

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Why Japan Should Consider a More Vibrant Secondary Mortgage Market

by Armando Falcon, Office of Federal Housing Enterprise Oversight and Daniel Bob, Council on Foreign Relations

Japanese policymakers who are looking for catalysts for long-term economic growth and the improved health of Japan's banking industry would do well to look at the US experience in developing its secondary mortgage market.

In the United States, the creation of a secondary market for mortgages occurred in a period of economic distress. During the Great Depression of the 1930s, American housing lenders suffered severe losses, and the availability of new funds for housing shriveled. To revive housing markets and the economy, the US government designed several programs to channel funds to housing markets. Among the most successful and enduring of these programs were

those that led to the development of a secondary mortgage market, beginning with establishment of the Federal National Mortgage Association (better known as Fannie Mae) in 1938.

Secondary mortgage market institutions provide an efficient link between capital markets and housing lenders because they securitize pools of loans for sale to investors. In other words, they buy loans from lenders, and sell securities backed by those loans to investors.

Benefits

The establishment of a secondary mortgage market in the United States has had several profound economic effects. First, the increased availability of mortgage capital nationwide has reduced volatility in real estate prices. Thus, a robust secondary mortgage has helped moderate the extreme price swings associated with real estate "bubbles," such as the one from which Japan is still reeling.

Second, a national secondary mortgage market has effectively removed the cyclical effects of

credit shortages in local markets by extending the supply of capital.

Finally, improved access to mortgage credit has enabled homeowners to use their equity to finance consumption spending through such instruments as home equity loans and second mortgages or, when interest rates are favorable, the refinancing of original mortgages.

The substantial macroeconomic benefits of this last point are clearly visible in the United States. While the US economy has struggled over the past three years, a healthy housing sector and home equity-based consumer spending has helped to prevent a full-fledged recession.

Mortgage lenders also benefit from the development of a secondary mortgage market. A robust secondary mortgage market turns a mortgage into a highly liquid asset, which in turn contributes to the financial health of the lender. More important, a secondary market allows banks and other originators to shed risk and generate additional fee income.

Lenders holding mortgages in their portfolios must actively

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Why Japan Should Consider a More Vibrant Secondary Mortgage Market

manage the credit and interest rate risks associated with the loans or risk losses. Selling the loans, while retaining the fee income from servicing rights (collecting and processing mortgage payments), reduces risks and frees up funds that can be used to originate additional mortgages and hence additional servicing fee income.

Secondary mortgage market institutions like Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac) provide capital markets with an efficient means of investing in a stable and profitable sector of the economy. The capital markets well understand the risks associated with mortgage investments and have become adept at designing various mortgage investment vehicles to meet the diverse interests of different investors. The many investment vehicles available have broadened the universe of mortgage investors, which ultimately has lowered the cost of mortgages to consumers.

Japan Can Duplicate This Success

Japan is well positioned to achieve the same success and benefits of a secondary mortgage

market. Its primary mortgage market already has the legal and structural attributes necessary to attract investors.

Indeed, an initial effort to create a secondary mortgage market in Japan is already underway. The Government Housing Loan Corporation (GHLC) has begun to issue mortgage-backed securities for investor purchase on a small scale using some of the corporation's own mortgages. However, the real benefits to Japan will not begin to accrue until the GHLC, or another similarly situated public or private institution, begins buying mortgages from private sector lenders and packaging them as mortgage-backed securities for sale to investors. Such sales will facilitate the flow of funds from the capital markets to mortgage lenders and on to future homeowners.

As with the US experience, the potential benefits to Japan are great. A secondary mortgage market would act as an economic stimulus, promote job creation and enhance Japanese living standards by enlarging and improving the

housing stock and stabilizing home prices.

According to a study by the US home-construction industry, building 1,000 single-family homes creates 2,448 full-time jobs and building 1,000 multifamily units (apartment buildings) creates 1,030 jobs. Approximately 50 percent of these jobs are in on-site construction work, with another 20 percent involved in transportation, trade, and other locally-based services. Still more jobs are created through the increase in demand for household goods and services. For Japan, enhancing the flow of mortgage credit through the creation of a secondary market will likely be more productive than public works projects as an economic stimulus.

In addition, a secondary mortgage market would help facilitate the development of long-term, fixed-rate mortgages. Such a mortgage option provides homeowners with certainty about the amount of their mortgage loan payment over a relatively long number of years. Most mortgages offered in Japan today are some form of adjustable-rate mortgage (ARM) that leaves homeowners exposed to higher interest rates and the possibility that their payments will increase significantly over the life of the mortgage. While a 35-year fixed-rate mortgage

Japan is well positioned to achieve the same success and benefits of a secondary mortgage market as the United States.

was recently introduced in Japan, a successful secondary market will make such mortgages more accessible.

With long-term interest rates in Japan going up, interest rate risk for banks may rise. Thus, the importance of spreading that risk to a broad capital market may become ever more important. The US experience shows that a secondary mortgage market works efficiently in

to ensure that all of the attendant risks are properly managed. Regulatory oversight, along with maximum transparency, also promotes investor confidence and market discipline. In the United States, the Office of Federal Housing Enterprise Oversight (OFHEO) was established in 1992 as the safety and soundness regulator of Fannie Mae and Freddie Mac.

tution and other large financial firms, and from the possible lack of sufficient counterparties for implementing risk management strategies, such as derivative counterparties, that are necessary to manage interest rate risks.

The development of a secondary mortgage market in Japan linking individual homebuyers to the capital markets would have a number of multiplier effects: It would result in more favorable mortgage credit terms for borrowers, help provide affordable housing, stabilize the price of housing, and act as an economic stimulus. In addition, the establishment of such a market in Japan should help banks stay strong and liquid while making use of the capital market's capacity for creating mortgage instruments that meet the needs of both borrowers and investors. ■

A secondary mortgage market in Japan would act as an economic stimulus, promote job creation and enhance living standards by enlarging and improving the housing stock and stabilizing home prices.

both declining and rising interest rate environments.

While securitization does not eliminate interest rate and credit risk, it does transfer those risks from lenders to secondary market institutions and a widely diverse investor base, thereby rendering the risk more manageable. Further, because capital markets draw funds not just from domestic sources but from around the world, the flow of funds to Japan for domestic investment in housing could be enhanced.

Oversight is Essential

Well-funded oversight by an independent regulator is essential

OFHEO imposes stringent capital standards on these firms as part of a comprehensive safety and soundness regulatory regime. While Freddie Mac is currently experiencing accounting and management-related problems, OFHEO's oversight has ensured that those problems have not harmed the company's financial safety and soundness.

Prudent oversight becomes even more essential as the secondary mortgage market institutions grow. The systemic risks associated with a large financial institution must be monitored and properly managed. Those risks arise from the interdependencies between such an insti-

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Japan's GMO Trend

by Kazuhiko Kawamura, Ministry of Agriculture, Forestry and Fisheries

Genetically-altered agricultural products grown in the United States and Canada have been available in Japan since the government confirmed that such foods are safe in 1996. But public opposition to Genetically-Modified Organisms (GMOs) has been fierce from the onset.

To date, nearly one million Japanese consumers have signed onto petitions demanding safety guarantees and clear labeling for genetically-modified foods. These petitions have prompted more than 1,000 local legislatures (about one-third of such legislative bodies in Japan), and parliamentary subcommittees to mandate genetically-altered food labeling.

The passage of GMO labeling standards in 2001 soothed public anxieties somewhat. But with the outbreak of mad cow disease (BSE), consumer concern about food safety remains deep-rooted.

Producers of genetically-altered foods must meet environmental, animal feed, and human consumption safety standards to sell in the Japanese market. To date, 111 strains from 16 products have met environmental safety standards, 37 strains from five products have met animal feed standards, and 55 strains from six products (four strains for soybeans, 16 strains for

corn, 15 strains for rapeseed, nine strains for cotton, eight strains for potatoes, and three strains for sugar beets) have met human consumption safety standards. Japan ranks alongside the United States and Canada in terms of government approvals on GMO products.

Producers of genetically-altered foods must meet environmental, animal feed, and human consumption safety standards to sell in the Japanese market.

Japan consumes approximately five million tons of soybeans annually. Of this amount, several hundred thousand tons are produced domestically, while more than 70 percent is imported from the US. Approximately 20 percent of soybean consumption is used by the processed food industry (to make bean curds, bean paste, etc), while approximately 80 percent is used for soybean oil. The exoleted soybean byproduct is used as animal feed. Non-GMO soybeans are used in processed foods. But a significant volume of genetically-altered soybeans used to make oils and fats is imported.

Japan consumes some 16 million tons of corn annually, the bulk of which comes from the US. Of this, 12 million tons is used as animal

feed, while 4 million tons go into making cornstarch, sweeteners, etc. Corn used for animal feed and to make processed food (which strips genetically-altered DNA) does not require labeling. Again, much of genetically altered corn is imported.

Other products sold in Japan contain some GMO content.

Rapeseed is imported primarily from Canada as a raw material for rapeseed oil. Although the importation of potatoes is prohibited due to plant quarantine regulations, processed products, such as mashed potatoes, are imported, mainly from the US. Cotton is imported, primarily from Australia, as a raw material for cottonseed oil. Sugarbeets are not imported because of plant quarantine regulations.

Labeling is required for genetically-altered foods that end up on Japanese dinner tables, including five agricultural products (soybeans, corn, potatoes, rapeseed and cottonseed); 30 groups of processed foods (whose primary ingredients are soybeans, corn and potatoes); and soybean-based foods containing

a high level of oleic acid. Processed foods other than these do not require genetically-altered food labels, though voluntary labeling is permitted.

If proper administrative controls are followed, “unintentionally commingled” (i.e. products that contain a mix of GM and non-GM products) will have no more than five percent genetically-altered content.

Like consumers in most advanced countries, much of the GMO food purchased by Japanese households is processed and most of the 30 types of processed foods contain non-genetically altered ingredients.

According to the Center for Food Quality, Labeling and Consumer Services, a quasi-governmental body, 60 percent of non-genetically altered processed foods are voluntarily labeled as such.

In order to ensure proper labeling, the national government and local authorities conduct

random DNA analysis of food products and ensure procedural requirements are followed throughout the production, distribution and processing.

Genetic-alteration technology has introduced agricultural products that are resistant to disease, have a longer shelf life, and are low in allergens to Japan. But the only genetically-altered and commercially sold product – purple carnations – are no longer grown in Japan. Indeed, Japan does not produce any agricultural products that have been genetically altered.

Genetically-altered rice, which reportedly helps hay fever sufferers, has received considerable publicity in Japan. But counter-campaigns by opponents of GMO products have occasionally been violent, as was the case when consumer groups and farmers broke into a soybean pilot farm and smashed cultivation experiments.

A Japanese biotech industry group, the Society for Techno-Innovation of Agriculture, Forestry

and Fisheries, surveyed consumer attitudes about GMOs earlier this year. The survey found that consumer interest in GMO content ranked fourth in food label priorities (after taste/shelf life, additives, and raw ingredients). Tied for fourth place was interest in country of origin. Coming in last were volume and calorie values.

When consumers were asked about whether they were concerned about the GMO content of bean-curd, 32 percent reported being “very concerned,” 40 percent to being “somewhat concerned,” 23 percent said they were “not particularly concerned,” and five percent purportedly were “not at all concerned.”

When asked about their concerns about specifically genetically-altered products, the majority, not surprisingly, responded that they are unconcerned about the GMO content of carnations and cotton, but they do care about the foods they eat.

Japan’s stance toward genetic alteration technology can be generally summarized as follows:

- Genetic alteration technology is an important technique, concerning which Japan will actively conduct research.

Like consumers in most advanced countries, much of the genetically-modified food purchased by Japanese households is processed and most of the 30 types of processed foods contain non-genetically altered ingredients.

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Japan's GMO Trend

- The safety of genetically-altered foods should be strictly evaluated from a scientific standpoint.
- The labeling of genetically-altered foods should be mandatory and such that its rationality, reliability and feasibility are ensured, so that consumers have free choice.

Because Japan is a heavy importer of agricultural products and food-stuffs, genetic alteration will always be an extremely important issue and repeated, extensive discussions about safety and labeling will continue.

The Japanese government has gone far to respond to the right of consumers to full, scientifically-based information while striving to balance the need for a smooth facilitation of trade. Based on experience to date, Japan will become increasingly active in building a global consensus about genetically-altered foods. ■

Mr Kawamura is a senior official for agricultural standards in the Food Safety and Consumer Affairs Bureau of Japan's Ministry of Agriculture, Forestry and Fisheries.

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MOVING CREDIBILITY OF FINANCIAL REPORTING

MODALITY OF ACTION	EFFECTIVE DATE
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Private sector initiative Business Accounting Council opinion	July 01 March 03 March 03 March 03
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1 COMMERCIAL CODE INCLUDES LAW FOR SPECIAL EXCEPTIONS TO THE COMMERCIAL CODE CONCERNING AUDIT, ETC OF CORPORATIONS ("SPECIAL LAW").

Heads Up On Hot Topics Affecting the US and Japan

KKC's monthly program featuring experts on breaking issues of importance to both countries.

Foreign Currency Manipulation

"My boss has always been a staunch advocate of free trade," insisted Phil Eskeland, Policy Director to the House Small Business Committee chaired by Rep. Donald Manzullo (R-Illinois). "But he is deeply concerned about the devastation of the US manufacturing sector, especially of small and medium-sized companies, rising industrial unemployment, and the US's eroding manufacturing base." Moreover, Eskeland contended, the problem is not confined to assembly work in factories – increasingly, skilled service jobs in the US are being outsourced to countries with cheaper labor.

Speaking at the October 6 'Heads Up' program, Eskeland said that many factors have affected the hard-hit Midwest, but an unfair currency advantage maintained by Asian trading partners – namely, China, Japan, South Korea, and Taiwan – first emerged in 1999 when American machine tool makers were overwhelmed by Chinese competitors. Tool makers, "typically the first to suffer and the last to recover," sounded the alarm that the undervalued Chinese yuan was largely the cause.

Rep. Manzullo does not propose an abrupt revaluation of the yuan, Eskeland explained. Rather, his resolution (a non-binding "Sense of

the Congress" statement) calls on China to make a gradual glide-path transition toward a wider currency trading band. Only if the resolution proves ineffective, would Manzullo consider asking the Bush Administration to support a 301 currency dumping lawsuit in the WTO.

Eskeland defined "foreign currency manipulation" as a case in which a government or a government-controlled entity has a specific target exchange rate and will intervene in the markets to keep it at that level. Significant too is how much independence the central bank has from the government, he added.

Eskeland suggested that the Japan government is actually more to blame for US manufacturing woes than is China. "Pegging a currency to the dollar (as China has done) is not illegal, but with the Japan government officially pledging decisive action to keep the yen around 110 to the dollar, it plays the US for a sucker. Japan should take actions to drive up consumer demand and overhaul its economy instead. Many in Congress are frustrated that the US is always looked to as the sole engine of economic growth."

When asked about specific policy recommendations, Eskeland said that Manzullo would probably favor a two-track approach. On China, Manzullo would be satisfied if the

undervalued yuan became a top Presidential priority. But on Japan, Manzullo would like the US Treasury Secretary to issue a condemnation every time the Bank of Japan intervened in currency markets and possibly use the Economic Stabilization Fund to offset each intervention.

The currency issue is likely to remain "hot" for some time, Eskeland acknowledged. ■

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Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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