

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Japanese and American Manufacturing: Is It Time to Seek a Common Agenda?

by Frank Vargo, National Association of Manufacturers

Throughout the 1980s Japan was America's principal trade concern. Japan's market was difficult to dent, much less than penetrate. US imports from Japan were rising rapidly – particularly in sophisticated higher technology products. The US trade deficit with Japan surpassed \$50 billion in 1986, becoming the largest bilateral deficit seen up to that time.

The period was marked by great concerns that Japan would surpass the United States as the world's dominant economic power. Business books and magazines were preoccupied with Japan, and airlines did a good business transporting trade negotiators back and forth across the Pacific.

Today, the story is quite different. Few US industries now rank Japan as their number one trade issue -- with the automotive industry being a major exception. But outside of this sector, it is difficult to find manufacturing industries expressing

great concern about Japan today. In a sense this is surprising, for United States still has a \$70 billion deficit with Japan, and few are satisfied that market access problems in Japan have been solved.

The US government's latest listing of foreign trade barriers in Japan occupies 35 pages -- more than for any other country. Most of the familiar old issues are still detailed in the report – autos and parts, medical devices, government procurement, marine craft, flat glass, standards and testing and certification issues – just to name a few. And that doesn't even touch the robust agricultural barriers to US farm products.

Changed Japanese Market

So why is Japan no longer a burning concern? Basically because Japan's economy regrettably has shown virtually no growth in a decade, and the Japanese market has diminished in importance to US exporters, particularly relative to other Asian markets. At the end of the 1980s, Japan accounted for 12 percent of US exports. Today it is just 7 percent. An additional factor is the deflation that has affected many Japanese industries. The combination of a stagnant market

and falling prices is not one that many American exporters find attractive. As one US executive candidly told me, "If the Japanese market opened up today – would anyone notice?"

Thus, while Japan's market is not dramatically more open, there is just not much interest in devoting large amounts of resources to obtain market access right now. That is not to say there has been no improvement in market access. Efforts over the years have resulted in some sectors becoming considerably more open, and a larger number that have opened up at least somewhat.

There is, however, a long way to go. Efforts continue in this regard, as well as attempts to encourage the deregulation necessary to open Japan's markets to competition and to get the Japanese economy growing again -- but with the absence of the friction that was once prevalent.

A second explanation for the change in attitude is that investment barriers in Japan have gradually been coming down, enabling more US firms to access Japan's market by producing there or by forming one of a variety of types of business

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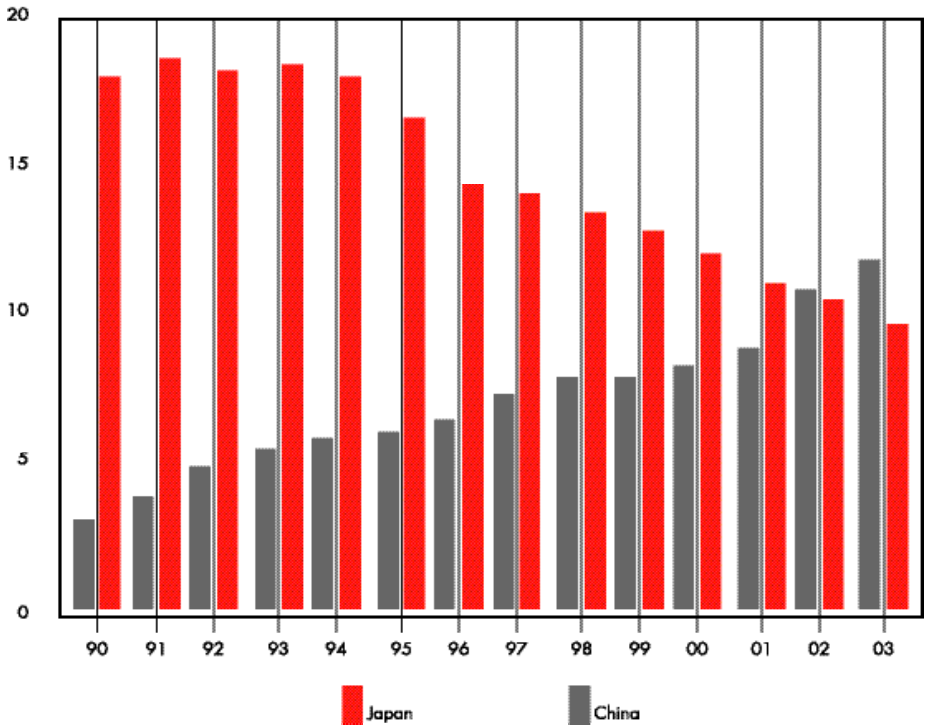
alliances. US investment has picked up rapidly since 1998 as Japan offered a more welcoming investment stance, and American firms have now invested nearly \$70 billion in Japan, according to US data. Substantial Japanese investment has also come into the United States – far more than has flowed the other way, and many Japanese companies are now large producers in the US market.

Japan's Vanishing Share of US Imports

Finally, and most significantly, there has been a dramatic turn-around in Japanese exports to the US market. Rapid export growth had expanded Japan's share of the US market to 20 percent by the late 1980s. Many US industries feared that this growth would continue unabated. But suddenly the growth stopped and a startling trade contraction began. Beginning in 1990 and accelerating rapidly after 1994, Japan's share of the US market plummeted.

In 1990 Japan supplied 18.1 percent of total US imports, but in 2003, its share was only 10.5 percent. That is an astonishing contraction. If Japan's market share had remained at its 1990 level, Japan's exports to the United States would have been \$89 billion higher in 2002 than they actually were.

FIGURE 1: CHINA'S SHARE OF US IMPORTS RISES WHILE JAPAN'S FALLS BY HALF



SOURCE: US CENSUS BUREAU

Figure 1 illustrates the dramatic change.

By the second half of the 1980s, Japan had become the world's largest exporter to the United States. But today it ranks only fifth – behind the European Union, Canada, China, and Mexico.

What caused this? It wasn't the yen. The yen is about 20 percent weaker today than in 1994. Moreover, if a strengthening yen had been the explanation, Japanese products would have been displaced

by domestic US production, but that didn't happen.

But if not the yen, then what? What happened in 1994 that could have had such a dramatic effect on Japan's exports to the United States? The answer is simple; it wasn't the yen, it was the Chinese yuan. In 1994 China devalued its currency by 30 percent, and since then has kept it at that low rate – making Chinese products irresistibly cheap.

Overall, as Figures 1 and 2 show, China's export gains to the United

FIGURE 2: CHANGES IN JAPANESE AND CHINESE SHARES OF US IMPORTS

HS	DESCRIPTION	SHARES OF US IMPORT MARKET				2002 VALUE OF SHARE CHANGE (in millions)	
		JAPAN		CHINA		JAPAN	CHINA
		1990	2002	1990	2002		
	TOTAL, ALL PRODUCTS	18.1%	10.5%	3.1%	10.8%	(\$88,809)	\$89,493
	SELECTED PRODUCT GROUPS						
39	PLASTIC	13.0%	7.1%	5.5%	18.5%	(\$1,204)	\$2,644
73	IRON/STEEL PRODUCTS	20.5%	9.2%	3.4%	17.7%	(\$1,623)	\$2,049
84	MACHINERY	30.4%	15.4%	0.7%	12.5%	(\$24,232)	\$19,072
85	ELECTRICAL MACHINERY	32.9%	13.1%	3.3%	16.1%	(\$30,169)	\$19,379
95	TOYS AND SPORTS EQUIPMENT	29.4%	10.6%	25.3%	67.3%	(\$4,046)	\$9,024
	SUBTOTAL					(\$61,274)	\$52,166

SOURCE OF DATA: US DEPT. OF COMMERCE, BUREAU OF CENSUS

States have closely mirrored Japan's losses. In fact, China's market share gains since 1990 raised its 2002 exports to the United States to \$89 billion above the level at which they would have been if its market share had not increased. That is identical to the \$89 billion loss of Japan's market share.

That is too simplistic an analysis, though, for Japan's sector-by-sector losses do not match perfectly with China's sector-by-sector gains. A sectoral analysis, however, shows that in many large trade categories, there has been an almost linear, dollar for dollar, import shift from Japanese to Chinese products.

Figure 2 illustrates this, showing the four largest product groups in which the bulk of Japan's share loss is concentrated. Figure 3 shows added detail for the machinery category. While closer investigation is merited, it appears to me that well over half of Japan's share loss in the US market is due to a shift to Chinese products.

Where Do We Go From Here?

Japan is off the front burner – for now – because of a combination of factors: its declining share of the US market, stemming from a diversion of imports from Japan to China; rising US concerns over China; and

slow growth and price deflation in the Japanese economy that make its import market less attractive.

Will trade frictions between Japan and the United States return? That is a distinct possibility, though China is almost certain to remain "center-stage" for some time. Frictions over agriculture and automotive trade (which now accounts for two-thirds of America's trade deficit with Japan and more than 10 percent of the global US trade deficit) will not disappear. The US auto and auto parts industries continue to be frustrated by market access impediments in Japan's market. And further tension arises from Japan's currency intervention that prevents markets from setting the dollar-yen exchange rate.

Once the Japanese economy begins growing again, more US industries that have been unable to penetrate the market in the past may decide again to challenge market barriers aggressively – particularly the distribution system and the standards and conformity assessment system.

A re-emergence of trade disputes between Japan and the United States is not inevitable, however, and is certainly not desirable. It would be wise to use this time of reduced trade frictions to see if

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**FIGURE 3: CHANGE IN JAPANESE AND CHINESE SHARES
OF US MACHINERY IMPORTS**

HS	DESCRIPTION	JAPAN			CHINA		
		SHARES OF US IMPORTS		2002 VALUE OF SHARE CHANGE (in millions)	SHARES OF US IMPORTS		2002 VALUE OF SHARE CHANGE (in millions)
		1990	2002		1990	2002	
84	MACHINERY TOTAL	30.4%	15.4%	(\$24,232)	0.7%	12.5%	\$19,072
8413	LIQUID PUMPS	25.2%	12.2%	(\$363)	0.5%	5.8%	\$148
8414	AIR PUMPS/COMPRESSORS	33.1%	14.7%	(\$833)	6.7%	19.2%	\$568
8415	AIR CONDITIONING	32.7%	6.9%	(\$571)	0.0%	18.3%	\$404
8418	OTHER COMPRESSORS, ETC	7.4%	1.5%	(\$108)	1.4%	16.0%	\$268
8465	TOOLS, WOODWORKING, ETC.	18.8%	3.1%	(\$132)	0.2%	11.9%	\$98
8467	HAND TOOLS, PNEUM, ETC	39.8%	11.2%	(\$685)	0.2%	39.6%	\$944
8471	COMPUTERS+COMPONENTS	38.4%	9.1%	(\$14,658)	0.2%	18.3%	\$9,036
8472	OTHER OFFICE MACHINES	47.6%	22.8%	(\$244)	1.1%	37.2%	\$355
8473	OFFICE MACHINE PARTS	35.7%	17.5%	(\$4,383)	0.2%	21.4%	\$5,089
8481	PIPE TAPS, COCKS, VALVES	19.2%	14.5%	(\$243)	0.8%	9.2%	\$438
8482	BALL/ROLLER BEARINGS	37.7%	29.1%	(\$114)	3.3%	11.9%	\$115
TOTAL OF ABOVE PRODUCTS		(\$22,334)			\$17,464		

SOURCE OF DATA: US DEPT. OF COMMERCE, BUREAU OF CENSUS

Japanese and American industry can find elements of a common agenda and address our increasingly similar problems.

Japanese and American manufacturers both suffer because manufactured goods prices are falling while their non-manufacturing prices are rising – putting enormous pressure on producers and serving as an incentive moving

production offshore. Industries in both countries also see their futures as related to more rapid advancement up the technology and innovation ladder, and both are struggling to deal with rising global competition.

How might such an agenda be constructed? For starters, industry in each country could construct a vision of where it wants to be in

2020, the obstacles it now faces that impede achievement of that vision, and possible courses of action to improve the prospects for achieving the vision.

As a second step, these documents could be the subject of mutual discussion to identify those areas that are bilateral US-Japan issues and those in which both countries might be able to work

together on third country or multilateral issues.

For example, one mutual concern is how to adjust to Chinese competition that is spurred by a sharply undervalued currency. This should be of concern to Japan, not only because of the direct implications on its economy but also because of the effect on Japan's exports to the United States. But Japanese industry has to ask itself if Japan can be an effective advocate for a floating yuan while Japan itself intervenes in exchange markets. Which course is more likely to result in achievement of Japanese industry's goals? Additionally, both Japanese and US industry have a need for effective and timely Chinese compliance with its WTO commitments.

Bilateral issues should also be addressed directly. For example, as both Japan and the United States see their futures tied to more rapid movement up the technology and innovation ladder, would we be better served by ending the bilateral barriers posed by different standards, regulatory, and conformity assessment practices that frustrate trade? Would mutual recognition or some other approach serve both industries in today's rapidly globalizing world?

Additionally, there should be intensive discussions of multilateral

issues and their effect on both countries' industries. Both face large trade barriers in exporting manufactured goods, particularly to the more advanced developing countries. Japanese industry has much to gain from the reduction of trade barriers around the world, and needs to explore whether the traditional priority that the Japanese government has given to narrow constituencies is something that Japan's manufacturing industry can still afford.

Frankly, stronger positive Japanese leadership in the World Trade Organization Doha Round is needed. Japan is now viewed as having a defensive strategy, rather than market-opening strategy.

More effort is also needed to obtain better intellectual property protection in parts of the world – particularly to combat counterfeiting. There are other multilateral areas of mutual interest as well.

There would be no point in initiating efforts to explore a common US-Japanese industry agenda if a "business as usual" approach is taken. But if both industries are willing to have frank and open discussions and are of the view that the changes in the world economy have rendered previous approaches obsolete, a

mutual effort could prove very productive. ■

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Corporate Governance in Japan: Today and Tomorrow

by Professor Nobuo Nakamura, Waseda University

Stung by a string of corporate scandals, the Japanese government amended the 1899 Commercial Law last year.

Under the old Commercial Law, corporate auditors – often themselves former directors or employees of the corporation they are charged with overseeing – had no right to select or discharge directors. Moreover, boards of directors were legally required to resolve a wide range of matters. Because executive decisions could not be made by representative directors, rapid and efficient management decision-making was impossible.

The 2002 Commercial Law established a new environment for

operating officer system. (Small corporations and unaudited medium-sized corporations are not eligible for this new style of management organization.)

Corporations that adopt the new option are required to elect one or more operating officers at meetings of their board of directors, for one-year terms. The operating officer can be entrusted by the board of directors to assume a wide range of responsibilities, including disposing assets and issuing new stock and debentures. (By contrast, representative directors under the conventional system are not authorized to carry out such tasks themselves.) Clearly, operating

tiered board system. The 2002 law also allows for a director to be named concurrently as an operating officer, for a one-year term, while external directors and auditing directors are not eligible. A majority of directors need not be external directors.

Under the new law, a company's auditing, nomination, and remuneration committees play a significant part in the management-oversight function of its board of directors. Committees must have at least three directors, of whom a majority are external directors. External directors and members of the auditing committee are prohibited from serving concurrently as operating officers. The election and dismissal of each committee member is carried out by the board of directors. The nomination committee is not involved in that function.

Nomination and remuneration committee members (other than external directors) are not expressly prohibited from serving concurrently as operating officers. But because the majority of committee members are external directors, having them monitor management ensures the effectiveness of their oversight duties.

Committee Responsibilities

The auditing committee audits the operating officer/director, as

“The 2002 Commercial Law established a new environment. Large corporations and audited medium-sized corporations would be given two options: keep their conventional corporate governance system, or establish auditing, nomination, and remuneration committees and an operating officer system.”

Japanese corporations. Large corporations (defined by the Commercial Law's special code) and audited medium-sized corporations would be given two options: keep their conventional corporate governance system, or choose to establish auditing, nomination, and remuneration committees and an

officers speed management decision-making and the execution of company business.

The basic function of a board of directors is to oversee the operating officer; directors themselves cannot execute business. Because the board can fire operating officers at any time, it essentially exercises a two-

“Even those Japanese corporations not publicly listed on US stock markets should pay attention to the corporate governance reform movement in the US.”

well as selecting, discharging, and reappointing professional auditors. Because these committee members have virtually the same authority as auditors, corporations are not permitted to also have corporate auditors. In order to ensure the independence of the auditing committee, committee members are not permitted to be operating officers of a corporation or its subsidiaries. They are also not allowed to become managers or employees of the corporation or its subsidiaries, nor may they serve as an executive business director of any subsidiary.

The nominating committee determines the content of proposals pertaining to the selection and discharge of directors that are submitted at stockholder meetings. Once the nomination committee reaches a decision, it cannot be overturned by the board of directors. This provision is intended to eliminate influence peddling by the representative director or president. It also ensures transparency and fairness in the process of selecting candidate directors.

The remuneration committee establishes policies pertaining to remuneration for persons serving concurrently as directors and operating officers. Decisions made by that committee about remuneration for operating officer/directors are final. By contrast, at corporations with conventional management organizations, remuneration decisions are made at shareholders meetings.

“The new business methods required by Japan’s Commercial Law will also go far in helping conventionally managed corporations improve the effectiveness of corporate governance.”

Under a 2001 revision of the Commercial Law, the auditing systems for conventionally managed corporations were strengthened: it extended the non-renewable term for corporate auditors from three to four years; it required that a resigning auditor be granted the right to state his or her opinions at a shareholders meeting; and it increased the number of external auditors to half or more of auditors numbering three or more. It also requires the boards of directors of

large corporations to secure the approval of the board of corporate auditors before submitting a slate of corporate auditors at a meeting of shareholders. This provision is aimed at eliminating influence peddling by boards and representative directors in selecting corporate auditors.

Weaknesses Remain

For all its strengths, the newly-modified Commercial Law does not require corporations that adopt a committee and operating officer system to have external directors constituting a majority of the board

of directors. Indeed, it permits directors concurrently serving as operating officers to possibly constitute a majority. Therefore, depending upon how the business is actually carried out, the hierarchical relationship between the board of directors and operating officers might possibly be reversed. In cases where such dual roles were permitted and it affected the appointment and dismissal of auditing committee member, the

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Some Comparisons Between Companies Adopting
Committees and Conventionally-Managed Organizations

Companies Adopting Committees

Selection of candidate directors

The nominations committee has the right to determine candidate directors. The directors are elected at shareholders' meetings. In order to secure fairness in personnel matters, the majority of members of the nomination committee are required to be external directors. Other committee members may serve concurrently as operating officers.

Remuneration of directors

The remuneration committee is entrusted with the authority to make the final decision concerning individual remuneration for operating officer/directors. The shareholders' meeting is not involved with decisions concerning such remuneration. Although a majority of the remuneration committee members are required to be external directors, other committee members can serve concurrently as operating officers.

Delegation of the authority of the board of directors

Delegation of much of the authority of the board of directors to the operating officer will facilitate expeditious management.

Ensuring the terms of the auditors and the independence of the audit

Membership on the auditing committee is predicated on being a director, so his term shall be one year, concurrent with his term as director.

Separation of operations and oversight/auditing

In addition to the majority of the auditing committee having to be external directors, all members are prohibited from serving as an operating officer or employee of the company or any subsidiary, and from holding a management position in any subsidiary. The board of directors elects the members of the auditing committee, without any need for agreement by that committee. If a majority of the board should consist of operating officers/directors, it is possible that the independence of that committee might be jeopardized.

Decisions on proposals concerning the disposition of profits, etc.

Because the board of directors has authority over the operating officer in terms of his appointment and dismissal, and also oversees the execution of business by the operating officer, there exists a hierarchical relationship between oversight and operations. However, except for external directors and auditing committee members, the law permits concurrent service as director and operating officer. Thus operating officers/directors can constitute a majority of the board, resulting in a situation in which this system has no teeth.

Based on certain conditions, the board of directors shall have the authority to decide upon proposals concerning the disposition of profits and losses.

Companies Maintaining a Conventional Management Mechanism

The board of directors selects candidate directors, who are elected at shareholders' meetings. This leaves some issues to be solved in terms of transparency and fairness relating to directorships because involvement on the part of external directors is not required by law.

The authority to determine remuneration for directors/auditors remains with the shareholders' meetings. However, it is common practice that the shareholders' meeting decides upon the overall remuneration amount for all directors, the apportionment of which is left to the board of directors.

Because the representative director is not empowered to make decisions, the number of decisions that must be made by the board of directors is relatively large.

The terms of auditors are stipulated by law to be four years, in order to ensure stability in those positions and to foster proper auditing.

After May 1, 2005, more than half of auditors numbering more than three are required to be external auditors. The requirements for external auditors shall be that, prior to that appointment, they shall never have been a director or an employee of that company or of any subsidiary. Some companies are already implementing this. Moreover, in order to ensure the independence of the auditors, the board of directors must obtain the concurrence of the auditing committee prior to submitting auditor candidates to the vote of the shareholders.

Although the auditors oversee the board of directors in terms of business execution, the auditing committee is not entrusted with the authority to dismiss directors, nor is it empowered to submit to the shareholders' meeting a proposal to dismiss any director. Thus operations and oversight exist in a parallel relationship.

The authority to decide upon proposals concerning the disposition of profits and losses remains with regular shareholders' meetings.

auditing committee's authority might be compromised. Another factor is that the terms of auditing committee members are shorter than those of the auditors – this mismatch may inhibit real oversight. The remuneration committee might possibly become a cover, as seen in the United States, for increased rewards to operating officers.

Of course, simply establishing the three committees will not be sufficient for corporations to systemically improve corporate governance – even those Japanese corporations not publicly listed on US stock markets would be advised to pay attention to the corporate governance reform movement in the US. Specifically, they should ensure that directors serving as operating officers do not constitute a majority of the board of directors and they should hire independent directors who meet American standards. In other words, they should establish method of business operations that compensate for inadequacies in present Japanese commercial law.

What might be needed is for the Tokyo Securities Exchange to establish a code of best practices

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concerning corporate governance for those corporations listed on the exchange.

Interestingly, some conventional corporations are voluntarily establishing nomination committees and remuneration committees in order to ensure transparency and fairness in the selection of directors and to introduce objectivity in deciding remuneration. Some voluntarily establish information disclosure committees to improve the objectivity and validity of their finances. And to speed up decision-making,

some have reduced the number of directors.

These new business methods will go far in helping conventionally managed corporations improve the effectiveness of corporate governance. If they are successful, companies may not need to adopt the committee system. Indeed, it may be that the major trend for the future will be Japanese-style corporate governance, with the voluntary establishment of committees, within conventionally managed corporations. ■

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