writing reform legislation without assistance from ministry bureaucrats and have formed a "brat pack" to push for faster economic reforms.

TASK FORCE POLICY RECOMMENDATIONS

As the 1990s progressed and Japan's prolonged economic stagnation persisted, there were gradual but perceptible changes in U.S. economic policy toward Japan. During the first half of the decade, the U.S. government pursued a series of sectoral trade negotiations with Japan. This approach had its roots in the 1980s when a growing number of American companies and policymakers became concerned that structural barriers to Japan's growing markets posed a threat to competitive American producers. Insulated by these barriers, several large export-oriented Japanese companies achieved the scale and technological sophistication to become formidable competitors on global markets, and American companies were increasingly disadvantaged by their inability to meet their Japanese competitors head-on in the world's second-largest market. American frustration with nontariff structural impediments to Japan intensified as the U.S.-Japan trade deficit deteriorated and triggered a decade of often-heated bilateral trade negotiations. Many of these negotiations, especially those that drew the most attention in press and policy circles, focused on structural barriers to particular markets including semiconductors, autos and auto parts, insurance, wood and glass products, and rice and other agricultural products. Such negotiations usually involved detailed U.S. requests for adjustments in how particular Japanese markets worked—for example, how auto inspections in Japan determined which companies were allowed to supply replacement auto parts or how insurance regulations affected the kinds of insurance Japanese and American companies could sell to Japanese consumers. In addition, U.S. negotiators emphasized the need for "objective indicators" to measure success and prevent backsliding in trade agreements with Japan.

Between 1993 and 1996, the U.S. government concluded twenty-three separate trade agreements with Japan. Although with varying degrees of success, these agreements improved the access of U.S. firms to Japan's markets for particular products. By the second half of the 1990s, however, the sectoral "results-oriented" emphasis in U.S. economic policies toward Japan began to show signs of change for three reasons. First, this emphasis had been strongly resisted and resented by Japan and had complicated U.S.-Japan relations on important noneconomic issues. By the mid-1990s, the Japanese government strongly opposed participating in any new trade talks built on this model. Second, the U. S. government began to rely on the newly created WTO as the first step in resolving trade disputes with Japan and other trading partners. As an example, in 1996 in lieu of insisting on bilateral negotiations with Japan, the U.S. government decided to bring Kodak's complaints about barriers

to Japan's market to the WTO for adjudication. The United States and Kodak ultimately lost this case in 1997, but decided against pursuing additional bilateral remedies. Third and probably most important, as the Japanese economy sank into recession in 1997 and as the magnitude of its banking crisis began to threaten the stability of global capital markets, the U.S. government understandably shifted the focus of economic negotiations with Japan from trade policy to macroeconomic policy. Helping to avert a financial collapse in Japan took priority over improving access to individual Japanese markets.

Nonetheless, even during the second half of the 1990s, when the Japanese macro-economy was in crisis, the U.S. government continued bilateral trade talks with Japan on deregulation and investment. While the investment talks focused on broad structural areas like Japan's laws on mergers and acquisitions, labor and pension mobility, and land use, the deregulation talks retained a sectoral focus with emphasis on telecommunications, finance, pharmaceuticals/medical equipment, and housing. But unlike the sectoral talks of the first half of the 1990s, those in the second half of the decade did not have "objective indicators" or hard and fast deadlines. Indeed, these talks were not even referred to as "negotiations" by either government. NTT's recent agreement to lower access charges for foreign and domestic users was an outgrowth of the deregulation talks between the United States and Japan in the telecommunications sector. What's instructive about this case is the fact that new-economy voices in Japan's business and political circles supported the U.S. proposal for a reduction in such charges and were instrumental in achieving this outcome.

The development of pro-reform groups in business and government provides both American companies and policymakers with allies in their quest to reduce structural barriers to competition in Japan. Indeed, domestic pressures for change have become powerful forces for opening Japan's economy along the lines sought by American trade negotiators during the last two decades. Real reforms in Japan that go to the heart of Japan Inc., along with the unleashing of domestic pro-reform forces within Japan, require that the United States make appropriate adjustments in its economic policies toward Japan.

The members of the Task Force recommend adjustments in the substance, form, and tone of U.S. policies toward Japan.

Recommendations about the Substance of U.S. Economic Policies with Japan

1. Focus on Areas of Reform That Serve Both American and Japanese Economic Interests

Two broad areas of reform should be a major focus of economic dialogue between the American and Japanese governments over the next several years. These are (1) reforms that improve the climate for foreign direct investment and (2) financial-market reforms affecting how capital is raised and allocated. The development of modern equity-based financial markets in Japan will ultimately affect the structure and performance of the rest of its economy. Thus, foreign direct investment by American and other companies will be a powerful catalyst for change. In addition, since a country's imports and its stock of foreign direct investment tend to be positively related, the continued growth of such investment by American firms is likely to increase Japan's imports, defusing trade tensions between the two nations to some extent.

Many actors within Japan, including American and other foreign businesses investing there, recognize the importance of such reform areas. The U.S. government should ally itself with these domestic and international actors to emphasize the benefits of economic deregulation, improved corporate governance structures, additional

corporate restructuring, and transparency and accountability, as well as competition policy and its enforcement for a Japanese recovery. Improvements in these areas may or may not translate into identifiable economic benefits for American companies in the near term, but they will foster both improved access and more rapid growth in Japan for all participants over the medium term.

2. Focus on Ongoing Reforms in the Financial Sector

The U.S. government should focus its dialogue with the Japanese government on policies affecting financial markets and the investment climate in Japan, including accounting and reporting standards, taxation, mergers and acquisitions, and antitrust/competition policies. These are all areas in which the U.S. government can rely on the support of both Japanese and American companies in its talks with Japan. They are also areas that lie at the heart of Japan's traditional closed economic structures. As reforms in these areas occur, the financial system created by main-bank lending and cross-shareholding will give way to an equity-based financial system. And an equity-based system will accomplish two important goals: (1) intensify pressures on existing Japanese companies to emphasize efficiency, profitability, and core business strategies, and (2) create opportunities for the entry of new competitors.

Acknowledging the need for continued implementation of its Big Bang financial reforms, the Japanese government officially introduced consolidated accounting for listed companies on April 1, 2000. Although it remains to be seen how thoroughly these new accounting standards will be applied, they are already making a difference in transparency and disclosure, making it easier for Japanese companies to divest non-core businesses and consolidate. This is another area where U.S. and Japanese interests converge, despite the fact that U.S. accounting standards are more stringent than commonly accepted international standards. Accounting reforms in Japan will undoubtedly affect the strategies, behavior, and performance of all Japanese companies. As Morgan Stanley and other U.S. investment banks have pointed out, accounting reforms do not simply provide transparency of accounting records for foreign investors interested in purchasing Japanese companies. Such reforms also enable troubled companies to command a higher price for their distressed assets than would have been possible if the economic health of the company were more difficult to discern with accuracy. The result is a win-win situation for both Japanese companies and interested foreign investors.

Unfortunately, the government of Japan has delayed implementation of the partner reform to consolidated accounting: consolidated taxation. Consolidated taxation would provide companies with the ability to write off or deduct losses of related companies. In the short term, this would reduce the revenue stream to the Ministry of Finance. The ministry has indicated that it intends to adopt OECD practices for consolidated taxation, but it has publicly refused to commit to an implementation date. Internally, the Ministry of Finance has set a target date of fiscal year 2002 or 2003. Unfortunately, this delay has already served to stifle investment and new start-ups by eliminating incentives for purchases and sales of troubled companies.

The U.S. government should continue to urge the Japanese government to enact consolidated taxation reforms quickly. Along with consolidated accounting reforms, consolidated taxation reforms will make it considerably easier for American companies to invest in Japan.

A barrier to consolidated taxation reforms in Japan is its century-old Commercial Code, whose provisions affect shareholder rights and corporate governance, and also impede modern financial transactions such as company issuance and redemption of

stock, stock splits, stock options, and pension portability. Japan's Commercial Code treatment of companies as single entities affects not only the consolidated taxation issue, but also the issue of stock option taxation. Although capital gains from stock options are taxed at a rate of 26 percent in Japan (which is considerably below the rate imposed on other kinds of income), employees rarely take advantage of this benefit. An individual employee can only receive stock options for the company for which he or she works and not from any related or parent companies. In addition, the number of options a company can issue is limited to 10 percent of outstanding shares, and each issuance of stock options to directors and employees must be authorized at the general shareholders' meeting. Again, an amendment to the Japanese Commercial Code is needed to change these limitations.

The Ministry of Justice has announced plans to update the code's rules and regulations, including those that pertain to corporate structure and board composition and to commercial issues such as stock issuance, buybacks, and options. But the plans proposed by the Ministry of Justice involve substantial delays and closed-door discussion among Japanese bureaucrats. Members of the Task Force believe that the goals of U.S. economic dialogue with Japan should include a timely and transparent process for revisions of Japan's Commercial Code, and a procedure by which foreign companies and legal experts would be allowed to comment on proposed modifications.

Another important topic for U.S. businesses in Japan that could be affected by revisions in the Commercial Code is the tax treatment of pensions. Currently, Japanese employees of American firms in Japan and American employees of Japanese firms are not allowed to put their pension money in the pension plans of American parent companies. Employees can only invest in registered, recognized pension plans in Japan, and they can almost never take their pension funds with them when they leave a company. However, in an atmosphere in which it is ever more important to increase shareholder pressure on managers, to improve private capital markets, and to enhance returns to Japanese savers, both the barriers to stock options and the barriers to investing in pensions should be removed. These barriers limit the spread of American-style corporate governance and employment practices to Japanese subsidiaries. Moreover, interfering with stock buybacks and pension funds limits the growth of American financial firms in Japan and the beneficial effects thereof. The U.S. government should work with American investors to convey the message to the government of Japan that the growth of foreign direct investment in Japan will be partly dependent upon reforms in these areas.

In addition to favorable tax treatment for stock options and pension plans, U.S. businesses would also like to see several other issues resolved through a renegotiation of the U.S.-Japan Income Tax Treaty last amended in 1971. American businesses and the U.S. government have already expressed interest in renegotiating this treaty to deal with a wide range of issues, including the development of Internet commerce, transfer pricing, new financial products and services, and the growth of intellectual property. U.S. businesses have also identified as important the resolution of complicated tax issues surrounding venture capital investments, tax-free stock-for-stock exchanges of foreign company shares, elimination of the double taxation that employees of foreign companies face on contributions to 401(k) plans, and a reduced withholding rate on royalties.

Of these topics, the most important revision from the U.S. business perspective is a reduced withholding rate. The current U.S.-Japan Income Tax Treaty provides for a withholding rate of 10 percent for dividend income, 10 percent for interest income, and 10 percent for royalty income for foreigners. In comparison, the U.S. model

treaty rates are much lower: 0 percent for interest income, 0 percent for royalty income, 5 percent for inner-company dividend income, and 15 percent on portfolio dividend income. Under current withholding rates in Japan, American companies with Japanese subsidiaries quickly reach their tax credit limitations. And they are not alone—Japan consistently withholds 10 percent from all income paid to foreign entities. So far France and Mexico have negotiated a rate of 0 percent of withholding for direct dividends, but these are the only exceptions.

The most important issue for the government of Japan in the renegotiation of the bilateral tax treaty relates to transfer pricing within multinational corporations. Japan claims that the United States assumes a profit margin by industry, while Japan uses an "arms-length rule" and a "competent authorities process" similar to other OECD countries.

U.S. officials do not expect negotiation of a new tax treaty with Japan for about two years, but the U.S. Treasury and the Bureau of Taxation in the Ministry of Finance have already begun meetings on the issues. These meetings are important first steps. Members of the Task Force believe that U.S. officials should prepare a detailed alternative to the current treaty after extensive pre-negotiation consultations with the Japanese government and business representatives from both the United States and Japan. Prematurely announcing a "formal negotiation" before such preparatory steps are completed would endanger the renegotiation process by encouraging posturing on both sides.

Task Force members believe that a core element of U.S. government policy toward Japan during the next several years should be the resolution of the taxation issues discussed above through the Japanese Commercial Code, the Japanese Tax Code, and the U.S.-Japan Income Tax Treaty. First, changing the tax structure will affect all sectors of the economy without requiring a confrontation in individual sectors. Second, there are constituents within the Japanese government who would like to see more progress on tax reforms and would welcome U.S. pressure to bolster their case. Third, the provisions of the tax code most likely to be reformed are those that relate to and reinforce many of the changes in the financial system that the U.S. government wants to see. Fourth, verifying implementation of any agreed changes in the tax system is relatively easy for the U.S. government to monitor. These negotiations would be filled with technical details. Moreover, both governments would benefit from forming a special task force comprising public sector and private sector representatives with the expertise necessary to keep the talks moving in line with political schedules. Finally, negotiations on corporate tax issues might also open the door to additional tax reforms in Japan, including reductions in sales and income taxes to stimulate domestic consumption.

3. Target Reforms in Other Areas of the Economy

Members of the Task Force recommend that the U.S. government emphasize services in its negotiations with Japan. Financial services, telecommunications services, and Internet services are areas in which American firms enjoy strong competitive advantages and in which regulation in Japan is still pervasive.

Deregulation in these activities is likely to provide significant benefits for Japan's consumers and for American companies as well. Access to the World Wide Web and the comparison shopping it enables may provide the greatest impetus for Japanese businesses and consumers to identify the reforms that best serve their interests. The ease and anonymity of the Internet and chat rooms allow consumer movements to build momentum, such as the spontaneous boycott of the Japanese government's initial proposal to bail out the Sogo department store using taxpayer money. Now

that the social contract among businesses, government, and banks has begun to fray, it is likely that Japanese companies, investors, and consumers will press the Japanese government for reforms to bolster competition and choice. Japanese firms, especially those in the high-tech and communications fields, and American firms investing in Japan are an important part of the growing domestic constituency in favor of reform in Japan. Instead of using *gaiatsu* (foreign pressure) to press the Japanese government for a particular outcome that will benefit a particular U.S. company or U.S. industry, the members of the Task Force recommend that the U.S. government support a more open, transparent regulatory process. In the LTCB sale to Ripplewood, for example, the U.S. government did not advocate for a particular buyer but simply urged the government of Japan to keep the bidding process open and transparent.

Task Force members also recommend that the U.S. government consider fostering an officially mandated dialogue on new-economy issues between American and Japanese leaders. (Such a dialogue could be part of the existing U.S.-Japan Business Roundtable or a separate entity.) Economic changes triggered by the diffusion of new information technologies are posing new policy challenges for both the U.S. and Japanese governments in such areas as telecommunications deregulation, Internet taxation and privacy, intellectual privacy protection, and competition policy. A dialogue on such issues could provide useful insights for both governments and could head off policy friction between them on such issues. In addition, most of the internal impetus for change within Japan is coming from firms in emerging Information Technology (IT) activities. Such a dialogue could yield mutually beneficial reforms recommendations and act as an additional source of pressure on the Japanese government from Japanese business leaders. The U.S. government should also explore the desirability and feasibility of establishing a tripartite dialogue among American, Japanese, and European officials and business leaders on new economy issues.

Within the telecommunications sector, a key issue in U.S.-Japan economic relations remains the dominance of NTT. Many observers both within and outside Japan believe that this represents a major stumbling block to Japan's ability to reap the economic benefits of the IT and Internet revolutions. After several years of discussion with U.S. trade negotiators, in July 2000 the Japanese government announced that NTT would cut access charges for use of its local network to both domestic and foreign operators of Internet and other telecommunication services by 20 percent over the next two years. This is a modest but important first step in Japan's path to deregulation and competition in telecommunications. Foreign investors are also taking action to weaken NTT's market power. For example, MCI is laying cables in Tokyo while AT&T, British Telecom, and Japan Telecom have formed a joint venture to provide services to business and residential consumers. The company formed by the merger of IDC and Cable & Wireless will also provide long distance competition to NTT, further intensifying the pressure for lower rates. If other Asian nations and the United States enter into an agreement on Internet access fees and other interconnection charges, the incentives for Japan to join will be powerful.

The greatest area of change within the telecommunications industry in Japan is wireless service. Japanese companies have gained a strong foothold in wireless phone technology and product development. DoCoMo, a subsidiary of NTT, dominates the cellular phone market in Japan with its tiny phones and strong technology. I-mode, DoCoMo's newest technology, allows users to link to the Internet from their cellular phones, thereby bypassing NTT's land lines and connection rates. In this area, the disruptive nature of the Internet and wireless

technologies is weakening NTT's dominance in its traditional markets and creating opportunities for new entrants, including American and European providers.

The Internet is also likely to play a major role in the ongoing transformation of Japan's retail distribution system. Nearly a decade ago, U.S. trade negotiators struggled with their Japanese counterparts to win access to Japan's market for Toys "R" Us. Today, the economic difficulties of some of Japan's retail giants, as evidenced by the recent bankruptcy of Sogo, and the expansion of foreign competitors like America's Costco and France's Printemps, are driving the gradual restructuring of Japan's retail industry. Technology too is playing a role as more Japanese consumers turn to mail-order catalogues and Internet sites for shopping and integrated services. For example, Ito Yokado's 7-11 stores are planning to leverage their existing retail networks to provide efficient integrated banking and Internet retail services. In Japan, as elsewhere, the lion's share of the productivity increases resulting from business-to-consumer and business-to-business Internet applications is likely to occur not in manufacturing but in the wholesale and retail distribution sectors. These are the sectors in which Japan's productivity lags the most relative to American standards.

The rise of new-economy activities in both the United States and Japan and the spread of cross-national mergers and acquisitions pose new challenges for antitrust policy. Recently, the United States and Japan concluded a new bilateral antitrust agreement that includes notification of enforcement activities, enforcement cooperation and coordination, positive comity undertakings, conflict avoidance, consultations, and exchange of antitrust-related information. The next administration should monitor the enforcement of this agreement to strengthen consultation and cooperation between the antitrust authorities of both countries. During the last few years, the antitrust authorities in the United States and the European Community have consulted and cooperated on a number of high-profile cases affecting both markets. There may be lessons from this experience that can be applied to U.S. relations with Japan in the antitrust arena.

Recommendations about the Forms of U.S. Economic Policies with Japan

To achieve success in the substantive policy recommendations suggested in this report, the U.S. government must recognize that its influence over the course of economic change in Japan is limited. The most powerful forces for such change reside in market competition and technological change, not in bilateral trade negotiations. As-or if-structural change and reforms continue to break down structural impediments to Japan's markets, Japan should begin to emerge as a more "normal" trading partner, and U.S. policies should adjust accordingly. The members of the Task Force believe that the new diplomatic and economic landscape requires three kinds of change in the form of economic relations between the United States and Japan: (1) greater use of multilateral channels to resolve disputes and shape new trade agreements; (2) a corresponding reduction in the role of bilateral sector-specific negotiations; and (3) stronger U.S. support for regional economic cooperation in Asia.

1. Greater Reliance on Multilateral Processes

Efforts by the U.S. government to encourage structural reforms in Japan's economy or to resolve trade and other economic disputes with Japan should be rooted whenever possible in the framework of multilateral organizations, including the WTO, the OECD, the G8, and APEC. Other more specialized institutions like the Basel Committee on Banking Supervision, professional associations of accountants and lawyers, and industry groups can also wield considerable influence. The U.S.

government should continue to rely on the WTO as the first step to resolving trade disputes with Japan. Additional WTO cases will help develop multilateral precedents about what comprises a "government" measure and how that term should be applied to actions involving a mix of government and business participants.

The next administration should support international efforts to restart a new round of multilateral trade negotiations. It should also seek fast-track authority from the U.S. Congress. In the long run, strengthening the WTO and broadening its coverage to areas currently excluded from its rules and dispute settlement processes will prove to be the most effective ways for addressing trade disputes with America's trading partners, including Japan.

As it did to develop support for a global agreement covering trade in information-technology products, the U.S. government should also continue to use regional organizations such as APEC to encourage sectoral trade liberalization agreements that can later be championed at the multilateral level. With its broad regional membership, APEC can serve as a useful forum for fostering reforms and trade liberalization throughout the Asia-Pacific region.

2. A Reduction in the Role of Bilateral Sector-Specific Trade Negotiations

During the last two decades, relations between the United States and Japan have frequently been strained by contentious bilateral trade talks focusing on structural impediments to Japan's markets. As-or if-these impediments continue to crumble in response to reform and technological pressure, the impetus behind such talks is likely to dissipate. This is not to say that bilateral trade disputes between the United States and Japan will disappear. After all, the United States continues to have heated disputes with Europe and Canada, both of whose economies resemble the United States far more than Japan. Moreover, U.S. companies hold far more direct investment in the European and Canadian economies than they do in Japan. However, in contrast to the pattern developed during the last twenty years, sectoral trade disputes are now likely to become the exception rather than the rule in U.S.-Japan economic relations. And when such disputes occur, they should be mediated through the WTO.

3. Stronger U.S. Support for Regional Economic Cooperation in Asia

New regional agreements on monetary cooperation and subregional agreements on trade are now under negotiation in Asia, and Japan is playing a leadership role in both. Japan is seeking to negotiate bilateral trade deals with Singapore and South Korea, as well as to promote a network of currency swaps to protect the Asian economies from speculative attacks. It is too early to tell whether such agreements will reinforce the multilateral system or compete with it-whether such agreements will prove to be outward-looking or inward-looking. Both the United States and Japan share an interest in a well-functioning global economic system, and regional agreements can be useful ways to explore solutions that can ultimately be applied on a global basis. Regional arrangements to prevent currency crises and contain their contagion effects could prove to be a useful addition to multilateral arrangements. And subregional trade agreements could reenergize the global trading system. The U.S. government should work with Japan to make sure that such regional agreements are consistent with the WTO and that they reinforce rather than weaken the multilateral financial system. Overall, the United States should encourage Japan's role as a partner in the Asia-Pacific region and should work with Japan to promote regional standards on issues of common interest, including the environment and infrastructure development.

Recommendations about the Tone of U.S. Economic Policies with Japan

1. Cooperate and Consult

Both American policymakers and business leaders should take advantage of the economic changes underway in Japan to foster a friendlier and more collaborative tone in their relationships with their Japanese counterparts. As domestic pro-reform forces gain strength in Japan, they can take the place of gaiatsu, or foreign pressure, to open Japan's markets to foreign competitors. Then the balance in the tone of U.S.-Japan relations can shift away from one of conflict and contention toward one of consultation and cooperation.

Frequently during the last two decades, the tone of American policymakers and business representatives in discussions with their Japanese counterparts has been somewhat condescending-or at least has been heard that way on the Japanese side of the table. Despite Japan's recent economic difficulties and the unique features of Japan's distinctive economic system-features that many American observers find frustrating-Japan is the world's second-largest economy and a rule-abiding member of the WTO. Japan wants and deserves to be treated with respect, both as America's trading partner and ally.

While remaining vigilant for signs of backsliding, the U.S. government should recognize and applaud Japan's success at implementing meaningful economic reforms and continue to offer technical assistance to design and implement such reforms through bilateral and multilateral channels.

2. Pursue a Unified Message

The U.S. government must continue to strive for a unified economic message in its relations with the Japanese government. Public differences among government agencies on the appropriate course of U.S.-Japan relations undermine the ability of the U.S. government to achieve its goals.

3. Promote Exchange and Education

Improved bilateral relationships and greater understanding among legislators and administration officials in both the United States and Japan will enhance the ability of the U.S. government to achieve its priorities in its relations with Japan. The next administration should explore the possibility of introducing a formal parliamentary exchange between the United States and Japan. The United States has such formal exchanges with Canada, Mexico, the United Kingdom, and the North Atlantic Assembly. In the absence of such a formal exchange program, contacts between American and Japanese legislators have become haphazard and relatively infrequent in recent years. Groups like the Japan Center for International Exchange that have been promoting this kind of dialogue for years have found it increasingly difficult to fill the American side of the roster on exchange trips. The U.S. government should encourage members from both political parties to make this kind of exchange and education a priority.

4. Secure Expertise and Skills

Given the significance and breadth of economic relations between the United States and Japan, the U.S. government should devote more resources to agencies responsible for overseeing them. An increase in the number of government officials with experience or expertise in U.S.-Japan economic relations and knowledge of the Japanese language would help the U.S. government achieve its objectives.

Notes

[1] Kenneth Curtis quoted in "Shaky Ground," Worldlink, World Economic Forum, July 5, 2000, www.worldlink.co.uk/stories/story Reader\$296.

ADDITIONAL VIEWS

U.S. PRESSURES FOR IMPROVED JAPANESE MACROECONOMIC POLICIES

The U.S. Treasury, and the U.S. government more broadly, put great public pressure on Japan for specific macroeconomic and financial policy measures during the years 1997-1999. After years in which trade disputes dominated the bilateral economic agenda, and in which U.S. Trade Representative and the Commerce Department had taken much of the lead in public diplomacy with Japan, this was a striking switch-and it occasioned strong reactions in both Japan and the United States.

This effort should be seen as a necessary response to several dangers. First, it responded to years of economic stagnation in Japan, which were contributing to mounting international imbalances, including rising U.S. trade deficits. Second, to the then-severe Asian economic crisis, and the likely harm to Japan's neighbors of still further reduction of Japanese demand and investment. And third, to the widespread perceptions of a sharp relative power shift in Asia due to the ineffectual response of Japanese policymakers to Japan's deepening recession.

Some observers criticized these American public demands at the time, and in retrospect, as misguided in various ways. They were thought to be economically counterproductive because stimulative policies would buy off structural reform with short-term growth, and politically misguided because public demands would likely cause the Japanese government to dig in its heels on policy matters. In addition, U.S. public demands were thought to be diplomatically ill advised because such loud complaints would poison U.S.-Japan relations across the whole range of bilateral issues. These criticisms are unfounded.

We the undersigned believe that the public demands by the U.S. government for stimulative Japanese macroeconomic policy in the late 1990s were on the whole the right approach at the right time. The demands were successful, not only to encourage needed changes in Japanese policy priorities, but to restore Japanese economic growth and to help resolve the Asian financial crisis. As discussed in the body of this Task Force Report, important structural change in Japan proceeded at the same time that macroeconomic stimulus improved growth. The financial-sector reforms which are the basis of further long-term improvements were importantly stimulated and supported by these sensible U.S. policy suggestions.

We recognize that no single economic issue should be allowed to imperil the underlying U.S.-Japan security alliance. By the same token, when the stakes are high enough, even heavy public criticism of macroeconomic policies should be possible without one partner ducking its responsibilities by claiming that such criticism threatens the security relationship-and in this instance the stakes certainly were very high.

It is important to recognize the degree to which public jawboning by the U.S. government was successful in improving Japanese macroeconomic policy during this period. Following the results of the July 1998 Japanese election, when the Obuchi government was ready to consider new macroeconomic and financial policies, many of the recommendations of the U.S. government provided the basis for a constructive alternative program. The Obuchi government pursued fiscal stimulus instead of

contraction in the midst of a persistent recession; it cut interest rates when facing deflation; it cleaned up at least part of the financial crisis through recapitalization and nationalization; and it increased transparency and consistency between declared and implemented policy. None of these measures were taken fully as far as the U.S. Treasury urged, but far enough that they removed the threat of outright financial crisis in Japan. The American government's public exhortation had served its purpose.

Had these measures not been taken, Japan faced a real risk of outright financial breakdown in 1997-1998-and it could have taken the crisis-hit countries of Asia and beyond with it. Had American macroeconomic diplomacy been quiet during this period, the critical recommendations might have been overlooked at the time of the new Obuchi government's agenda setting-just as the quiet advice given by the United States in 1995 was ignored when the Hashimoto government aborted the nascent recovery and brought on a deeper recession by raising taxes and neglecting financial fragility.

With Japan and East Asia now both back from the brink, and perhaps even on the road to long-term reform, we believe that it makes sense for the U.S. government now to turn down the volume. As is argued in the body of this Task Force Report, we believe that public dispute between the Japanese and American governments is often counterproductive, especially when directed toward narrow sectoral issues. A return to quiet discussions, however, should not hide the fact that the performance of the Japanese economy remains important to U.S. interests. A weak Japanese economy is a source of uncertainty and therefore volatility in international capital flows; a weak Japan that is still America's third-largest trading partner presents a huge missed opportunity for mutual gains from trade.

We believe that the difference between now and even two years ago is that two years ago a few specific macroeconomic and financial policy initiatives could turn the Japanese economy from a self-destructive path onto a viable if weak growth path. Now, it will take many smaller policies over a longer time frame to turn a still weak Japanese economy into a sustainably growing one. The suggestions for how the U.S. government can serve the American national interest by contributing to this long-term process are the subject of the body of this report, and we endorse those recommendations. We add this comment to the report to make sure that the role of American macroeconomic diplomacy in creating the preconditions for the Task Force recommendations, and for Japanese economic reform and revival, is not overlooked.

A general principle we would propose is that public demands for specific macroeconomic policies are best confined to situations in which a clear policy decision is needed to respond to an imminent threat. Japan was initially disinclined to believe in the legitimate merits of American calls in the mid-1990s for expansionary policy because the United States had "cried wolf" by calling for Japanese expansion in the mid-1980s, when misguided U.S. fiscal policies were largely at fault for international imbalances. Similarly, the escalation of public demands regarding specific trade disputes to the volume level practiced in macroeconomic diplomacy, no matter how legitimate the demand in question, is likely to lead to the U.S. government having less influence over Japan's major policy choices at critical moments.

We believe that the success of the U.S. government's public pressure for expansionary macroeconomic policy and financial reform in turning the Japanese economy around in the late 1990s demonstrates the importance not only of saving one's voice for the occasions when one has to be heard, but also of being unafraid to speak as loudly as necessary when the situation demands.

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MANAGING THE TRADE-OFF BETWEEN MACROECONOMIC STIMULUS AND STRUCTURAL REFORM

The Task Force chose not to address the issue of macroeconomic policy, but we would like to make a couple comments.

U.S. policymakers often confront trade-offs between America's interest in Japanese reform and other important goals. One of the thorniest is the trade-off between macroeconomic stimulus to achieve recovery in the short term and the structural reforms that are indispensable to lasting recovery in the long term.

In theory, this trade-off need not exist. Macroeconomic stimulus should be a partner of reform. It should offset the depressive pressures, such as temporary job losses, that will inevitably accompany a long and difficult transition. Instead, Tokyo has used it as a means of making the economy just strong enough to make reform seem less urgent. Indeed, whenever the economy shows any growth at all, Tokyo puts reform on the back burner in favor of "muddling through."

Unfortunately, at times, Washington officials have argued (behind closed doors) that reform should be put off until after self-sustaining recovery is achieved. Their reasoning is that the initial effects of reform will be deflationary. Such an approach ends up supporting the anti-reformism of the Liberal Democratic Party leadership. Indeed, in the name of stability, sometimes Washington has deliberately supported the forces of the status quo—such as in 1998, when it supported Prime Minister Keizo Obuchi against those urging more aggressive bank reform.

Not all trade-offs can be avoided. But it is often possible to manage them better. For example, when public works is the main vehicle for fiscal stimulus, this shores up one of the main bastions of opposition to reform: the construction industry and its representatives in the Diet. A better approach would be to pursue fiscal stimulus through permanent tax cuts for individuals (not firms). This would not only provide immediate lift to demand, but also help the necessary transition to a consumer-led economy.

A similar trade-off comes up regarding monetary policy. More monetary stimulus boosts demand, and is thus urged by Washington. However, as long as banks can pay depositors virtually zero, they can afford to sustain nonperforming loans on their books indefinitely. It is no coincidence that, after the initiation of the Zero Interest

Rate Policy (ZIRP), the banks' rate of write-offs halved. Admittedly, the ZIRP was not the only factor. In exchange for the 7.5 trillion yen (\$70 billion) injection of government money into the banks, the LDP pressed the banks to end the so-called credit crunch. The upshot is that nonperforming loans now stand at an all-time record, despite the \$430 billion Tokyo has spent so far on the capital injection, takeover of failed banks, purchase of nonperforming loans, and other measures. Similarly, ultra-low interest rates have been used to finance fiscal schemes designed to keep moribund firms afloat, such as the \$370 billion program of loan guarantees for uncreditworthy firms. Certainly, the Bank of Japan cannot substitute for political leadership in promoting structural reform. However, the Bank of Japan is correct to refuse to finance "convoy capitalism."

The United States needs to be more sensitive to the fact that seemingly technical monetary issues have important institutional ramifications for the success or failure of structural reform. Any effort to strengthen the Finance Ministry's leverage over the Bank of Japan would end up supporting one of the strongest institutional opponents of reform at the expense of one of reform's strongest supporters.

The Economics of Macroeconomic Stimulus vs. Structural Reform

Some policymakers and economists contend that most of Japan's problems can be cured via better macroeconomic policy (i.e., fiscal and monetary measures) accompanied by a clean up of the bad debt problem. Reform, while optimal, has less urgency, it is said. In our view, while macroeconomic stimulus is necessary, it is hardly sufficient. Without fundamental structural reform, Japan will not regain vibrancy.

Consider this: if Japan had been able to sustain the 3.7 percent "trend" growth rate of 1975-90, today its GDP would be 20 percent higher than it actually is. Yet, by most accounts, Japan's "demand-supply gap"-the gap between actual GDP and the GDP that Japan could produce at full capacity-is around 5 percent. In other words, only a quarter of Japan's stagnation is due to a shortfall in demand that could be addressed by macroeconomic remedies. The lion's share of the problem is that, even at full capacity, Japan can no longer grow as fast as it used to. Conventional estimates of Japan's potential growth rate without reform have been continually downgraded, and now range from 1 percent to 2 percent. The primary culprit is not demographics. The major problems are declining productivity growth and slowing investment. Investment is slowing because Japan can no longer do what it did in the past: i.e., stimulate unproductive, unprofitable capital investment as "disguised public works." Indeed, the mountain of nonperforming loans is a reflection of past episodes of excessive and misguided private investment. Thus, most of Japan's growth problems can only be addressed via productivity-enhancing structural reform.

Moreover, when we examine the demand problems, there is more to the problem than simple mistakes. No one can deny that Tokyo's avoidable mistakes made a bad situation worse. And clearly, Tokyo's ultimate reversal in 1998-its decision finally to apply massive stimulus-had a very positive effect. Nonetheless, most of Japan's demand problems are not the product either of mistakes or traditional short-term difficulties. They are part and parcel of Japan's institutional defects. Thus, they are not amenable to the traditional temporary macroeconomic fixes. Excess physical capacity, the mountain of nonperforming loans, the continued presence of all the "bad borrowers," and monopolistic prices that suppress real consumer income, all combine to act as strong headwinds. Indeed, they have reduced the potency of both fiscal and monetary tools. That is why heroic measures-deficits at 10 percent of GDP and interest rates at zero-have so far failed to catalyze a strong, durable, self-sustaining recovery. Japan has become a stimulus addict. Without structural reform,

it will remain so. Macroeconomic measures will work best when they are accompanied by genuine reform.

Sectoral Disputes vs. Structural Issues

The Task Force report counterpoises "sectoral disputes" to "structural issues" and suggests that U.S. economic diplomacy should shift its weight from the former to the latter. We would like to make a few comments on this.

Firstly, this is another area where U.S. policymakers face inevitable trade-offs between different goals. When U.S. firms present legitimate complaints regarding trade concerns, the U.S. government has no choice but to address them in some way. At times, the political capital spent dealing with such complaints may undermine the feelings of harmony needed to make progress in other areas. But as long as market-access problems remain, it will not be possible to avoid such trade-offs.

Secondly, we think some of the distinction between "sectoral" and "structural" issues is overdrawn. Consider the recent negotiations over Internet access fees in telecommunications. Clearly, it involved the interests of a particular U.S. industrial sector. But it also had very important ramifications for structural reform. It exposed the manner in which the Nippon Telegraph and Telephone (NTT) monopoly blocks progress on Information Technology. It will also help lower Japan's extraordinarily high consumer prices, an indispensable ingredient in improving consumer purchasing power.

In fact, we would argue that the most powerful leverage will occur where sectoral issues involving specific U.S. firms intersect with structural issues affecting the operation of the Japanese economic system. Without the urging of powerful U.S. constituents, mainly multinationals, Washington is unlikely to act. On the other hand, U.S. action is most effective when the American agenda coincides with the desires of major interest groups inside Japan, and when those changes have system-wide ripple effects. For example, in the negotiations over the Internet access fee, many businessmen and bureaucrats in Japan sided with the United States against the NTT monopoly and its Japanese protector, the Ministry of Posts and Telecommunications. Other cases of successful sectoral-structural intersection have involved the role of Toys "R" Us in reforming Japan's restrictions on the opening of large stores, and the U.S. financial community's role in a series of financial agreements. By contrast, if only U.S. interests are at stake with no corresponding interest-group pressure in Japan, even the most ardent efforts often fail. The never-ending dispute over flat glass is a case in point.

Thirdly, even in cases of what seem like purely bilateral sectoral disputes, it is often possible to approach them in ways that simultaneously give U.S. efforts a greater chance of success, and that can have structural ramifications. Take the flat glass issue. From the U.S. standpoint, it seems like a simple issue of market access. But, from a Japanese vantage point, this is a classic case of the Japanese consumer and taxpayer getting "ripped off" by a cartelized construction industry. The dango system of rig-bids means that public works are overpriced. Glassmakers can pass their costs along because the construction firms can pass their costs along to the taxpayer. It should be a prime subject for taxpayer revolt inside Japan. Of course, even if Washington does everything right on such issues, there is no guarantee that potential allies in Japan will respond. That brings us full circle to the dilemma of unavoidable trade-offs.

Prospects for Reform and U.S. Response

Task Force members-and analysts generally-disagree on the prospects for fundamental reform in Japan. Some accentuate the positive changes seen so far. Others highlight the strength of resistance. Both polar vantage points capture pieces of the whole puzzle: a long and bumpy struggle between the pressures for reform and the forces of resistance. In the long run (perhaps as long as a decade), we believe reform will succeed. Otherwise, Japan cannot revive. The status quo is steadily being removed from the menu of realistic options. Either Japan reforms or it suffers ongoing malaise for years to come. Muddling through, which tends to be the LDP's preferred option, becomes increasingly less viable.

The point for U.S. policymakers is not to speculate about the probability of successful reform. The issue is whether there is anything the United States can do to increase that probability and to speed up the pace. The thrust of the Task Force Report is that the United States can. We believe that is correct. That assessment stands whether one agrees with the report's optimistic description of the pace of reform so far.

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