JAPAN

TRADE SUMMARY

The U.S. trade deficit with Japan totaled $70.1 billion in 2002, a slight increase from 2001. Also in that year Japan was the United States' 3rd largest export market, after Canada and Mexico. During 2002, two-way goods trade between the United States and Japan was $173 billion, a 6 percent decrease from 2001. U.S. exports to Japan totaled $51.4 billion, a 10.5 percent decrease from 2001. U.S. imports from Japan also decreased in 2002 to $121.5 billion, a 3.9 percent decrease from the previous year.

U.S. exports of private commercial services (i.e., excluding military and government) to Japan were $30.8 billion in 2001 (latest data available), and U.S. imports from Japan were $17.2 billion. Sales of services in Japan by majority U.S.-owned affiliates were $33.3 billion in 2000 (latest data available), while sales of services in the United States by majority Japanese-owned firms were $28.5 billion.

The stock of U.S. foreign direct investment in Japan in 2001 was $64.1 billion, up from $59.4 billion in 2000. U.S. foreign direct investment is concentrated largely in finance, manufacturing, and services sectors.

REGULATORY REFORM OVERVIEW

The United States welcomes the structural and regulatory reforms Japan has taken in recent years, which are a prerequisite for its return to sustainable growth. Nonetheless, Japan still has much work to do in order to clear away regulations that continue to impede economic growth and restrict market access for U.S. companies. In large part because it has not moved more aggressively to deregulate, the Japanese economy remains mired in stagnation – output has grown by only 0.5 percent since 1998. Prime Minister Koizumi's continuing commitment to "implement bold regulatory reform across sectors" has advanced the reform agenda in Japan. The United States is particularly interested in Japan's plans to implement the so-called Special Zones for Structural Reform that would plant the seeds of deregulation locally for subsequent growth nationwide. Clearly, however, forces resistant to positive change have managed to temper progress and delay implementation of key reform measures. Recognizing that a vibrant Japanese economy is vital to a healthy regional and global economy, the United States urges Japan to press ahead boldly with regulatory reforms that will help it return to sustainable growth.

The U.S.-Japan Regulatory Reform and Competition Policy Initiative

Launched by President Bush and Prime Minister Koizumi on June 30, 2001, the Regulatory Reform and Competition Policy Initiative (the Regulatory Reform Initiative) is one of the six "pillars" of the U.S.-Japan Economic Partnership for Growth (the Partnership). This Initiative addresses key sectors, including telecommunications, information technologies, energy, medical devices and pharmaceuticals, and financial services. It also addresses crosscutting issues, including competition policy, transparency, legal system reform, revision of Japan's commercial law, and distribution. Within the context of the Regulatory Reform Initiative, the United States continues to advocate the reform of laws, regulations, administrative guidance and other measures that impede access for U.S. goods and services into Japan.

Following numerous working-level meetings and several High-Level Officials Group (deputy/vice-minister level) meetings in late 2001 and in the first half of 2002, progress achieved during the inaugural year of the Regulatory Reform Initiative was detailed in the First Report to the Leaders. That report was concluded on June 25, 2002 and presented to President Bush and Prime Minister Koizumi at the G-8 Summit in Kananaskis, Canada.

Kicking off the second year of the Regulatory Reform Initiative, the United States submitted its annual recommendations to Japan on October 23, 2002. The United States urged Japan to adopt those recommendations at working-level meetings held in Tokyo and Washington in late 2002 and early 2003. A High-Level Officials Group met on February 27 and 28, 2003 in Washington to review the status of the discussions underway in the Working Groups established under the Initiative, narrow differences on outstanding issues, and set priorities in the lead-up to concluding a Second Report to the Leaders before the G-8 Summit in France in early June.

JAPAN

SECTORAL REGULATORY REFORM

Telecommunications

Under the Regulatory Reform Initiative, the United States is seeking regulatory changes to promote competition – and thereby innovation and choice – in Japan's telecommunications sector. In 2002, Japan concluded a long-term review intended to put the regulatory framework on a pro-competitive footing and create conditions to promote the development of a networked society. The conclusions of this review gave strong support to promoting market entry through measures to open up bottleneck facilities and recommended eliminating outdated regulations limiting the flexibility of operators to combine owned and leased facilities. These and other conclusions are expected to serve as the basis for revisions to the Basic Telecommunications Law in FY 2003, following an initial phase of reforms in 2001.

The outcome of the process will be an important indicator of Japan's willingness to implement a regulatory framework adequate to address the overwhelming market power of the dominant carrier group, Nippon Telegraph and Telephone Corporation (NTT), of which the Government of Japan owns 46 percent. NTT companies control access to greater than 98 percent of the local telephone network, giving them the ability to inhibit new competitors and services while promoting their own products and technologies. These problems are compounded by the fact that the Ministry of Public Management, Home Affairs and Posts and Telecommunications (MPHPT) is unduly influenced by political and industry interests (particularly NTT) that can inhibit competition enhancing measures.

The United States has asked Japan to take measures to address specific market access impediments related to a wide range of policies in this sector, both through its October 2002 Regulatory Reform Initiative submission and in bilateral consultations. These measures should help address important market access and regulatory barriers. Nevertheless, ensuring effective competition in Japan, especially in the local telecommunications markets, will require an independent regulator attuned to ensuring equitable opportunities for new entrants and unbiased treatment of all operators. In November 2001, Japan established a Telecommunications Business Dispute Resolution Commission within MPHPT. In its first year, this Commission mediated a number of interconnection disputes and issued its own administrative judgments on policies in two cases. It remains unclear whether this panel, which addresses issues after they arise rather than minimizing the occurrence of disputes, has the independence, full-time expertise, and enforcement powers necessary to ensure a competitive telecommunications market in Japan. Symbolically important enforcement actions by the Japan Fair Trade Commission (JFTC) over the last two years regarding unfair marketing practices and access to NTT facilities represent a welcome step toward ensuring competition in the market and illustrate the importance of establishing a truly independent regulatory authority that can exercise oversight and take necessary measures to safeguard competition in this sector.

Interconnection and Pricing: One of the most significant examples of insufficient safeguards on dominant carriers impeding competition is the high cost and onerous conditions that NTT regional operators are allowed to impose on their competitors. As a result of bilateral discussions (1997 - 2001), Japan introduced a pro-competitive methodology called LRIC, or long-run incremental cost, for setting interconnection rates. This resulted in rate reductions of 22 percent (for interconnection at the local switch) to 60 percent (at the regional switch) between JFY 2000 and JFY 2002. Partly as the result of lower interconnection rates, competition in local services increased and local calling rates fell by 15 percent or more in 2001. Still, the interconnection rates these operators charge their competitors to use their network are twice comparable rates in the United States, Germany, France or the United Kingdom.

The United States and Japan resumed discussions on further reductions in interconnection rates in connection with revision to the LRIC model in 2002. While revised rates have not yet been set, MPHPT has proposed a significant rate increase, raising serious questions about its impartiality and commitment to competition.

NTT has maintained its dominance through other measures such as denial of access to emergency services to interconnecting carriers, and proposals for higher interconnection charges

on carriers competing with alternative technologies (for DSL services).

New entrants to Japan's telecommunications market have expressed concern about the high and non-transparent interconnection and access rates charged by NTT DoCoMo, the dominant wireless service provider, as well. Under reforms to the Telecommunications Business Law in 2001, DoCoMo was recognized as a dominant carrier in 2002, but MPHPT has not required DoCoMo to explain how these rates are calculated, and the law places the onus on competing carriers to identify anti-competitive behavior and press for corrective action. In October 2002, in response to such a complaint, the Telecommunications Business Dispute Settlement Commission found that certain domestic wireline carriers have the right to set the retail rate it offers its customers for their calls from the wireline network to mobile numbers. This important decision should allow wireline carriers to overturn the established practice by which a mobile carrier is allowed to set prices for both incoming and outgoing calls for its network and new entrants are unable to compete on price – one of competitors' most important strategies. The Commission also recommended establishment of a rational and transparent system for interconnection rate setting, and MPHPT announced that it would set up a study group on this issue.

Rights-of-way: New competitors in Japan find it extremely time-consuming and expensive to build competing networks in Japan because of costs and difficulties related to access to "rights-of-way." The Government of Japan promulgated guidelines in April 2001 related to access to poles, ducts and conduits held by NTT and utility companies. However, there are few safeguards against exorbitant rates for the use of poles, ducts, conduits and other rights-of-way facilities. Moreover, if new entrants seek to dig roads to lay their own cables and facilities, they encounter a labyrinth of restrictions that industry sources say makes construction roughly ten times more expensive, and can result in digging times six times longer, than in other major markets. The Government of Japan's e-Japan strategy, which is designed to make Japan a global information technologies leader by 2005, includes measures to relieve these problems on an experimental basis. The United States has proposed that Japan establish pro-competitive rules to ensure non-discriminatory, transparent, timely, and cost-based access for telecommunications carriers and cable TV operators. The United States continues to urge mandatory rights-of-way access for new competitors.

Unbundling: Enhanced government oversight to assist new entrants in building their networks is also needed to require dominant local carriers to provide other carriers access to their network on an "unbundled" (or separate) basis. Japan has made advances in this area, but one notable exception is access to the operations support system (OSS) essential to customer acquisition and support for voice services. Extending unbundling obligations to this area would assist new carriers in building their networks more rapidly and efficiently.

Leased Lines: Japan's regulatory framework is based on whether carriers own or lease lines. Although new carriers have several means to use other carriers' facilities, they must apply for MPHPT approval of these arrangements. This adds extra time and expense for new carriers and increases uncertainty in business planning because many of the criteria MPHPT uses to evaluate these requests are non-transparent. The United States has urged MPHPT to eliminate current restrictions and allow carriers to freely combine both owned and leased facilities in their network without the need for government approval. Revisions to the Telecommunications Business Law in 2003 may address this problem.

Information Technologies

Japan has taken significant steps towards and continues to make progress on realizing its ambitious plan to become a global leader in information technology (IT). Even so, the Government of Japan itself has recognized through the "2002 e-Japan Priority Policy Program" that legal and other barriers persist which hinder growth in the IT sector. As Japan responds to the challenges that lie ahead in this pivotal sector, the U.S. Government is working with Japan through the IT Working Group under the Regulatory Reform Initiative to establish a regulatory framework that ensures competition, promotes innovation, allows private sector-led regulation where appropriate, and protects intellectual property rights in the digital age. The aim of this working group is to foster an environment that is not over-regulated and to

promote the development of IT-related businesses and innovative information technologies to spur growth in other key sectors of Japan's economy.

In its October 2002 Regulatory Reform Initiative submission, the United States made several recommendations and proposals for the IT sector on removing regulatory and non-regulatory barriers, strengthening the protection of intellectual property rights, promoting and facilitating public and private sector use of electronic commerce, and expanding procurement opportunities for IT-related goods and services. Specific recommendations include removing existing barriers that impede business-to-business and business-to-consumer electronic commerce, and allowing non-attorneys to provide mediation and arbitration services for profit. With regard to strengthening the protection of intellectual property, the United States made several recommendations which include extending Japan's terms of copyright protection and strengthening the enforcement system against infringement. To promote the use of electronic commerce, the United States has urged Japan to support private sector self-regulatory mechanisms for privacy and alternative dispute resolution, ensure that laws governing electronic transactions are technology-neutral, and provide security for commerce in the digital age. The United States has also called on Japan to support fair and open procedures for e-government and e-education procurement by ensuring transparency, efficiency, security, and private-sector led innovation.

The recommendations also address the United States' concerns that Japan's progress in building a vibrant information technology sector may be seriously hindered by regulatory barriers to electronic commerce and the lack of progress in such areas as online privacy, intellectual property rights protection, and transparency in IT procurement and online bidding.

Under current law, the consumer credit sector cannot benefit from the security, speed and efficiency of electronic notifications because consumer lenders are still required to provide written, paper notifications, even when consumers clearly express a preference to receive notices by electronic means. As a result, consumer credit customers are not able to apply for credit cards or receive bills and notifications electronically as a substitute for paper-based transactions. The United States urges Japan to revise the E-Notification Law or, if necessary, the Money Lending Business Law itself so that lenders can allow customers who have consented to electronic notification to receive notification by electronic means.

The Diet will likely consider revised legislation on privacy in 2003, and if passed, the United States urges the Government of Japan to ensure that the implementing ordinances and regulations: provide adequate protection of the privacy of personal information; avoid undue restrictions on trans-border data flows; support a self-regulatory framework; and encourage private sector approaches to the development of authentication systems which do not unduly intrude on individuals' personal privacy. In addition, the United States urges Japan to utilize its Public Comment Procedures and provide a minimum 30-day comment period in developing any implementing ordinances and other measures required by the new law.

Japan's liability rules for Internet service providers (ISPs) went into effect in May 2002 along with implementing guidelines drafted by a private sector-led working group. Given the voluntary status and language of the guidelines, the United States remains concerned that the liability rules: remain unclear; do not provide the appropriate balance among the interests of telecommunication carriers, ISP's, right holders, and website owners; and fail to provide adequate protection for right holders. The lack of adequate protection for right holders: prevents them from obtaining appropriate remedies when infringement has occurred; adversely affects the financial stability of several creative industries such as the music, game software and movie industries; and may hinder the development of creative works and new products that could be subject to online piracy. The United States urges the Government of Japan to monitor compliance with the implementing guidelines for ISP liability rules and their effectiveness for ensuring that infringing materials are taken down from websites quickly and adequate remedies are provided for any injuries suffered. The United States also urges the Government of Japan to support the continued existence of the private sector working group, and any revisions of the guidelines and/or the law for ISP Liability Rules that may be necessary to ensure an

effective "notice and take down system" and the appropriate balance of the rights and interests of all parties.

The Government of Japan took a significant step forward in protecting temporary copies, (e.g., digital copies made in the RAM of a computer), by recognizing that "temporary storage" implicates the reproduction right. However, the scope of protection for temporary copies remains vague, which could erode the ability to protect copyrighted materials in Japan. Given the importance of this new interpretation, the United States urges Japan to clarify and ensure the scope of protection for temporary copies. (*Further discussion of this issue can be found in the Copyright subsection.*)

Japan's 2002 e-Japan Priority Policy Program strives to digitize administrative procedures at all levels of government, building the foundation of E-Government online services. As a result, public institutions will dramatically increase their purchases of hardware, software, and network infrastructure. The United States urges the Government of Japan to ensure that new e-government and e-education procurement policies and rules are implemented in a transparent and consistent manner throughout all the ministries, facilitate open competition, and support private sector-led innovation in IT-related procurement.

MPHPT has already launched its online bidding system for non-public works and all other ministries are expected to do so by April 2004. The United States urges the Government of Japan to ensure that the online procurement systems promote fair and open tendering procedures; and support the concepts of transparency, efficiency, security, and private sector leadership.

In addition to addressing these specific areas of concern, the United States urges Japan to continue focusing on reinvigorating a vibrant and innovative information technology sector by expeditiously removing remaining regulatory and other barriers, and by ensuring transparency and open competition.

Energy

As Japan moves to liberalize its energy sector, the United States views ongoing bilateral discussions as a key forum for input into the process and support of Japan's goals of improved energy efficiency and lower energy costs, which are among the highest in the world. To achieve its goals, it is critical for Japan to attract new entrants into its electricity market – the third-largest power market in the world – and create robust competition in this sector.

Electricity: In recent years, Japan has taken a number of steps to reform its electricity sector. In March 2000, for example, the Government of Japan liberalized the retail sale of electricity for large-scale users, who represent about 27 percent of total electricity consumption in Japan. During the same time period, Japan also abolished its antimonopoly exemption for natural monopolies, including electricity and gas. While the United States welcomed these steps, Japan's partial market opening has yielded little progress in lowering energy costs and improving efficiency. The sector also has seen minimal new entry since 2000.

Nevertheless, Japan is currently embarking on a new phase of electricity sector reform and is preparing to submit legislation to the Diet in the spring of 2003 to achieve this. To support this effort, the United States shared its own experiences on reform of this sector and made numerous recommendations to Japan throughout 2002 in the Energy Working Group, such as ensuring that METI's energy sector regulatory divisions are free from undue political and industry influence, clarifying the type of market structure Japan will adopt, taking steps to promote fair and transparent competition in electricity transmission and distribution by all market participants, and promoting new entry by streamlining siting requirements and developing a concrete plan and schedule for expanded retail choice.

Largely consistent with these working-level discussions, the reform legislation includes key elements, such as: (1) establishing a neutral body to set transmission and distribution rules; (2) securing fairness and transparency of transmission and distribution systems through information firewalls, monitoring, and prevention of cross-subsidization; (3) abolishing the transmission pancaking system; (4) preparing for a nationwide wholesale power exchange; (5) organizing and strengthening the governmental structure responsible for market monitoring and dispute resolution; and (6)

setting forth a plan and schedule for expanded retail choice.

Welcoming the fact that METI solicited public comments on the draft report that was used as the basis for this reform legislation, the United States generally supported the key elements listed immediately above in the comments it submitted in January 2003. The United States, however, did raise several concerns and questions, such as the manner in which the proposed neutral body would be established and potential problems with not undertaking operational unbundling. The United States will continue to urge Japan to take vigorous steps to liberalize its electricity market in a manner that will promote market efficiency, reduce energy costs through competition, and encourage market entry.

Natural Gas: In parallel with the electricity sector, Japan is also moving to undertake significant reform of its gas sector and is planning to submit legislation to the Diet to achieve this in the spring of 2003. Similarly, the United States shared its own experiences on reform of this sector and made numerous recommendations to Japan throughout 2002 in the Energy Working Group, such as: taking steps to foster new entry by streamlining siting requirements; promoting open access to the gas pipeline network and transparency on pricing and availability of information for all market participants; and expanding gas transportation infrastructure and gas market liberalization to guarantee new entry by suppliers of gas.

Largely consistent with the working-level talks, the gas reform legislation will include important elements, such as: (1) taking special measures to increase pipeline investment incentives and promote interconnection of pipeline networks; (2) securing fair and transparent competition between the gas companies that maintain and operate the network and other companies that use the pipelines; (3) taking necessary measures to separate accounts and prohibit discriminatory treatment towards certain businesses to which gas companies supply gas; (4) promoting third-party usage of LNG terminals by, for example, establishing rules for resolving disputes over negotiations; (5) setting forth a plan and schedule for expanded retail liberalization; and (6) developing guidelines and establishing a neutral and fair system for conducting market monitoring and dispute resolution.

In February 2003, the United States submitted public comments on the draft report that served as the basis for the gas sector reform legislation. In those comments, the United States generally lauded the recommendations contained in the draft report, but also noted that the proposed current framework does not appear to contain any provisions for truly private pipelines. While welcoming the proposal to implement accounting separation and information firewalls, the United States also raised questions about the difficulty of preventing abuse if gas transportation and supply remain bundled. The United States will continue to address these issues with Japan in the Energy Working Group.

Medical Devices and Pharmaceuticals
Since the 1986 Report on Medical Equipment and Pharmaceuticals Market-Oriented, Sector-Selective (MOSS) discussions, the United States and Japan have continued to address regulatory and reimbursement market access concerns in the medical device and pharmaceutical sectors. The MOSS Med/Pharm working group now also serves as the venue for discussion of medical device and pharmaceutical issues under the Working Group on Medical Devices and Pharmaceuticals established under the Regulatory Reform and Competition Policy Initiative.

In its October 2002 Regulatory Reform Initiative recommendations, the United States urged Japan to pursue a more comprehensive approach to health-care reform. In particular, the United States has urged Japan to consider how different cost structures in various parts of the health-care system influence each other and how faster access to innovative products can result in cost savings. To facilitate such discussions, the United States suggested the creation of a Prime Minister's council, inclusive of foreign stakeholders, to discuss comprehensive health-care reform. It is encouraging to see that the Ministry of Health, Labor and Welfare has made public a health-care reform proposal as a starting point for wide-ranging discussions with all stakeholders. This proposal highlights structural factors that push up health-care costs in Japan such as the fact that the current medical fee structure contributes to very lengthy average hospital stays as well as lack of hospital specialization. The United States looks forward to active and open discussions of this proposal.

The United States also continues to stress the

importance of a transparent and predictable pricing process to appropriately reward innovative medical devices and pharmaceuticals as well as to reflect the intellectual property and investment costs of meeting additional regulatory hurdles of biological products. In pursuing its regulatory reform, Japan should ensure faster and more efficient product approvals that give maximum consideration to common international practice.

Severe fiscal pressure on Japan's national health-care system led Japan to implement on April 1, 2002 price cuts on medical devices, pharmaceuticals and doctors' technical fees as well as increases to patients' premium and co-payments. While this approach required a "sharing of the burden," it did not address the key structural problems within Japan's health-care system that are driving a sustained increase in health-care spending. Therefore, it is likely that fiscal pressures will continue to influence health-care policy.

Furthermore, despite strong concerns raised by the United States, Japan implemented a "foreign reference price" or "foreign price adjustment" mechanisms to cut and cap device prices by linking them to lower prices in overseas markets. The United States continues to view this type of mechanism as inappropriate. While Japan raised the premium pricing ratio for innovative pharmaceuticals and created premiums for medical devices in April of 2002, the United States urges Japan to periodically review the new and expanded premium pricing systems to ensure that premiums are being used to fully recognize and encourage innovation as intended.

Given its importance to U.S. suppliers, the United States has been urging Japan to increase transparency in the medical device and pharmaceutical pricing process. While Japan has taken some measures to address this issue, the United States believes Japan should provide adequate access for applicants to discuss product characterizations with decision makers. Specifically, the United States encourages Japan to allow applicants to consult directly with the Health Insurance Bureau (HIB) officials who draft pricing recommendations for the Drug Pricing Organization (DPO) and the Special Organization for Insurance-covered Medical Materials (SOIMM). The United States would also like to see that applicants have access to HIB recommendations, and be allowed to present opinions to and hear explanations from the DPO or SOIMM.

Expediting regulatory review and new product approval procedures also remains a key goal, and Japan's amendment of the Pharmaceutical Affairs Law (PAL) takes some steps in the right direction with respect to product safety and licensing/approval reform. Japan plans to create a new independent administrative corporation by combining the Organization for Pharmaceutical Safety and Research (Kiko) and the Pharmaceutical and Medial Device Evaluation Center (Shinsa Center). This new organization will oversee the regulation of medical devices and pharmaceuticals from development to final market approval. The United States generally welcomes these measures as they are expected to improve the medical device and pharmaceutical regulatory system. The United States, though, urges Japan to continue to actively consult with all industry stakeholders on the new organization's fee-for-service structure and payment levels, and to ensure an adequate transition time.

Another aspect of the PAL amendment involves reform of Japan's Blood Law, with the ultimate aim of establishing Japan's "self-sufficiency" in blood plasma and blood products. There are three major areas of concern in the legislation: the demand and supply plan; the labeling requirement of "paid" vs. "unpaid" donors; and the designation of "biologics" vs. "special biologics." Japan confirms that the measures to implement the law will be done in a transparent and non-discriminatory manner. However, the United States has encouraged Japan to continue science-based discussions with all stakeholders to ensure that bias does not enter into the process.

Finally, in a bid to create a more internationally competitive and economically vibrant pharmaceutical and medical device industries, Japan is developing major policy papers dubbed "Industry Visions." These papers point to many important factors that are needed for innovative, research-based pharmaceutical and medical device industries to thrive, including the need for pricing to encourage investment in R&D. The United States urges Japan to give careful attention to new pricing approaches that could better meet this goal. Specifically, the United States is encouraging Japan to abolish rules that

penalize or fail to recognize the value of innovation, such as re-pricing, and actively apply rules designed to reward and encourage innovative products, such as premium pricing. This is critical for Japan to meet its goals of providing high quality care as well as becoming an attractive environment for cutting edge research and development. The United States has encouraged Japan to continue to provide foreign industry with meaningful access to discussions regarding the "Industry Visions" and to ensure that their implementation is unbiased. In addition, the United States is concerned about the related proposal for a "Megatrial Network," a physician-initiated clinical trial system that would result in manufacturers having no control over the type, design or results of any clinical trials. Such implementation would raise serious ethical, liability and intellectual property concerns. While the United States supports the development of a better clinical trial infrastructure in Japan, the United States has emphasized that participation in any clinical trials by manufacturers should be voluntary.

Financial Services

Japan has made great progress in reducing financial market access barriers since the early 1990s, easing some of the restrictions that have traditionally hindered the emergence of a fully competitive market for financial services. These restrictions include the use of administrative guidance, lack of transparency, inadequate disclosure, the use of a positive list to define securities, and lengthy processing of applications for new products. The U.S.-Japan comprehensive financial services agreement concluded in February 1995 featured an extensive package of market-opening actions in the key areas of asset management, corporate securities, and cross-border financial transactions. In the seven years since the agreement was signed, Japan has implemented the specific commitments made within the specified time frames. In some instances, the timetable for implementation was accelerated, and Japan has taken or announced additional actions in several areas to improve the liberalization of Japanese financial markets.

The past few years have seen notable changes in Japan's financial sector. Foreign financial institutions have made important acquisitions in securities brokerage, insurance, and banking. Consolidation among Japanese financial institutions has increased in an effort to cut costs and boost competitiveness, while traditional segmentation among various types of financial institutions is steadily being phased out. These changes have expanded opportunities for foreign financial firms in Japan to compete on a clear and level playing field. While supervision and disclosure have improved, it is important that Japan continue to move forward in establishing clear and consistent regulation and supervision of financial institutions, in line with international standards and best practice.

Financial sector deregulation continued in 2002. Rules governing Money Management Funds (MMFs) were strengthened in January 2002, although the exception from mark-to-market valuation was retained. Legislation eliminating the requirement for physical certificates for Government of Japan Bonds and corporate debentures passed the Diet in June 2002 and is set to be implemented effective January 6, 2003. This follows the elimination of the requirement for physical certificates for commercial paper on April 1, 2002. Banks were granted limited entry into the insurance business in April 2002 (initially non-life only), and restrictions on banks' insurance activities were further removed in October 2002, including authorization of bank sales of variable annuities.

In August 2002, the Financial Services Agency (FSA) announced a package of securities market reforms, including legislation to be submitted during the January 2003 ordinary Diet session, to reduce minimum capital requirements for securities companies, investment trust management companies, and investment advisory companies, to make new market entry easier, while introducing a sales agent system to permit certified public accountants, licensed tax accountants, and financial planners to sell corporate stocks to investors as an agent of a security brokerage house. It also included authorization for banks and securities houses to share business spaces beginning mid-September 2002 and relaxation of restrictions on the discretionary execution of customer orders by securities companies, as well as measures to strengthen the competitiveness of Tokyo financial markets and to deepen housing loans and other asset securitization markets.

STRUCTURAL REGULATORY REFORM

Antimonopoly Law and Competition Policy

Under the Regulatory Reform Initiative, the United States has proposed a number of progressive measures to strengthen competition policy and enforcement of Japan's Antimonopoly Act (AMA) that are critical to bolstering competition and improving market access. Foreign companies continue to face numerous impediments, including anticompetitive practices, to accessing Japan's distribution channels across a wide range of sectors.

One of the key problems in addressing anticompetitive practices in the Japanese market has been the Japan Fair Trade Commission's historical weak status within the Government of Japan and its lack of sufficient enforcement powers and resources to implement the AMA in the most effective manner. There have been improvements in recent years due in large measure to sustained U.S. efforts to work with Japan to strengthen its competition policy and AMA enforcement regimes. Under the Regulatory Reform Initiative, the United States has emphasized the need for concrete progress on the following AMA and competition policy-related issues.

Independence of the JFTC: An independent JFTC has been a longstanding and important principle of Japan's antimonopoly enforcement system that the United States strongly believes should be maintained. However, in January 2001, the JFTC was subsumed as an organization under MPHPT. Since MPHPT is also responsible for postal services and telecommunications, there is a real risk that the JFTC will not be able to act independently in these crucial areas, both in enforcement decisions and competition advocacy. Therefore, the United States has urged Japan to make the JFTC an independent agency under the Cabinet Office. In April 2001, Prime Minister Koizumi called for examining the possibility of transferring the JFTC out of MPHPT and into the Cabinet Office. Legislation calling for the transfer of the JFTC is expected to be introduced in the ordinary Diet session beginning in January of 2003.

Effectiveness of AMA Enforcement. Cartel activity, including widespread bid rigging, continues to be a serious problem in Japan. One of the most important reasons is the JFTC's lack of adequate investigatory tools to root out illegal behavior and insufficient administrative and criminal sanctions against companies and individuals found to have engaged in unlawful anticompetitive practices. Although the AMA provides for criminal sanctions against violators, criminal prosecutions have been rare, and sentences have been modest. In fact, no corporate executive has ever been imprisoned for violating the AMA, and the JFTC has not initiated any criminal prosecutions of AMA violators since 1999.

There are a number of factors that limit the effectiveness of the JFTC's enforcement against hard-core AMA violations. First, the JFTC does not have the powers enjoyed by other Japanese criminal investigation authorities, including the power to conduct compulsory searches and seizures. Nor does it have the ability to reduce or eliminate criminal sanctions or administrative surcharges for companies that come forward to expose illegal activities. These weaknesses make it difficult for the JFTC to gather enough evidence to support filing a criminal complaint with the Ministry of Justice. Second, an extraordinary provision in the AMA that requires the Ministry of Justice to explain to the Prime Minister why it has not pursued a criminal referral from the JFTC has resulted in the JFTC being required to produce an exceptionally high degree of evidence before a referral from the JFTC will be accepted. Although in 2002, Japan increased five-fold the maximum criminal fine against corporate AMA offenders, increased fine levels are irrelevant if they are not accompanied by an active program of criminal prosecution.

In its October 2002 regulatory reform recommendations to Japan, the United States called for Japan to improve the JFTC's enforcement tools by strengthening JFTC investigative powers, increasing administrative sanctions (surcharges), introducing *per se* illegality for cartels, increasing criminal AMA prosecutions and introducing a leniency policy for companies that bring evidence of illegal cartel activities to the JFTC. The United States also recommended that Japan take further measures to address prolific bid rigging, including aggressively implementing the newly-

enacted law against bureaucrat-led bid rigging (so-called *kansei dango*), instituting procedures for collecting overcharges from companies that have participated in bid rigging conspiracies and assisting citizen suits aimed at recovering overcharges suffered by local governments as a result of bid rigging.

Private Remedies: The United States believes that the unfettered availability of injunctive relief and monetary damages to private litigants injured by AMA violations is an integral part of a comprehensive and effective antimonopoly legal regime. Private AMA enforcement can help reinforce to Japanese firms the importance of conforming their business practices to the AMA, which in turn will keep markets free, open and competitive. Legislation providing for private actions seeking injunctions against an alleged violator of the AMA went into effect in 2001. Nevertheless, there is concern that the law does not apply to the most egregious AMA violations, particularly cartel behavior and monopolization, and that the Japanese court system lacks the capacity and expertise to effectively implement this new remedy. Further improvements in the private litigation system are needed before it will become a reliable avenue for the deterrence and redress of antimonopoly violations.

Promotion of Deregulation by the JFTC: Successful regulatory reform in Japan must be built on a solid foundation of effective competition policy. As the only Japanese agency charged with promoting competition throughout the economy, the JFTC should substantially boost its actions as an advocate of competition policy and regulatory reform. The United States has proposed that the JFTC actively participate in the process of deregulating Japan's public utilities. This is necessary to ensure both that maximum deregulation occurs in the electricity, natural gas, telecommunications and transportation sectors consistent with sound competition policy, and that anticompetitive conduct by dominant incumbent firms will be strictly dealt with under the AMA. Some steps have been taken. In April 2001, the JFTC established the Information Technologies and Public Utilities Task Force to investigate and take enforcement action against AMA violations in industries undergoing deregulation. This task force continues its efforts, but has been hampered by shortages in JFTC staffing levels and industry expertise, as well as by the need to coordinate bureaucratically with ministries having jurisdiction over the sectors in question. In 2001, JFTC and MPHPT jointly issued guidelines spelling out prohibited anticompetitive behavior in the telecommunications sector, and the agencies revised those guidelines at the end of 2002. A JFTC study group also issued a report in November 2002 advocating deregulation and reliance on the AMA over *ex ante* regulation in the telecommunications sector, but it is not clear whether the JFTC has the capacity to respond quickly and effectively to complaints of competition problems in this sector to make this an effective option in the near term.

JFTC Staffing & Resources: The JFTC's ability to enforce the AMA is hindered by its shortage of personnel. The United States has urged for more than a decade that the JFTC's budget and staff be increased significantly to ensure that it is able to fully carry out its mandate. Some progress has been made, as seen by the increase in the JFTC's staff levels from 474 in 1990 to a proposed 642 for 2003. Even more importantly, the number of the JFTC's investigative staff has increased from 129 in 1990 to 294 in 2002. These increases are welcome, particularly in the face of pressure to cut government spending generally. Nonetheless, the JFTC remains understaffed – particularly in the areas of economic analysis and investigations – to adequately enforce the AMA and to engage in necessary competition promotion. This is especially true given the potential effects on Japan's competitive environment of the increase in mergers, the liberalization of holding companies, the elimination of many AMA exemptions, and stepped up deregulation that now requires the JFTC to police more business behavior. In its October 2002 Regulatory Reform recommendations, the United States called on Japan to increase the staff and budget of the JFTC substantially and to establish an office of graduate school-level economists to provide economic analysis and expertise for the JFTC's enforcement and competition policy activities.

Transparency and Other Government Practices

An essential prerequisite for a vibrant Japanese

economy is a transparent, fair, predictable and accountable regulatory system. It is important that domestic and foreign firms alike have full access to information and opportunities to participate in the regulatory and rulemaking process. While Japan has made some progress in this regard, additional measures are necessary to improve the accountability and transparency of its regulatory system. In its October Regulatory Reform submission, the United States therefore urged Japan to increase transparency in the following areas:

Special Zones for Structural Reform: The U.S. Government has followed with much interest the Government of Japan's proposal to establish Special Zones for Structural Reform and that Prime Minister Koizumi has made the zones the centerpiece of his drive to achieve bold regulatory reform in an expeditious manner. The United States included the topic in its October 2002 submission to Japan and it became the focus of an extended discussion during the High-Level Officials Group meeting held in Washington in February 2003. This new approach to deregulation and structural reform could provide important opportunities for Japan to return to sustainable growth and for greater market access for U.S. and other foreign firms. As Japan moves forward with this proposal, the United States recommends that the zones be selected and established in a transparent manner, that a focus be placed on expanding market-entry opportunities, that domestic and foreign companies alike have non-discriminatory access to operate in the zones, and that successful measures used in the zones be applied on a national basis as promptly as possible.

Public Comment Procedures: Japan's adoption in 1999 of Public Comment Procedures (PCP) offered the potential of significantly improving Japan's regulatory system by allowing all interested parties to review and submit comments on draft regulations before they are finalized and implemented. After three years of implementation of the PCP, however, there are still serious concerns with its effectiveness. A survey issued on August 22, 2002 by the Ministry of Public Management, Home Affairs, Posts and Telecommunications (MPHPT) on the use of the PCP revealed serious and persistent deficiencies in the use of the PCP. As in past years, a majority of comment periods were less than 30 days. Moreover, the percentage of cases in which government agencies incorporated comments into final regulations fell to only 14 percent of the 354 rules and regulations open for comment in FY2001. To address these concerns, and to make the PCP a useful and effective regulatory mechanism, the United States urged the Government of Japan in the October 2002 submission to: (1) establish a centralized system that would allow parties to find solicitations of public comments of interest to them in one location, preferably on the Internet; (2) require the use of a minimum 30-day comment period; and (3) undertake the legal steps necessary to incorporate the PCP into the Administrative Procedure Act, a move that would strengthen it from a mere guideline to a law.

Public Participation in the Development of Legislation: Governmental agencies in Japan generally do not provide opportunities for interested parties, other than those represented on advisory councils or with special access, to have input into the development of legislation before it is submitted to the Diet. The United States welcomed the Cabinet Secretariat decision in the fall of 2002 to provide the public with a rare and important opportunity to review the "Summary of the Proposed Intellectual Property Basic Law" before it was finalized and submitted to the Diet. In its October submission, the U.S. Government urged other Government of Japan ministries and agencies to follow this example and implement the practice of facilitating public input into draft legislation while it is being developed by the Government prior to Diet submission. In a welcome subsequent development, METI solicited public comments in early 2003 for draft reports on electricity and gas reform proposals that served as the basis for legislation scheduled for submission to the Diet in March 2003.

Public Corporations: The United States has noted with interest Prime Minister Koizumi's drive to restructure and privatize Japan's public corporations. The United States recognizes that, if implemented vigorously, this reform effort could have a major impact on the Japanese economy, stimulating competition and efficiency and leading to a more productive use of resources. In its reform recommendations, the United States urged Japan to ensure that the process of restructuring and privatizing public corporations is transparent and that private

sector entities have an opportunity to provide input.

Commercial Law

Japan made substantial revisions to its Commercial Code in 2002, the first comprehensive review of Japan's commercial law in half a century. Reform of Japan's commercial law was important in order to introduce necessary flexibility into the organization, management and capital structure of Japanese companies and to facilitate merger and acquisition activities by both foreign and domestic firms in Japan. Until the 2002 amendments, Japan's Commercial Code stifled investment (both domestic and foreign) and hurt Japan's efforts to integrate more fully into the international economy. The 2002 revisions will introduce greater flexibility to the capital structure of Japanese corporations and strengthen corporate governance mechanisms, both of which should contribute to Japan's efforts to revitalize its economy. The reforms should also enhance the ability of foreign firms to enter and operate in the Japanese market.

Specifically, Japan's Commercial Code was amended to: liberalize substantially restrictions on the issuance of stock options; permit companies to issue tracking stock and shares with limited voting rights; eliminate the requirement that foreign companies must set up a branch office in Japan; and provide companies the option of adopting an American-style executive committee (audit, nominating and compensation committee) system, composed of at least a majority of outside directors, as an alternative to appointing statutory auditors. Japan also undertook to examine the possible introduction of modern merger techniques, such as triangular mergers and cash mergers, into its commercial law.

The United States has commended Japan for its broad-ranging reforms of its commercial law. In its October 2002 Regulatory Reform submission, the United States urged Japan to build on these reforms by taking further measures to improve commercial law and corporate governance. Specifically, the United States recommended that, while it is examining the general introduction of modern merger techniques into its commercial law, Japan revise the Industry Revitalization Law to permit firms seeking to restructure to use such merger techniques immediately. The United States also urged Japan to improve corporate governance in Japan by requiring pension fund managers to vote proxies for the benefit of fund beneficiaries and by providing for increased disclosure on a more timely basis of information necessary for shareholders to exercise their voting rights in an effective manner.

Legal System Reform

Reform of the Japanese legal system is essential to the establishment of a legal environment in Japan that is conducive to international business and investment and that supports deregulation and structural reform. The Government of Japan has recently taken some significant steps to address the need to modernize its legal system. In June 2001, the Judicial Reform Council made significant recommendations on needed legal reforms. To implement the recommendations, the Government of Japan enacted the Judicial Reform Promotion Law in November 2001 and set up the Judicial Reform Promotion Headquarters (headed by Prime Minister Koizumi) in December 2001. In 2002, Japan took important steps toward modernizing its legal system. Most significant was the adoption by the Japanese Cabinet in March 2002 of a Program for Promoting Justice System Reform, which set out the timetable for introducing legislation to implement Japan's plans for judicial system reform. These plans include the introduction of legislation in early 2003 to, among other things, liberalize restrictions on partnership and employment relationships between Japanese and foreign lawyers; reduce by 50 percent the time required to complete court trials; and modernize Japan's arbitration law to improve the legal framework for domestic and international commercial arbitration.

In its October 2002 Regulatory Reform Initiative submission, the United States urged the Government of Japan to expeditiously implement the Program for Promoting Justice System Reform. In particular, the United States recommended that Japan, in order to meet its goals of increasing the speed and efficiency of civil litigation and reducing by 50 percent the length of trials, submit legislation in the next ordinary session of the Diet that would provide for measures to promote efficient scheduling of hearings and to facilitate litigants' collection of

evidence at early stages of litigation. The United States also called on Japan to meet its stated goal of taking necessary measures to ensure effective judicial oversight of administrative agencies by November 2004. (*For more details, see the Professionals Services section with regard to legal services.*)

Distribution and Customs Clearance

Japan's rigid and inefficient distribution and customs systems restrict market access for imported products and undermine their competitiveness. The ability to move goods quickly and inexpensively from producers to consumers is of vital importance to Japan, which seeks to benefit from the information technology revolution. The demand for the rapid delivery of goods and information has produced a number of new industries, such as express carrier services, that are vital for further development of the global economy. It is important therefore, to minimize the regulations, procedures, and costs that could inhibit the free exchange of goods and information.

While more remains to be done, the Government of Japan has implemented several measures and provided a number of assurances in the context of the U.S.-Japan Regulatory Reform Initiative that will enhance the ability of U.S. express carriers to provide an efficient, speedy exchange of goods and information to benefit the Japanese economy.

In the First Report to the Leaders, the Japanese agreed to consult with U.S. express carriers before deciding on measures to be adopted: to replace the current temporary fee structure employed by the Nippon Automated Customs Clearance System (NACCS) Center; to undertake to use the Public Comment Procedure whenever the Air-NACCS fee structure is revised in the future; that the NACCS Center will in the future provide information to the public about its operations in a timely fashion when requested to do so; to implement the Pre-Arrival Examination System for import cargoes (the system that allows the instant issuance of import permits for air cargo upon arrival) and the manifest declaration system for express consignments of a certain value, and pledged to continue to simplify Japan's customs procedures.

Landing fees at Japan's international airports, notably at Narita and Kansai, are the world's highest. These high fees increase the costs for cargo carriers, mail delivery, air travel, and tourists and are increasingly at odds with the regional trend to lower landing fees. To promote financially healthy airline and air-freight industries, our October 2002 reform recommendations called on Japan to formulate the level of landing fees in an open and transparent manner, using internationally accepted accounting standards, and to base those fees on the actual cost of providing services. The Ministry of Land, Infrastructure and Transport (MLIT) has thus far strongly opposed any lowering of these fees.

Our submission also urged Japan to undertake further measures to simplify and automate customs processing and to provide customs clearance availability 24 hours per day and 365 days per year without incurring overtime charges as stipulated under Sections 98(1) and 100(1) of the Customs Law. In 2003, the Government of Japan indicated that it will partially accommodate this request by providing 24 hour customs clearance at several major ports and reducing overtime customs charges by 50 percent. The Government of Japan is also considering our request to allow pre-clearance declaration approval of air cargo prior to landing, such as when the plane enters Japan's Exclusive Economic Zone.

Finally, the U.S. Government continues to monitor progress on customs processing procedures and the fair and uniform implementation of the Large Store Location Law.

IMPORT POLICIES

Rice Import System

Although Japan has generally met import volume commitments made during the Uruguay Round and subsequent negotiations, Japan's highly regulated and non-transparent distribution system for imported rice assures that high quality U.S. rice does not have meaningful access to Japanese consumers. U.S. rice exports to Japan in calendar year 2002 were valued at just under $91 million, representing 312,553 metric tons of rice or approximately 47 percent of Japan’s minimum access requirement.

In 1999, Japan established a tariff-rate quota

(TRQ) that was to assure access to the Japanese market for 682,000 metric tons (milled basis) of imported rice annually. The Japan Food Agency (JFA) manages imports within the TRQ through periodic minimum access (MA) tenders for imported rice and by imports through the simultaneous-buy-sell (SBS) system. In both programs, the activities of the JFA lack transparency, and less than one-half of one percent of rice imported from the United States reaches Japanese consumers as an identifiable product of the United States. Imports of U.S. rice under the periodic MA tenders, for example, are destined almost exclusively for government stocks or re-exported as food aid. A small share of U.S. rice imported under these tenders is released from JFA stocks and permitted to enter the industrial food-processing sector. Since Japan moved to a tariff system in 1999, no rice has been imported outside of the import quota because it would be subject to a duty of 341 yen per kilogram, which is equivalent to a 400-1,000 percent *ad valorem* tariff, depending on the variety of rice.

Through the MA tenders, the JFA imports roughly 582,000 tons of rice. The U.S. rice industry has been disappointed by the JFA's record of buying medium quality rice for industrial use, food aid, and blending, rather than top quality rice for table use. The percentage of broken rice purchased by the JFA has also been an area of concern and the United States continues to urge Japan to reduce the share of broken rice. The U.S. industry also faces barriers in moving rice imported under the JFA's MA tenders into the market place. The industry believes that medium grain U.S. rice – the type of rice imported directly by the JFA – can be competitive in the non-table use market. However, lack of information on obtaining U.S. rice held in JFA stocks has made the development of this commercial market difficult.

Under the SBS system, also administered by the JFA, Japan imports the remaining 100,000 tons of its total MA commitment. The U.S. rice industry is particularly concerned over the operation of the SBS system, which was designed to allow exporters access to final consumers in Japan in order to engage in consumer market development. The SBS system, which provides a substantial mark-up to the JFA (equal to the difference between the import price of rice and the wholesale price in Japan), has not allowed U.S. exporters to develop markets in Japan for high-quality short grain U.S. rice used for the table market.

In December 2002, the Ministry of Agriculture, Forestry, and Fisheries (MAFF) announced a comprehensive rice reform plan designed to cut government spending, curb surplus production and make Japanese rice farmers more efficient. The reforms are scheduled to be fully implemented by 2008. However, many areas of the plan remain vague, and there is concern that parts of it may be undone before it is fully implemented. In the long term, the reforms would reduce the need for extremely high levels of protection for Japanese rice farmers. Despite these reforms, Japan's position on rice market access in ongoing WTO agricultural negotiations is to decrease Japan's Minimum Access commitment for rice, allegedly because of Japan's changing demographics and declining rice consumption. This proposal is counter to one of the principal aims of the Doha Development Agenda, which is to open agricultural markets and expand trade.

Expanding market access for U.S. rice hinges on: increasing Japan's market access commitment, reducing tariffs, getting high quality U.S. table rice to the end consumer, maintaining significant U.S. market share, decreasing the percentage of broken rice, changing the import system to make pricing and bidding more transparent, and revising the SBS system so the market can function freely and SBS licenses are awarded on the basis of quality and price. The United States will work towards these goals bilaterally in the current WTO round.

Wheat Import System

Japan requires that wheat be imported through MAFF's Food Agency, which then releases wheat to Japanese flour millers at prices that are substantially above import prices. High wheat prices discourage wheat consumption by increasing the cost of wheat-based foods in Japan. The United States is addressing problems related to trade-distorting state trading in the WTO agriculture negotiations.

Corn for Industrial Use

To support demand for domestically produced

potatoes and sugar, the Government of Japan requires Japanese corn starch manufacturers to blend potato starch with corn starch in manufacturing corn sweeteners. The tonnage of cornstarch production must be matched by purchases of domestic potato and sweet potato starch in the ratio of one part of potato starch for 12 parts of cornstarch. If corn sweetener producers use potato starch at a lower ratio than 1:12, they cannot import corn at the zero tariff rate accorded to the pooled quota. Instead, they must pay a tariff on corn of 12,000 yen per ton or 50 percent of the value of a shipment, whichever is higher.

The blending requirement discourages consumption of imported corn by raising the cost of corn sweeteners, and directly displaces over 200,000 metric tons of U.S. corn sales annually. The United States will address this issue in the WTO agriculture negotiations.

Pork Import Regime

U.S. pork exports to Japan, valued at approximately $800 million annually, comprise more than 65 percent of the value of all U.S. pork exports. However, Japan's pork import system is inflexible and fails to meet the needs of either Japan or the United States. The system includes a gate-price and a safeguard negotiated during the Uruguay Round, which automatically raises tariffs if imports are 19 percent or more above the average level of imports during the previous three years.

The gate-price system distorts pork trade by encouraging Japanese importers to buy mixed shipments with different cuts of pork. Importers buy mixed shipments in order to minimize tariffs by keeping the average CIF price of their shipments at or below the gate-price.

Japan's pork safeguard, which was triggered in 2002, is also of concern because it results in erratic purchasing patterns. The safeguard system encourages high imports when the safeguard is not in place, and the high imports then tend to trigger the safeguard. Once the safeguard is triggered, importers tend to buy more expensive cuts of pork in order to raise the cost of their import shipments to the new, higher gate-price.

The United States seeks substantial reductions in pork tariffs, reform of the gate-price system and safeguard, and greater transparency in Japan's import regime. Japanese consumers would ultimately benefit from reasonably-priced, plentiful, high-quality supplies of imported pork. The United States is addressing this issue in the WTO agriculture negotiations.

Beef Safeguard

Japan's beef safeguard was negotiated during the Uruguay Round to afford protection to domestic producers in the event of an import surge. The safeguard is triggered when imports increase by more than 17 percent from the previous Japanese Fiscal Year on a cumulative quarterly basis. Once triggered, the safeguard remains in place for the rest of the fiscal year. If triggered, beef tariffs increase from 38.5 percent to 50 percent.

As beef imports recover from depressed levels caused by the 2001 *Bovine Spongiform Encephalopathy* (BSE) crisis, they are expected to meet the technical requirements that would trigger Japan's beef safeguard. The Government of Japan has indicated it plans to impose the safeguard. The United States, however, believes the imposition of this safeguard in response to a recovery in beef imports rather than to a true import surge would be inappropriate. A recovery in demand to normal levels does not represent the type of import surge for which the safeguard was designed. The Government of Japan has acknowledged that this safeguard measure was not designed with the present beef market conditions in mind. The United States considers this safeguard to be a right and not a rule, and as such, believes Japan can choose not to exercise it.

In the latter half of 2002, the United States voiced its concerns at the highest levels of the Government of Japan in pursuit of a temporary suspension of this safeguard measure. In early 2003, the Japanese Diet is expected to consider annual tariff legislation governing this measure. The draft version of this legislation reportedly does not contain language suspending the safeguard measure, but opposition Diet members and Japanese consumer groups continue to lobby in favor of a suspension. The United States, working with like-minded parties, will continue to press the Government of Japan on this matter.

Fish Products

JAPAN

Japan is the most important export market for U.S. fish and seafood, accounting for approximately 37 percent of U.S. exports of such products in 2002. Japan maintains several species-specific import quotas on fish products. U.S. fish products subject to import quotas include pollock, surimi, pollock roe, herring, Pacific cod, mackerel, whiting, squid, and sardines. During the Uruguay Round, Japan agreed to cut tariffs by about one-third on a number of fishery items, but avoided commitments to modify or eliminate import quotas.

The United States and Japan hold annual fish consultations to discuss marine science, ecology and other bilateral and international fishery-related issues. U.S. exporters have been concerned about the quota application process and other administrative procedures. However, over the past few years, Japan has made substantial improvements in its import quota system for fish products, due in large part to recommendations from the United States and European Union. These changes include greater transparency in disclosing the recipients of quota allocations, changes in the timing of quota allocations, and the breakout of several types of fish (including mackerel, sardines, Pacific cod and others) from the "Fish and Shellfish" category into individual categories with quotas listed by weight rather than value.

High Tariffs on Beef, Citrus, Dairy, and Processed Food Products

Japan maintains a high-tariff regime on a number of food products that are important trading items for the United States, including red meat, citrus, and a variety of processed foods. Examples of double-digit import tariffs include 38 percent on beef, 32 percent on oranges, 40 percent on processed cheese, and 30 percent on natural cheese. These higher tariffs generally apply to food products where Japan is protecting domestic producers.

High tariffs discourage the use of imported products, and in some cases keep Japanese prices so high that they reduce total consumption of certain products. Tariff reductions are therefore a high priority in the WTO agriculture negotiations.

Wood Products and Housing

Japan is the second largest overseas export market for U.S. wood products, with U.S. exports totaling more than $800 million in 2002. Japan continues to restrict the import and use of U.S. wood products through tariff escalation (i.e., progressively higher tariffs on processed wood products). The elimination of tariffs on wood products has been a longstanding U.S. objective, and the United States will continue to urge Japan to eliminate wood product tariffs in the current WTO negotiations.

With just under 1.2 million housing starts in 2001, Japan's home building materials market is second in size to only that of the United States. Estimates of the size of the home building materials markets range upward of $62 billion, not including materials going into the repair and remodeling market. According to the Department of Commerce, imports of building materials from the United States for use in the residential construction market decreased in 2001, because of continued weakness in the Japanese housing market. The housing market in Japan is expected to remain weak for the foreseeable future given that the number of dwellings exceeds the number of households.

Restrictions on building size and designs, and products continue to constrain the use of some foreign building products and systems that are commonly used in the United States and elsewhere, thereby limiting choice for consumers and artificially inflating housing costs. The United States continues to have serious reservations about the transparency and basis of certain testing methodologies for evaluating fire resistance; discussions are ongoing.

In 2001, the United States and Japan agreed that future discussions on wood/building products related issues would be under the auspices of the Wood Products Subcommittee and its two technical committees, the Building Experts Committee and JAS Technical Committee. (These committees were set up under the terms of the 1990 U.S.-Japan Wood Products Agreement.) The Wood Products Subcommittee met in Tokyo in April 2002, and the Building Experts Committee and the JAS Technical Committees met in Seattle in September 2002. The discussions were deemed productive.

Marine Craft

Japan's non-transparent system of small craft safety regulation for boats, marine engines, and marine equipment is a serious impediment to market access in this sector. The regulations, which are administered by the Ministry of Land, Infrastructure and Transport (MLIT) and the Japan Craft Inspection Organization (JCI), are vague and subject to arbitrary and inconsistent interpretation. Testing requirements are expensive and documentation requirements are non-transparent and burdensome, forcing companies to disclose sensitive proprietary information about product design, material specifications, and manufacturing techniques. Inspection fees are excessive and not in line with the actual cost of conducting the inspections.

Following initial working-level discussions which took place in 1999 and 2000, the United States in 2001 held a series of discussions with Japan in an effort to address these issues. The U.S. Government also provided Japanese authorities with a series of papers detailing our specific concerns with Japan's engine inspection and certification procedures, and addressing the overarching issues of Japanese boating safety and Japan's justification of its inspection and certification regime. While virtually none of the U.S. concerns have been resolved, the United States and Japan have agreed to continue formal discussions of these issues on a regular basis through a working group process.

The Marine Craft Working Group was established at the U.S.-Japan Trade Forum in July 2002 to improve transparency and efficiency of safety standards and inspection systems and to resolve these issues in a mutually satisfactory manner within one year. The participants in the working group are MLIT, JCI, the Japan Marine Importers Committee, U.S. industry (represented by the National Marine Manufacturers Association) and the U.S. Embassy Commercial Section and/or Department of Commerce. In November 2002 and January 2003, the Working Group met to begin discussions on a long list of issues affecting imported boats, including: plastic fuel tanks, engine durability test requirements, inconsistent JCI inspection requirements in different parts of Japan, lack of transparency in regulations, and a new operator licensing system taking effect in June 2003. A formal review of the progress and achievements of the working group will take place in the summer of 2003.

Leather/Footwear

The process by which the Government of Japan establishes quotas lacks transparency. U.S. industry reports that there is no consultation with leather shoe importers to determine anticipated import levels. Indeed, Japanese authorities make no effort to limit quota allocations to firms that plan to use them. The U.S. Government will continue to seek elimination of these quotas.

In 1991, Japan liberalized treatment of footwear imports, setting a footwear quota of 2.4 million pairs per year. By JFY 1998 it had raised this quota to roughly 12 million pairs per year. In the Uruguay Round, Japan agreed to reduce tariffs over an eight-year period on under-quota imports of leather footwear, crust leather and other categories.

Above-quota imports of footwear still face market access barriers, despite the fact that Japan has met its Uruguay round agreements to lower the *ad valorem* ceiling rate by 50 percent and the alternative "per pair" or specific-rate ceiling by 10 percent. According to the latest Government of Japan Customs Tariff Schedule, the above-quota rates have declined to the higher duty of either 30 percent *ad valorem* or 4,300 yen per pair. However, because Japan is entitled to apply the higher of the two rates, which is typically the 4,300 yen per pair specific-rate, the effect of the larger *ad valorem* rate reduction is negated.

Distilled Spirits

As a result of 1996-1997 WTO dispute settlement rulings and subsequent negotiations between the Japanese and U.S. Governments, Japan agreed to bring its liquor taxation system into WTO conformity in December 1997. Japan proceeded to revise its liquor excise system in stages until taxation rates on all distilled spirits were brought into WTO conformity by May 1998, with the exception of low-grade *shochu*, which was harmonized in October 2000. At the same time, the liquor tax for imported whiskey and brandy was reduced by 58 percent.

In April 2002 Japan eliminated tariffs on all brown spirits (including whisky and brandy), and on vodka, rum, liqueurs, and gin. This completed the tariff and tax measures needed to comply with the 1996-97 WTO dispute

settlement agreement. The United States will continue to monitor Japan's implementation of the settlement to ensure that no measures are adopted that would undermine the settlement's benefits.

STANDARDS, TESTING, LABELING AND CERTIFICATION

Japan has many import standards that limit trade in farm and forest products. Japan has always been conservative on questions involving food safety, sanitary and phytosanitary standards. However, recently there appears to have been an increase in Japan's use of standards and other administrative requirements to limit agricultural imports and a greater tendency to deviate from scientific principles in setting new import policies.

Ban on U.S. Poultry

In 2002, Japan imposed a number of national and statewide bans on U.S. poultry due to the detection of low pathenogenic strains of avian influenza in limited areas in the United States. As a result, U.S. poultry exports to Japan in 2002 suffered a 45 percent drop to $100 million compared to $182 million in 2001.

According to standards set by the international animal health organization, the Office of International Epizootics (OIE), quarantine procedures are only necessary for highly pathenogenic strains of avian influenza, and not for low pathenogenic strains.

The United States repeatedly raised concerns with the Government of Japan on its improper institution of these bans, and as of early 2003, the bans had been removed. In addition, the OIE has established a panel of scientists to review Japanese regulations for low pathogenic strains of avian influenza.

Ban on Imports of Rendered Livestock Products Due to BSE

Japan placed global bans on imports of various livestock products after *bovine spongiform encephalopathy* (BSE) was found in Japan in the fall of 2001. The bans were applied to U.S. products, such as meat and bone meal and tallow, even though the United States is free of BSE. Japanese imports of U.S. animal products affected by the import bans totaled about $14 million in 2001.

Since the United States meets the criteria set by the OIE for a country that is free of BSE, there is no scientific reason to ban imports of livestock products from the United States. Moreover, the ban includes products processed from cattle parts, such as tallow, and products from non-bovine species, such as pork blood and poultry products, which could not possibly transmit BSE.

Although there is no scientific reason for these bans, Japan has indicated that they will remain in place until it has completed a country risk assessment for the United States. Despite the fact that the United States provided information to Japan in response to their risk assessment questionnaire in a timely manner, Japan's assessment has yet to be completed.

Fresh Apples Quarantine Requirements for Fireblight

Japan imposes burdensome quarantine restrictions on apples, limiting the ability of U.S. growers to access the Japanese market. Of particular concern are Japan's requirements that aim to prevent transmission of fireblight. Scientific evidence does not support Japan's assertion that mature, symptomless apples can transmit the fireblight bacteria. Japan's quarantine restrictions for fireblight include the prohibition of imports of U.S. apples from any orchard containing fireblight, three inspections of fireblight-free orchards at different times in the growing season, maintenance of a 500-meter fireblight-free buffer zone surrounding export orchards, and post-harvest treatment of apples with chlorine. These requirements are not scientifically based, significantly raise costs, and reduce the competitiveness of U.S. apples in Japan.

Joint research conducted by U.S. and Japanese Government scientists confirmed the results of earlier studies that mature, symptomless apples are not carriers of fireblight and provided additional scientific support for the United States' position that Japan's restrictions are unwarranted. In light of Japan's continued refusal to modify its restrictions on the basis of the scientific evidence, on March 1, 2002, the United States requested consultations under WTO dispute settlement procedures. After consultations failed to produce a bilateral

solution, the United States requested a WTO panel to adjudicate this dispute in May 2002. A report from the panel is expected in the second quarter of 2003.

Ban on Fresh Potatoes

Japan bans imports of fresh potatoes from the United States, alleging that such a ban is necessary to prevent the introduction of golden nematode and potato wart into Japan. The United States has urged Japan to immediately lift the ban on fresh potatoes for processing from major production areas not infested by the golden nematode, such as the Pacific Northwest, California, and other U.S. potato exporting areas. Potato wart is not found in the United States. Separately, MAFF has raised new concerns regarding a number of viruses that would necessitate post-entry quarantine of imported potatoes even if the ban were lifted. The United States will continue to urge Japan to recognize disease-free areas in the United States for golden nematode. The United States is also urging Japan to permit imports of peeled potatoes for use in the food service industry.

Ban on Fresh Bell Peppers and Fresh Eggplant

Japan continues to ban imports of fresh bell peppers and fresh eggplant based on concerns over tobacco blue mold (TBM). In initial bilateral discussions held in August 1999, the United States emphasized that the fruit of peppers and eggplants are outside any pathway of transmission of TBM. In bilateral technical meetings held in September 2000, Japan agreed to consider lifting its ban if it can be demonstrated that the fruit is not a host to the disease. The United States is currently developing test data to demonstrate that bell peppers and eggplants are not a host for TBM. Through discussions in both bilateral and international fora, the United States will continue to urge Japan to permit imports of U.S. bell peppers and eggplant.

Excessive Use of Fumigation

Japan requires unnecessary fumigation for a number of imported fresh horticultural products. The fumigation requirement is particularly detrimental to trade in fresh fruits and vegetables, including lettuce, citrus, and cut flowers. Fumigation adds unnecessary costs and results in produce deterioration, making the product unmarketable. The U.S. lettuce industry estimates that exports would increase by at least $100 million if this issue could be resolved.

Japan routinely requires that imported produce be fumigated for insect species that are already present in Japan. This practice is inconsistent with international practice, and with the International Plant Protection Convention (IPPC). Japan claims that these pests are under official control by MAFF in order to limit their spread within Japan. However, in practice, MAFF does not appear to have any official control programs requiring the fumigation of locally grown produce.

After repeated requests by foreign governments for reform, MAFF has begun to implement a non-quarantine pest list by partially amending the Plant Quarantine Law to exempt 53 pests and 10 plant diseases from fumigation requirements. While this appears to be an important positive step, the exemption list does not include ten common insect species found on U.S. fresh fruits and vegetables, which are also known to occur in Japan. The United States will continue to urge Japan to adopt international standards, develop a comprehensive list of non-quarantine pests, and reduce excessive, unnecessary, trade distorting and costly fumigation requirements.

Biotechnology

Japan has adopted a largely scientific approach in its approval process for biotechnology foods. To date, MAFF and the Ministry of Health, Labor, and Welfare (MHLW), which regulate biotechnology products, have approved the importation of 43 biotechnology plant varieties for food, including corn, potatoes, cotton, and soy beans. For the most part, U.S. and Japanese regulatory approaches to assessing the safety of biotechnology products have been closely aligned. However, the United States has continuing concerns regarding Japan's failure to approve biotechnology potato products.

The United States is also concerned by Japan's efforts to expand mandatory labeling of foods made from the products of biotechnology because, by suggesting a health risk when there is none, such labeling may discourage consumers from purchasing these foods. In 2002, MAFF included potato products, frozen

potatoes, dried potato, potato starch and potato snacks in the mandatory biotechnology labeling scheme. The United States believes consumers should have information on foods that have been produced through biotechnology, but alternatives to mandatory labeling, such as educational materials, public discussions, and voluntary labeling regimes, can provide more meaningful information to consumers. The United States is also concerned by MAFF's plans to expand mandatory labeling on feed and seed, which are now being discussed internally in the Ministry.

The United States is urging Japan to continue to participate in discussions on biotechnology advancement and regulation in international fora, such as the WTO, the Codex Alimentarius Commission, the OECD and APEC. Given the continuous development of new biotechnology-produced food products, the United States and Japan share a common interest in working together to promote effective food safety policies.

Restrictive Food Additive List

Japan's overly restrictive list of food additives still limits imports of U.S. food products, especially processed foods. Japanese regulations, which limit the use of specific food additives on a product-by-product basis, are out of step with international practice. For example, Japan refuses to allow the importation of light mayonnaise, creamy mustard, or figs containing potassium sorbate, a food additive evaluated and accepted by numerous national and international standard-setting organizations, including the Joint FAO/WHO Experts Committee on Food Additives. However, Japan allows its use in 36 other foods, most of which are traditional Japanese food products not normally produced outside of Japan.

In 2002, MHLW announced plans to make more use of international safety data to expedite applications for Japanese approval of certain food additives that are widely used internationally.

Feed Additive Ban

In August 2002, MAFF publicly announced its intent to ban 29 animal feed additives. After gathering additional information, MAFF decided in October to ban only those additives that could create a resistance problem for humans. Antibiotic animal feed additives have been in use for over 30 years. Many countries, including the United States, are in the process of reviewing regulations regarding the use of these antibiotics. In December 2002, the United States received conflicting reports that Japan had decided to move forward with a ban in advance of a report on the matter from a MAFF scientific committee, and seemingly in the absence of a science-based risk assessment. The United States expressed its concerns to the Government of Japan and sought assurances that Japan's review of these additives would be performed in a transparent, thorough, and science-based manner. The Government of Japan provided such assurances, and the United States will continue to follow the issue closely to ensure that Japan decides this matter in a manner consistent with its WTO obligations.

Dietary Supplements

Dietary supplements (vitamins, minerals, herbs, and non-active ingredients) have traditionally been classified as drugs in Japan. As a result, severe restrictions have been imposed on the shape, dosage, and retail format for such supplements. These regulations create excessive costs and difficulties for most foreign supplement firms participating in the Japanese market.

Japan is proceeding to allow producers of dietary supplements to make nutritional and health benefit claims in the marketing of their products, if there are scientific data and information to support such claims. However, concerns have been raised regarding the type of data that may be required to make such claims. The data requirements of the regulatory system should be reasonable and appropriate, and limited to criteria necessary to ensure safety and efficacy. Furthermore, regulatory decisions should be based on clear scientific grounds, taking into full consideration all available data and information. Japan has agreed to continue to discuss the scope of using non-Japanese data and information required to evaluate and approve products. This and other dietary supplement issues are being taken up under the Regulatory Reform Initiative.

Other Issues

Textiles: The U.S. textiles industry has raised

concerns regarding new, stricter formaldehyde labeling and emissions standards proposed by the Japan Industry Standard (JIS). The new standards, to be adopted in July 2003, may make it very difficult for wall covering manufacturers in the United States to export to Japan. The U.S. Government is currently monitoring this issue.

GOVERNMENT PROCUREMENT

Computers

While U.S. producers of computer goods and services are global leaders in technology and performance and continue to be among the largest and most successful foreign firms in Japan's private sector, access to the Japanese public sector computer market remains problematic. The last bilateral review under the 1992 bilateral Computer Agreement was held in March 2001, at which time Japan presented data showing a very slight increase in the foreign share of the public sector market. According to Government of Japan data, the foreign share of the public sector computer market remains roughly equivalent to what it was when the Computer Agreement was concluded. Further, it has never even approached the approximately 30 percent market share foreign companies have maintained in Japan's private sector for many years.

Given the continued gap between the U.S. share of the Japanese private and public sector computer markets, as well as the rapid technological advancements in this sector, the United States has proposed that Japan more fully utilize the Internet for public procurements, broaden its use of "overall greatest value method" (OGVM) in bid evaluations, and provide advance information to potential bidders on a larger number of upcoming procurements. As a positive step forward, on March 29, 2002 a Government of Japan interagency task force comprised of all ministries issued a memorandum of agreement, outlining new rules which are designed to prevent extremely low-priced bids by domestic Japanese firms and to procure high-quality information systems at a reasonable price. The Governments of Japan and the United States agreed in June 2002, under the Regulatory Reform Initiative, to continue to exchange information about IT procurement reforms.

Construction, Architecture and Engineering

Two public works agreements are in effect: the 1991 U.S.-Japan Major Projects Arrangements (MPA) and the 1994 U.S.-Japan Public Works Agreement, which includes the "Action Plan on Reform of the Bidding and Contracting Procedures for Public Works" (Action Plan). The MPA included a list of 42 projects in which international participation is encouraged. Under the 1994 Agreement, Japan must use open and competitive procedures for procurements valued at or above the thresholds established in the WTO Agreement on Government Procurement (GPA). Construction-related issues are raised in the Trade Forum established under the Partnership. During the inaugural meeting of the Trade Forum in July 2002, the United States urged Japan to eliminate the obstacles that prevent U.S. companies' full and fair participation in Japan's public works sector.

The U.S. share of Japan's public works market, valued at $210 billion, has consistently remained well below one percent – a troubling fact given the competitiveness of American design/consulting and construction firms throughout the rest of the world. Practices in Japan's public works sector that prevent the full involvement of U.S. firms include failure to address rampant bid-rigging, use of discriminatory qualification and evaluation criteria, unreasonable restrictions on the formation of joint ventures, and the structuring of individual procurements so they fall below thresholds established in international agreements.

The public works market continues to be plagued by bid-rigging practices (*dango*), under which companies consult with one another and prearrange a bid winner. The United States welcomes the recent legal and administrative steps taken to address *dango* and urges the Government of Japan to increase its efforts to eliminate these practices and sanction government officials who aid them. Some Japanese architectural design firms and general contractors have submitted bids that are so low that they raise the question as to whether the work can be performed without incurring a financial loss. This is hampering U.S. firms' abilities to offer quality services while remaining competitive. The United States urges the Japan to formulate effective policies to prevent such practices.

Regarding Japan's continued use of vague and

discriminatory qualification and evaluation criteria, the United States urges Japan to specify the criteria used in particular procurements so as to maximize, rather than restrict, the number of firms that would be able to participate in the procurement. For many years, the United States has asked Japan to introduce into its public works market Construction Management (CM) and Program Management (PM), which are advanced technologies used to maximize the efficiency of a project by saving time and money. Although the United States is pleased that Japan began using CM for public projects in 2001, it is concerned that discriminatory qualifying criteria may have been used to impede the involvement of U.S. firms in these procurements. The United States urges Japan to issue more CM procurements and to structure them such that the increased efficiencies offered by CM technologies are fully utilized and that foreign firms with appropriate expertise are deemed eligible to compete. The United States also urges Japan to implement PM projects. In addition, the United States is concerned about how and when ISO 9000 series registration is being used as qualification criteria and urges Japanese commissioning entities not to use ISO 9000 series registration to discriminate against U.S. firms.

During the 2002 Trade Forum, the United States welcomed Japan's decision to address a long-standing U.S. concern regarding joint ventures for design projects by allowing design firms to conduct "design architect" work as joint venture members. Business opportunities for U.S. architectural design firms are expected to increase, provided this method is properly used by commissioning entities. However, unreasonable restrictions on the formation of joint ventures continue to impede foreign firms' participation in construction projects. The United States has urged Japan to abolish the three company joint venture rule, which limits to three the number of members in joint ventures for most construction projects, and to allow companies, not procuring entities, to determine the number of companies that should execute a project, based on the scope of the work and various firms' abilities.

Regarding new developments in Japan's public works market, the United States urged Japan during the 2002 Trade Forum to use the Public Comment Procedure when considering implementing new bid/contract policies and procedures for design and construction work. The United States is endeavoring to promote U.S. firms' effective participation in Urban Renewal (*Toshi Saisei*) projects and Private Finance Initiative (PFI) projects being undertaken by Japan. Also during the Trade Forum, the United States asked for the full disclosure of information regarding these projects to ensure opportunities for participation by U.S. firms. In addition, the United States urged the use of the fair, transparent, and non-discriminatory procedures of the Action Plan for these projects. In October, Japanese private sector organizations hosted the fourth U.S.-Japan Construction Cooperation Forum (CCF), which focused on facilitating the formation of joint ventures between U.S. and Japanese design/consulting and construction companies for Urban Renewal projects.

The United States is paying special attention to several major projects covered by the public works agreements of particular interest to U.S. companies. These projects include the New Kitakyushu Airport, Haneda Airport including its expansion stages, Central Japan International Airport, Kansai International Airport, Kobe Airport, Kyushu University Relocation Project, Okinawa Graduate University Project, Japan Railways procurements, laboratory projects commissioned by the Ministry of Education, Culture, Sports, Science and Technology, and the remainder of projects stipulated in the MPA.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

The United States has continued to pursue its intellectual property rights protection agenda with Japan through bilateral consultations and effective coordination in multilateral and regional fora.

Japan is a party to the Berne and Universal Copyright Conventions, the Paris Convention on Industrial Property, the Patent Cooperation Treaty, and the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Japan has ratified the World Intellectual Property Organization (WIPO) Copyright Treaty, and the WIPO Performances and Phonograms Treaty. Japan was removed from the Special 301 Watch List on May 1, 2000 but was mentioned in the 2001 and 2002 Special 301 Reports. The 2002 Report expressed concerns over the adequacy and effectiveness of

Japan's Internet Service Provider liability law and implementing measures to provide the necessary protection of right holders and the appropriate balance of interests between service providers and right holders.

Japan continues to make progress in improving the protection of intellectual property rights and, relative to other countries, piracy is not a major problem, though several key issues, including the need to improve Japan's legal and administrative intellectual property framework to protect copyrights in the digital age, remain. The United States has identified a number of areas where further action by Japan is needed, including: (1) addressing persistent patent-related problems; (2) improving and expanding protection of copyrighted works, particularly on the Internet; (3) providing effective protection for well-known trademarks; (4) providing protection for geographical indications; (5) affording greater protection of trade secret information; and (6) continuing to improve border enforcement mechanisms.

Patents

The United States has focused particular attention on improving the processing and approval of patent applications, and reforming Japan's practice of affording only narrow patent claim interpretation. The United States remains concerned with several aspects of Japan's patent administration, including the relatively slow process of patent litigation in Japanese courts, the lack of an effective means to compel compliance with discovery procedures, and the lack of adequate protection for confidential information produced relative to discovery.

In recent years, Japan has taken a number of steps to address these issues. A revised patent law took effect on January 1, 2000. This law is designed to make it easier for plaintiffs to prove patent infringement in courts. Key provisions include requiring defendants to justify their actions, obligating defendants to cooperate with calculation experts, giving judges discretion over the amount of damages, increasing the penalty in cases where patents were obtained fraudulently, and allowing courts to seek technical advice from the Japan Patent Office (JPO). The United States will continue to monitor closely whether these revisions reduce the cost of access to Japanese courts that has been particularly onerous to foreign patent owners in the past. In addition, under the new law the period between when a patent is applied for and when an applicant must pursue has been reduced from seven to three years. Another law, which took effect on January 6, 2001, increased the number of patent lawyers and expanded their scope of permitted services. The United States welcomes these steps to improve the level of patent protection in Japan and will continue working with Japan to strengthen its patent laws in several fora.

Copyrights

The increasing use of the Internet and explosive growth of high-speed access in Japan has presented new challenges for protecting intellectual property rights, especially for copyrighted materials. The protection of this material is critical for electronic commerce to flourish and for the continued development of content-related industries such as games, music, film and software. The United States is therefore concerned that Japan's Internet Service Provider (ISP) liability law does not provide adequate protection for the works of right holders on the Internet or the appropriate and necessary balance of interests among telecommunications carriers, service providers, right holders and website owners. The United States urges Japan to use all the opportunities available to improve these shortcomings in the law. *(For more details, see the Information Technologies section under Sectoral Regulatory Reform.)*

The United States is also concerned about Japan's reluctance to clearly stipulate that temporary copies (e.g., copies in the RAM of a computer) implicate the right holder's reproduction right. Article 9 of the Berne Convention, which is incorporated into the TRIPS agreement, provides that authors must have the right of authorizing the reproduction of their works in any manner or form. The WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty, to which Japan is a party, contain in footnotes an agreed statement affirming that the reproduction right fully applies to works in digital form. Japan has acknowledged that some temporary copies are subject to copyright protection by recognizing that "temporary storage" implicates the reproduction right. Although this is a major change in its position, the Government of Japan has not widely disseminated this information or

clearly defined the scope of protection for temporary copies. The United States' concerns about treatment of temporary copies in Japan were exacerbated by a Japanese court ruling in 2000 that a company airing music programs digitally in a program format designed to facilitate copying of those works does not constitute a copyright violation. According to the court, broadcasters have the right to duplicate copyrighted materials and subscribers can decide for themselves whether or not to copy the music. The court said that by offering such an opportunity to listeners, the broadcasting company was not encouraging them to make copies. Continued interpretations along similar lines could erode the ability to protect copyrighted materials. The United States is particularly concerned by the implications of such a position for copyrighted works.

In 2001, Japan raised the cap on punitive damages for copyright infringement from 3 million to 100 million yen, and in recent years it has made progress in combating computer software piracy. However, according to the most recent figures available, the revenue loss from software piracy actually increased in 2001. The United States continues to urge Japan to reduce the piracy rate, especially in light of the growing threat of online piracy. A notable step toward creating an effective deterrent against piracy would be amending Japan's Civil Procedures Act to award statutory damages rather than actual damages, and to provide for more effective procedures for collecting evidence. In addition, in order to set an example for the private sector, the United States urges Japan to issue a statement clarifying Japan's agreement to use only legitimately produced and licensed software in its government operations.

A revision of some aspects of the Copyright Law took effect in January 2000 in preparation for Japan's accession to the WIPO Copyright Treaty. Key provisions of the revised law included criminal penalties for producing and distributing devices designed to circumvent copyrights and for illegally revising copyright management information to make a profit. The United States is concerned about the provision on anti-circumvention in the Copyright Law, which states that the penalties for copyright circumvention devices will be applied only to devices whose "principal function" is circumvention. The law also expands the coverage of screening rights from motion pictures to still pictures and sets transfer rights so that the first sale doctrine covers films, books, and CDs.

In addition, the United States is concerned over the recent consideration by some in Japan's private sector and government to impose certain formalities as a precedent for copyright protection, especially for content on the Internet. The United States would like to underscore that any such shift would be a step away from the internationally accepted norms of copyright regimes and could cause significant problems for right holders, both foreign and domestic.

In a positive vein, Japan's Agency for Cultural Affairs is preparing legislation to extend the term of copyright protection for cinematographic works, animation, and video games to 70 years to bring the term of protection closer to the international norms among developed countries. The United States continues to urge the Government of Japan to extend all copyright terms to life plus 70 years, or where the term of protection of a work (including a photographic work), performance or phonogram is to be calculated on a basis other than the life of a natural person, not less than 95 years or, if it is not published within 25 years from the creation, not less than 120 years.

Trademarks

Trademarks must be registered in Japan to ensure enforcement. Thus, any delays in the registration process make it difficult for foreign parties to enforce their marks. Legislation passed in preparation for Japan's ratification of the Madrid Protocol in March 2000 contains several useful provisions. Effective January 1, 2000, Japan began establishing a system to notify the public of trademark applications received. Effective March 14, 2000, trademark holders are entitled to compensation for damages for the period from application until registration of the trademark.

A 1997 revision to Japan's Trademark Law aimed to accelerate the granting of trademark rights, strengthen protection of well-known marks, address problems related to unused trademarks, and simplify trademark registration procedures in order to bring Japan into compliance with the Trademark Law Treaty. These measures also increase penalties for trademark infringement. Regrettably, in spite of

the existence of provisions in Japan's Unfair Competition Law designed to afford greater protection to well-known marks, protection of such marks remains weak. Of particular concern is Japan's register of well-known marks, where employees of the Japan Patent Office make *ex officio* determinations whether a mark is well-known or not. One defect of the "list" approach to well-known mark protection is that one can essentially pay one's way onto the list by requesting defensive registrations in many classes.

Geographical Indications

Articles 22 to 24 of the TRIPS Agreement set forth the obligations of WTO Members with respect to geographical indications and their relationships to trademarks. It is unclear whether Japan currently provides interested parties with the legal means to prevent misuse of a geographical indication or whether Japan provides trademark owners with the legal means for resolving conflicts between trademarks and asserted geographical indications, as required by the TRIPS Agreement. The United States looks forward to receiving further information regarding the legal means by which Japan fulfills its TRIPS obligations under Articles 22 to 24. Outstanding questions in this area remain of particular concern since it is unclear whether Japan maintains an undisclosed list of protected geographical indications against which applications for trademark registration are reviewed.

Trade Secrets

Although Japan amended its Civil Procedures Act to improve the protection of trade secrets in Japanese courts by excluding court records containing trade secrets from public access, the law is inadequate. Since Japan's Constitution prohibits closed trials, the owner of a trade secret seeking redress for misappropriation of that secret in a Japanese court is forced to disclose elements of the trade secret in seeking protection. Because of this, and the fact that court discussions of trade secrets remain open to the public with no attendant confidentiality obligation on either the parties or their attorneys, protection of trade secrets in Japan's courts will continue to be considerably weaker than in the courts of the United States and other developed countries. The Government of Japan has announced plans to submit legislation that will subject illegal acquisition and usage of corporate secrets to criminal charges. The United States supports this measure and continues to urge Japan to undertake further reform in this area.

Border Enforcement

The United States remains concerned about the 1997 Japan Supreme Court decision to allow parallel imports of patented products and continues to monitor the Japan Customs and Tariff Bureau's (JCTB) implementation of this policy. Further, insofar as Japan provides *ex officio* border enforcement of trademarks and copyrights through the JCTB, efforts should be made to enhance such enforcement through aggressive interdiction of infringing articles. In an effort to bolster Japan's border control measures, the United States has urged Japan to improve its application, inspection and detention procedures to make it easier for foreign right holders to obtain effective protection against infringed intellectual property rights at the border. The United States urges Japan to continue to improve and tighten its border enforcement to ensure effective implementation of TRIPS obligations.

SERVICES BARRIERS

Insurance

Japan's private insurance market is the second largest in the world, after that of the United States, with direct net premiums of an estimated $295 billion in 2001. In addition to the offerings of Japanese and foreign private insurers, there is a large public sector provider of postal life insurance products (*Kampo*), the National Public Health Insurance System, and a web of mutual aid societies (*Kyosai*) that also provide significant amounts of insurance to Japanese consumers.

The Japanese insurance sector, aside from *Kampo* and the *Kyosai,* is regulated by the Financial Services Agency (FSA), which was established in June 1998. The FSA is responsible for all aspects of financial regulation in Japan, including inspection, supervision, and surveillance of financial activities related to banking and securities business in addition to insurance.

Two bilateral Insurance Agreements, implemented in 1994 and 1996, are in effect and

have contributed significantly to the deregulation of the Japanese insurance market. Largely as a result of positive changes brought about by these agreements, foreign insurance companies have visibly and substantially increased their presence in both the life and non-life insurance sectors in Japan. While maintaining their strong third sector sales, U.S. and other foreign insurance companies have rapidly expanded their share in the primary sectors in recent years through product development and marketing innovations. Foreign insurers in Japan currently hold an estimated 5.4 percent share of the total non-life insurance market and 5 percent of the total life insurance market. In the third sector, foreign firms have captured approximately 69 percent of the health-related insurance market and about 19 percent of the non-life market. In addition, new business partnerships and recent acquisitions in this sector involving foreign firms have significantly increased foreign presence in Japan.

Despite some noteworthy successes for U.S. industry in this sector, a number of issues have emerged that are of high priority to U.S. insurers. Of greatest concern is the unlevel playing field between private industry and Kampo/Kyosai and uncertainty regarding future funding of the life and non-life insurance safety net systems, or Policyholder Protection Corporations.

Kampo and *Kyosai* enjoy significant tax, legislative and regulatory benefits that afford them unfair advantages over private sector insurers. For example, while *Kampo* and the *Kyosai* compete with the private sector, both are exempt from Japan's Insurance Business Law and from contributing to Japan's insurance safety net systems. In addition, *Kampo* and *Kyosai* both possess advantageous tax status, which in *Kampo's* case, exempts it from paying any corporate and income taxes. Despite expectations that the Koizumi Administration would move aggressively to reduce the public sector's substantial participation in the insurance market, this has not occurred, and *Kampo* remains by far the largest player in the insurance market. In March 2002, there were 87 million *Kampo* issued life insurance policies in force compared to just 115 million for all private life insurance companies. According to the Japan Cooperative Insurance Association, in 2000, *Kyosai* sold approximately 20 percent of all life insurance policies in Japan.

In April 2003, the postal agencies, including *Kampo* will be transferred to a public postal corporation. There are indications that *Kampo* will come under some form of FSA oversight and may be subject to an as yet undefined level of taxation. Regardless, *Kampo* will continue to enjoy significant advantages that will enable it to maintain its considerable influence in the insurance market.

Throughout 2002, the United States voiced its *Kampo* related concerns to the Government of Japan, stressing the need for, inter alia, increased transparency in the creation of the public postal corporation, the continued prohibition on *Kampo's* ability to underwrite any new insurance products; and the postal financial institutions to be subjected to the same standards as their private sector counterparts. As any modification to the postal financial system could have significant impact on competition in the Japanese insurance market, the U.S. Government also strongly urged that any decisions related to the future of the postal financial institutions, including possible privatization, be made and implemented in an open and transparent manner.

In 2002, the Government of Japan announced, as it did in 1999, that it would levy additional contributions on private sector life insurers for the Life Insurance Policyholder Protection Corporation (LIPPC). The life and non-life PPCs are mandatory policyholder protection systems created by Japan in 1998 to provide capital and management support to insolvent insurers. The LIPPC, in particular, has been nearly depleted as a result of industry failures. Private sector insurers have contributed considerable sums to the PPC systems and U.S. industry, particularly life insurers, expressed serious concern at the prospect of additional contributions. The United States raised, both in the August insurance consultations and the November Regulatory Reform discussions, the need for transparency in determining future PPC funding. The United States called on the Government of Japan to decide the matter in a transparent manner and stressed the need for a sustainable funding framework which did not unfairly burden the private sector and lead to greater imbalance in the competitive playing field with *Kampo*.

In late 2002, the Government of Japan announced that it intended to extend its funding guarantee to the LIPPC and that it would tap private sector life insurers, on an as needed basis, for an additional 100 billion Yen. The Government of Japan also announced that it would undertake a thorough review of the PPC system and consider reforms long recommended by private insurers. U.S. insurers, while displeased with the additional levy, welcomed the review. The U.S. Government will continue to follow this issue closely and has stressed the need for transparency and the involvement of all interested parties.

Lastly, throughout 2002, U.S. industry expressed concerns about reports that the Government of Japan might permit troubled life insurers to reduce the assumed interest rate on certain unprofitable policies. U.S. life insurers believe this would be a draconian step that would undermine the integrity of contracts in the Japanese financial marketplace and, if improperly applied, could discriminate against foreign life insurers operating in Japan. As of late 2002 it was uncertain whether the Government of Japan would proceed with this plan. The United States will follow this issue closely and will urge the Japanese authorities to consider the manner in an open and transparent manner.

Professional Services

The ability of foreign firms and individuals to provide professional services in Japan is hampered by a complex network of legal, regulatory and commercial practice barriers. U.S. professional services providers are highly competitive and their services are important, not only as U.S. exports, but as vehicles to facilitate access for U.S. exporters of other services and goods to the Japanese market. Moreover, U.S. services professionals often can contribute valuable expertise gained from broad experience in international markets and stimulate innovations for the economies they serve. Availability of such services can be a key factor in U.S. firms making decisions to invest in Japan, and thus is central to improving the environment for FDI in Japan.

Accounting and Auditing Services: U.S. providers of accounting and auditing services face a series of regulatory and market access barriers in Japan that impede their ability to serve this important market. Regulated accounting services may be provided only by individuals qualified as Certified Public Accountants (CPAs) under Japanese law or by an Audit Corporation (composed of five or more partners who are Japanese CPAs). To qualify as a CPA, a foreign accountant must pass a special examination for foreigners in order to obtain a professional certification. This examination was last offered in 1975. CPAs must also be registered as members of the Japanese Institute of Certified Public Accountants and pay membership fees.

Only individuals who are Japanese CPAs can establish, own or serve as directors of Audit Corporations. An Audit Corporation may employ foreign CPAs as staff, but foreign CPAs are not allowed to conduct audit activities. Furthermore, an Audit Corporation may engage in a partnership/association relationship with foreign CPAs only if the partnership/association does not provide audit services. Audit Corporations are prohibited from providing tax-related services, although the same individual may perform both functions as long as totally separate offices are maintained. Establishment is required for Audit Corporations, but not for firms supplying accountancy services other than audits. Branches and subsidiaries of foreign firms are not authorized to provide regulated accounting services. Nor can a foreign firm practice under its internationally recognized name; its official firm name must be in Japanese and is subject to approval by the Japanese Institute of Certified Public Accountants. The United States will continue to urge Japan to remove these restrictions.

Legal Services: U.S. lawyers have sought greater access to Japan's legal services market and full freedom of association with Japanese lawyers (*bengoshi*) since the 1970s. However, strong opposition from the Japan Federation of Bar Associations (*Nichibenren*) and a reluctant Japanese bureaucracy have largely thwarted this objective. Since 1987, Japan has allowed foreign lawyers to establish offices and advise on matters concerning the law of their home jurisdictions in Japan as foreign legal consultants (*gaikokuho-jimu-bengoshi* or *gaiben*), subject to restrictions in the Special Measures Law Concerning the Handling of Legal Business by Foreign Lawyers.

While Japan has liberalized several restrictions on foreign lawyers, the most critical structural deficiency in Japan's international legal services sector remains the severe limitations on the relationships permitted among Japanese lawyers and registered foreign legal consultants. In its October 2002 submission under the Regulatory Reform Initiative, the United States made the elimination of all prohibitions against freedom of association between Japanese and foreign lawyers a top priority and has urged the Government of Japan to allow Japanese and foreign lawyers, as equal legal professionals, to determine their own forms of association that will enable them to best serve their clients' needs. The United States also emphasized that the "specified joint enterprises" (*tokutei kyodo jigyo*) system, which Japan established in 1995 instead of allowing *bengoshi* and foreign lawyers to form partnerships, does not provide the framework needed for effective teamwork between *bengoshi* and *gaiben*; nor will further adjustments of that system meet the needs of lawyers in Japan.

The United States also recommended that Japan allow foreign lawyers to hire Japanese lawyers, to provide advice on so-called "third country" law (that is, the law of a country other than the one that is a foreign lawyer's home jurisdiction) on the same basis as Japanese lawyers, and to establish professional corporations, limited liability partnerships (LLPs) and limited liability corporations. The United States also recommended improvements in Japan's foreign lawyers regulatory system, and specifically asked the Government of Japan to ensure that the Nichibenren and the mandatory local bar associations provide *gaiben* with effective opportunities to participate in the development and enforcement of all laws and rules that affect them.

Partially in response to these recommendations, the Judicial Reform Promotion Headquarters will submit to the Diet in early 2003 a bill providing for some relaxation of current restrictions on foreign lawyers. Exact details have yet to be determined.

INVESTMENT BARRIERS

The Investment Initiative was established under the Partnership to focus on needed changes in the basic operating rules of Japanese markets and to encourage policy changes that will help improve Japan's overall environment for foreign (and domestic) investment. The Investment Initiative met twice in 2002 and participated in investment seminars in both Japan and the United States. Similar meetings and seminars are scheduled again for 2003. Through these avenues, the two Governments continue to explore ways to enhance the investment climate in Japan. The private sector participates actively in this process and has offered detailed suggestions on how to increase transparency, as well as recommending the introduction of new financial instruments for international transactions.

Despite being the world's second largest economy, Japan continues to have the lowest inward FDI as a proportion of total output of any major OECD nation. As of the end of 2001, Japan's total cumulative stock of FDI totaled only 1.3 percent of GDP, compared with 12.5 percent for the United States and 29 percent for the United Kingdom. FDI in Japan has been rising rapidly, albeit from a small base, up 300 percent in JFY 2000 from the previous year's level. In JFY 2000, high growth sectors were banking and insurance, and telecommunications. However, FDI inflows sharply declined in JFY 2001, down 30.3 percent from the previous year. U.S. direct investment flows for this period plunged 36.4 percent, but still accounted for 31.8 percent of all FDI in Japan. During the first half of JFY 2002 (April to September, 2002), the downward trend continued, primarily reflecting continued economic slump in Japan. FDI coming into Japan in the period dropped 58.7 percent from the levels of the same period a year ago, and U.S. direct investment was also down 49.1 percent. Although many direct legal restrictions on FDI have been eliminated, some bureaucratic obstacles remain. Japan's low level of inward FDI flows also reflects the impact of exclusionary business practices and high market entry costs.

Japan has enacted new and revised legislation providing opportunities for foreign investors. For example, the Industrial Revitalization Law provides existing firms undergoing reorganization (both domestic and joint-venture) with tax and credit relief once the Government of Japan approves the firm's business restructuring plan. A new bankruptcy law (the Civil Reconstruction Law) also may provide investment opportunities as it encourages business reorganization, including spin-offs,

rather than forced liquidation of assets. Other legislative changes now provide for stock options for employees, a key issue for foreign firms wishing to attract high quality employees. In addition, Japan prepared legislation on corporate divestiture that will facilitate companies' streamlining efforts. New accounting rules are bringing Japan closer to international standards and to a degree have helped reduce extensive cross-shareholding among firms, as the new accounting rules identify non-performing assets and liabilities. Finally, work is now underway to introduce legislation in early 2003 to make the use of cross-border stock swaps for international mergers and acquisitions (M&A) deals possible, although details on the key tax provisions of the proposed bill are still unclear. While U.S. businesses have applauded these changes, they continue to urge that Japan's tax regulations be clarified and amended to facilitate use of these measures.

Investment access through M&As is more difficult in Japan than in other countries, partially because of conservative attitudes towards outside investors. U.S. investors cite the lack of financial transparency and disclosure and differing management techniques among the obstacles to M&A activity in Japan. The scarcity of qualified lawyers, auditors, and accountants needed for M&A activities also inhibits FDI.

Some progress has been made on M&As through the introduction of consolidated taxation and the introduction of more flexible bankruptcy procedures to make it easier for a corporation and its assets to be acquired or merged in a "rescue" format. U.S. proposals still include: (1) making assets available for investments and reducing due diligence costs; (2) removing the surcharge on consolidated taxation in order to spur investment by lowering the post-tax cost to a parent firm of investing in new risk ventures; (3) improving corporate governance practices in order to mitigate senior management emphasis on firm loyalty over shareholder return, which can lead to premature rejection of M&A offers; (4) continuing with financial market regulatory reform, such as allowing tax-free cross-border stock-for-stock transactions; (5) improving financial data disclosure to assist firms interested in pursuing M&A relationships with other firms; and (6) increasing the availability of M&A-related services, including further easing of restrictions governing the accounting and legal professions.

Finally, this year the United States has begun exploring with the Government of Japan ways to facilitate investments in two sectors, education and health-care services, where extensive regulatory regimes have restricted foreign participation.

ANTICOMPETITIVE PRACTICES

Anticompetitive practices are a cross-cutting issue in U.S.-Japan trade relations. In addition to this section, there is detailed discussion related to anticompetitive practices and Antimonopoly Act (AMA) enforcement in several other sections, particularly under Structural Regulatory Reform.

Exclusionary Business Practices: While there has been some improvement in recent years, U.S. firms trying to enter or participate in the Japanese market may face exclusionary business practices that can block market access opportunities. These include:

- Anticompetitive private practices that violate the AMA but go unpunished;
- Corporate alliances and exclusive buyer-supplier networks, often involving companies belonging to the same business grouping (*keiretsu*);
- Corporate practices that inhibit FDI and foreign acquisitions of Japanese firms (e.g., non-transparent accounting and financial disclosure, high levels of cross-shareholding among *keiretsu* member firms, a low percentage of publicly traded common stock relative to total capital in many companies, and the general absence of external directors);
- Trade associations and other business organizations, often under the auspices of government ministries, that develop and enforce industry-specific rules limiting or regulating, among other things, fees, commissions, rebates, advertising, and labeling for the purpose of maintaining "orderly competition" among their members, and often among non-members.

Exclusionary business practices exact a heavy toll on the Japanese economy. By constraining market mechanisms, exclusionary business practices reduce the choices available to businesses and consumers, and raise the cost of goods and services. In addition, by discouraging competitors who seek to break into Japan's market with innovative products and services, these practices impede the development of new domestic industries and technologies. Such practices discourage potential foreign investors, whose market presence and technological innovation would stimulate the economy and provide critical channels for exports and sales by foreign firms.

Law Against Unjustified Premiums and Misleading Representations: The JFTC imposes overly restrictive limits on the use of premium offers (prizes) and other sales promotion techniques, and thereby discourages even legitimate cash lotteries and product giveaways used in such promotions. Foreign newcomers, who depend on innovative sales techniques to market their company names and products, are significantly impaired by the JFTC's restrictions on premiums. In addition, the JFTC allows "fair trade associations" (essentially, private trade associations) to set their own promotion standards through self-imposed "fair competition codes." Trade associations can, and often do, use the cover of these codes to adopt additional standards that are stricter than required by JFTC regulations under the Premiums Law and have the effect of restraining vigorous competition. As of January 1, 2003, there were still 39 JFTC-authorized premium codes.

ELECTRONIC COMMERCE

Although Japan's electronic commerce market is one of the largest in the world, its tremendous potential for growth remains unfulfilled because of regulatory and other barriers that remain. The Government of Japan has recognized in its "2002 e-Japan Priority Policy Program" that legal and other barriers persist which hinder Electronic Commerce and has identified key policies to reinvigorate Japan's goal of becoming the world's most advanced IT nation by 2005. These priority policies include facilitation of electronic commerce, digitization of government administration and other public services, and ensuring security and reliability of advanced information networks.

The United States made several recommendations and proposals in its Regulatory Reform submission for increasing consumer confidence and promoting electronic commerce in the private sector. Specific areas addressed include online privacy, consumer protection, network security, and facilitating online transactions and electronic government. The United States is urging Japan to support private sector self-regulatory mechanisms for privacy and alternative dispute resolution, as well as to ensure that laws governing electronic transactions are technology-neutral. The United States is working with Japan on these and other electronic commerce issues through the IT Working Group in the Regulatory Reform Initiative. *(For more details, see the Information Technologies section under Sectoral Regulatory Reform.)*

A threshold requirement for promoting electronic commerce is to provide affordable access to the Internet. Broadband services are now widely available at competitive rates however, a large number of consumers and businesses still access the Internet through dial up networks for which rates remain high. These rates are a result of the market access barriers to Japan's telecommunications sector (*see Telecommunications in the Sectoral Regulatory Reform section*) which the United States is currently addressing with Japan through the Telecom Working Group under the Regulatory Reform Initiative.

The United States welcomes and supports the Government of Japan's measures to digitize administrative procedures at all levels of government. Recognizing the key role that electronic government has in providing the impetus for spurring electronic commerce in the private sector, the United States recommends that Japan further expand and accelerate its electronic government programs to facilitate online transactions between the government and consumers and businesses for procurement, information and online services such as applications and licensing.

Japan implemented legislation in 2001 to define the legal basis for electronic signatures, which in some cases can substitute for written signatures or seals, as well as establish a voluntary system

for accrediting electronic signature certification services. The United States continues to closely monitor implementation of the law to ensure that it is technology-neutral and allows for the use of any and all appropriate technologies. The United States is also monitoring a new law allowing local governments to issue electronic signature technologies to Japanese citizens to conduct transactions with the government online. In addition, the United States continues to monitor the development of electronic commerce and the Internet in Japan to ensure that Japanese standards and technologies for electronic commerce and the Internet remain open and internationally interoperable. The United States will also monitor actions by regulators such as MPHPT and METI (e.g., regarding licensing requirements and restrictions on new standards and technologies) to ensure that such actions promote a liberal environment for the growth and development of electronic commerce in Japan.

As the second largest economy in the world, Japan is an important market for electronic commerce and a key player in international discussions regarding the regulatory framework for global electronic commerce and the Internet. Japan has, in its policy statements and its regulatory actions, endorsed an open, private sector-led and minimally regulated environment for the Internet and electronic commerce. The United States urges Japan to continue our cooperative efforts in promoting the growth of global electronic commerce by supporting and relying on the principles reflected in our "e-initiatives" for liberalizing trade of digital products and promoting the expansion of Electronic Government services agreed upon in the 2002 Report to the Leaders on the Regulatory Reform Initiative.

OTHER BARRIERS

Aerospace

Japan is the largest foreign market for U.S. aircraft and aerospace products. The United States accounted for approximately 80 percent of Japan's aerospace imports in 2002. Many Japanese firms have entered into long-term relationships with American aerospace firms.

The commercial aerospace market in Japan is generally open to foreign firms, but the United States is monitoring Japan's funding of feasibility studies for new projects and technologies, and its important role in apportioning work among major Japanese aerospace companies. A recent proposal by METI to develop a 30 to 50-seat commercial aircraft, replacing the earlier YSX project, bears monitoring.

Military procurement by the Japan Defense Agency (JDA) accounts for over half of the domestic production for aircraft and aircraft parts, and continues to offer the largest source of demand in the aircraft industry.

Japanese defense projects are carried out according to the current Mid-Term Defense Program (JFY 2001-JFY2005) with a projected budget of 25.16 trillion yen, or approximately $206 billion, over this five year period. Major projects include: modernization of the F-15 fighter aircraft, procurement of F-2 fighter support aircraft, air refueling tankers, Apache Attack helicopters, AEGIS destroyers, and development of fixed wing patrol (P-X) and air transport (C-X) aircraft.

Although U.S. firms have frequently won contracts to supply defense equipment to Japan (over 90 percent of the annual foreign defense procurement is from the United States), the JDA has a general preference for domestic production or the licensing of U.S. technology for production in Japan to support the domestic defense industry.

Although Japan has considered its main space launch vehicle programs as indigenous for many years, in fact U.S. firms continue to participate actively in those space systems, including Japan's primary space launch vehicle, the H2-A. The U.S. Government has welcomed Japan's plans to develop a supplementary GPS navigation satellite constellation known as the "quasi-zenith" system, with the first launch scheduled for 2008. The United States is working very closely at the technical level with Japanese counterparts to ensure the Japanese system remains compatible with ours, and anticipates that US companies will have the opportunity to supply major components of this system. The United States will continue to promote expanded access by American firms to commercial opportunities within Japan's domestic space programs as appropriate.

Autos and Auto Parts

Further opening of the Japanese auto and auto parts markets remains an important objective of the United States. Access to Japan's automotive market continues to be impeded by a variety of overly restrictive regulations, a lack of transparency in rule-making, and lackluster enforcement of antitrust laws. In recent years, Japan's lingering economic slump, limited market access, and weak competitive environment have disproportionately hurt foreign vehicle and auto parts manufacturers. Further, while there has been a trend toward closer integration and important technological advancements in the global automotive industry over the past several years, the effect these changes will have on market access and competition in this sector remain unclear.

The U.S. Government remains disappointed with falling sales of North American-made vehicles and parts in Japan. Sales in Japan of motor vehicles produced in the United States continued to decline in 2002, with combined sales decreasing by 14 percent (year-on-year) following a decline of approximately17 percent the previous year. Today, American auto makers sell less than a quarter as many U.S.-made vehicles in Japan as they did in 1995.

Structural changes in the automotive industry have led U.S. companies to alter their distribution and marketing strategies in Japan. American automakers have been active in making equity investments in Japanese auto manufacturers. Nonetheless, foreign access to Japan's automotive distribution network has continued to be of concern to U.S. auto companies. The U.S. automotive trade imbalance with Japan – $46 billion in 2002 ($35 billion deficit in autos and $11 billion deficit in auto parts) – is the equivalent of more than 66 percent of the overall U.S. trade deficit with Japan and made up ten percent of the 2002 worldwide U.S. trade deficit.

In order to address barriers in and improve U.S. companies' access to the domestic Japanese automotive market and Japanese auto plants in the United States, the United States and Japan established a new Automotive Consultative Group (ACG) on October 24, 2001. The ACG serves as the focal point for addressing lingering as well as emerging issues in this key sector of both countries' economies. The ACG is co-chaired by USTR and the Department of Commerce on the U.S. side, and METI and MLIT on the Japanese side and met in January 2003 in San Francisco, California. At its initial meeting, the group discussed trends in the industry based on a series of trade and economic data on autos and automotive parts provided by both countries and identified areas in which specific action can be taken by Japan to address U.S. concerns. This would include further deregulation (particularly with respect to the automotive parts aftermarket), increased transparency in rules and regulations governing this sector, and more rigorous application of Japanese competition laws.

In addition to meetings under the ACG, the United States is continuing to address cross-cutting issues impacting the automotive sector under the Partnership. This includes expanding opportunities for foreign investment, increasing transparency in governmental rule-making, and promoting corporate restructuring in the Japanese economy.

Civil Aviation

Market access for U.S. air carriers in Japan improved significantly with the 1998 bilateral civil aviation agreement, but carriers remain constrained by extremely high airport costs in Japan and by enduring restrictions on traffic rights, operational flexibility, and pricing.

Limited slot availability at Narita airport, partly the result of artificial limits on movements, also prevents U.S. carriers from utilizing rights under existing agreements. Since 1998, U.S. non-incumbent combination carriers have been unable to operate several routes made available under the 1998 Memorandum of Understanding (MOU). A second runway opened in April 2002 provides additional slots, but at less than 2500 meters, the runway cannot accommodate most long-haul operations. The issue of excessively high landing fees at Narita and Kansai airports continues to be raised through the U.S.-Japan Regulatory Reform talks and is summarized in the Distribution section of this report.

In the 1998 MOU, the two sides agreed to hold further negotiations by 2001 "with the objective of fully liberalizing the civil aviation relationship between Japan and the United States." However, since mid-2001, officials at Japan's Ministry of Land, Infrastructure, and Transport have declined to engage in any

substantive discussion of further aviation liberalization.

The United States will continue to pursue further liberalization consistent with its global policy to promote competition and market access in civil aviation.

Electric Utilities

The United States still believes that by introducing genuine competition into non-fuel procurement (valued at approximately $12 billion annually), Japan can effectively reduce the costs of its electric power, which remain the highest in the industrialized world.

Many utilities have continued to show interest in increasing imports and reducing costs, although the results have been insignificant due to the economic slowdown and consequent reduction in their investments. A major utility participated in the Power-Gen International 2002 as a buyer-exhibitor and received many interesting offers. Some other utilities sent buying delegations to the same electrical equipment show in the U.S. Japan's utilities actively participate in the New Orleans Association (NOA), a U.S. Embassy-sponsored forum that enhances communication between Japanese electric power firms and U.S. suppliers of non-fuel materials and equipment. The United States continues to urge Japanese utilities to further increase procurement of foreign products, which often prove more economical.

Foreign firms still face barriers due to standards and specifications used by Japanese utilities that often discriminate against or disproportionately burden foreign suppliers. Problems remain in the use of narrow, dimension-based technical standards rather than performance-based technical standards, and requirements that suppliers provide detailed information for spare parts originating from outside sources. Because each utility uses its own specifications (in some cases, different departments of a utility use their own specifications), suppliers have to prepare more than ten production lines in order to sell to Japan's ten electric power companies. Although several utilities are moving to unify their specifications and comply with world standards, this remains a long-term project.

The United States continues to seek greater transparency and fairness in the procurement process. There were cases in which utilities referenced insufficient after-sales service as the reason to decline offers from overseas suppliers at the final moment of negotiations, after having already obtained full technical information on the products from these suppliers. Then, the utilities passed manufacturing orders to their subsidiaries or keiretsu firms. Access to procurement information is also a problem, and foreign firms often do not learn about procurements until after they have been awarded. It is also important for the utilities to publish specifications in English and accept offer sheets, drawings, explanatory documents, and contract sheets in English, and to treat foreign and domestic firms equally and fairly.

U.S. exports currently account for approximately 3.5 percent of Japanese electric utility procurements, or around $420 million per year. Should barriers be lifted, that share could plausibly rise to five percent, or around $600 million per year.

Flat Glass

Despite efforts under the 1995 four-year bilateral Flat Glass Agreement to spur Japanese glass distributors to diversify supply sources and not to discriminate based on capital affiliation, Japan's three domestic flat glass producers to date have maintained largely constant market shares through informal coordination and tight control over distribution channels, thereby restricting market access for U.S. manufacturers. In other major industrial markets, including the United States and the EU, the market share of foreign-owned companies (via imports and in-country production) is more than five times the level in Japan.

After the expiration of the bilateral Flat Glass Agreement in December 1999, the United States engaged Japan in discussions under the Enhanced Initiative on Deregulation and Competition Policy. As a result of these discussions, the Government of Japan recognized the economic benefits of competition in the distribution sector. Japan also confirmed that it would be detrimental to competition and a violation of Japan's Antimonopoly Act for distributors to collude to exclude imported or other competitors' products from entering the market, and METI agreed to continue to pursue economic reforms to ensure competition in the distribution sector.

The United States has expressed its concerns regarding access to the flat glass market, most recently in the July 2002 meeting of the U.S.-Japan Trade Forum. During the Trade Forum discussion, the U.S. Government highlighted the continuing problems that prevent market entry, including the need for a stronger JFTC and tighter enforcement of rules against anticompetitive behavior. The U.S. Government also has highlighted the need to modify regulations that would facilitate use of energy efficient glass in Japan. The United States continues to urge Japan to take concrete steps to promote competition in and access to its glass market.

Motorcycles

Japan's ban on tandem riding of motorcycles (carrying a passenger) on motorways is the only remaining restriction on motorcycling in Japan that the United States seeks to eliminate. The ban artificially limits Japan's market for large motorcycles, adversely affecting U.S. exports. More important, by forcing riders to use less-safe ordinary roads, the ban significantly reduces the safety of motorcycling in Japan.

The Government of Japan continues to consider the U.S. petition against the ban and, to date, has taken no action. The Japan Automobile Manufacturers Association (JAMA) has recommended that Japan lift its ban on tandem riding of motorcycles on highways in Japan, and in February 2001, released a report summarizing a survey it conducted on motorcycle tandem riding on expressways in Europe (specifically, in Germany and Italy). It found that accidents involving tandem motorcycle riders on expressways are extremely rare, and for motorcycles, traveling on expressways is much safer than on public roadways. The report noted that the accident rate involving motorcycle tandem riders is below that of single riders, and no cases could be found in which tandem riding actually caused motorcycle accidents on expressways. These findings are similar to the findings of a U.S. research study of motorcycle tandem riding safety, which was given to the Government of Japan in 1999.

Paper and Paper Products

The United States remains concerned that there has been no meaningful increase in Japanese imports of paper and paperboard products, and the level of import penetration for paper and paperboard products in Japan remains the lowest in the industrialized world. According to U.S. producers, exclusionary business practices remain a key problem. U.S. industry representatives estimate that the removal of systemic barriers to the Japanese paper market would result in at least a 10 percent share for U.S. suppliers, or approximately $5 billion, compared to the current level of $650 million.

Sea Transport/Ports

U.S. carriers serving Japanese ports have long encountered a restrictive, inefficient, and discriminatory system of port transportation services. In 1997, the Federal Maritime Commission assessed a $100,000 fee on each ocean voyage to the United States by Japanese shipping lines, prompting Japan to agree in October 1997 to substantial regulatory reform of its ports sector. The U.S.-Japan understanding also noted side agreements designed to reduce the power of the Japan Harbor Transport Association (JHTA) from deterring competition in the sector. Japan amended its Port Transport Law (effective November 2000) to eliminate the need for new entrants to prove there is surplus demand. Also, fees no longer need to be approved by MLIT.

Since 1999, the United States has expressed its concern that reforms have not lessened JHTA's ability to deter new entry and restructuring in the ports sector. The United States has also noted that the revised Port Transport Law contains cumbersome administrative requirements, gives MLIT wide authority to intervene in pricing decisions of terminal operators, and increases minimum permanent staffing by 50 percent. MLIT has not addressed concerns about the prior consultation process nor about the apparent threat of illegal strikes against foreign carriers who obtain permission to operate their own container terminals.

The United States' concerns led the Federal Maritime Commission, in August 2001, to order major Japanese shipping lines and ocean carriers that provide substantial U.S.-Japan service to furnish detailed information on the effects of recent changes in Japanese port laws and ordinances. The United States will continue to closely monitor how these changes affect port operations and to urge faster regulatory reform in the port sector. However, both the Japanese

and U.S. positions have solidified over the years. At the February 2003 High Level Regulatory Reform meeting, the U.S. Government's reiterated its position that the Government of Japan has failed to implement important aspects of the wide-ranging port deregulation.

Steel

The U.S. steel industry suffered hardship due to the surge of steel imports over the past several years from Japan and other countries.

While U.S. imports of steel from Japan are down due to safeguard measures and several antidumping orders, the underlying causes of the surge in the Japanese domestic steel market should be addressed to ensure that this is not repeated in the future. U.S. steel producers often have expressed concerns that Japanese steel companies may be engaging in anti-competitive practices. With respect to Japan's domestic market, it has been alleged that Japan's integrated producers have coordinated output, pricing, and market allocation goals. In addition, it has been alleged that Japanese mills have entered into arrangements with foreign counterparts to regulate bilateral steel trade.

Japan has participated constructively in bilateral consultations and in OECD High-Level Meetings on Steel during 2002 aimed at reducing excess inefficient steelmaking capacity around the world. However, it is estimated that considerable excess capacity in Japan still needs to be reduced or eliminated. The United States will continue to actively address anti-competitive activity, market access barriers, and/or market-distorting trade practices in the steel sector.