THE ORIENTAL ECONOMIST
REPORT

VOLUME 83, NO.10 PUBLISHED BY JAPAN WATCHERS LLC October 2015

PERSPECTIVE

'One-way-street' definition of free trade

TPP: Ball is in GOP court

In a surprising development, it is Congressional Republicans and a few of their business allies who now pose the biggest threat to the Trans-Pacific Partnership (TPP), a trade agreement among 12 countries with 40% of the world's GDP. When, after five years of talks, an agreement was finally announced on October 5, neither a single Republican leader in Congress, nor any broad business federation could be found to support it. With a few exceptions, the Democrats were always a lost cause for proponents of TPP. However, the Republican majority in both Houses led most observers to think they would try to ratify it.

So, now the ball is in their court and ratification is not just a question of "when," but also "if." "Without the ardent efforts of GOP leaders to move some of their reticent rank-and-file, the TPP cannot be ratified," said a Washington player who has been lobbying Capitol Hill Republicans for years.

Legally, Congress cannot even vote until February at the very earliest and, in an election year, ratification will be very difficult even with the support of GOP leaders. Without it, 2017 may be the earliest chance. Either way, Republicans are indispensable since most Congressional Democrats oppose TPP, Hillary Clinton has just come out against it, and candidates like Donald Trump denounce it. If Clinton were to win in November and/or the GOP lose the Senate, then TPP would be dead. Derek Scissors, a trade expert at the conservative American Enterprise Institute, called waiting for 2017 "a very bad bet."

TPP comes into force when ratified by at least six nations with at least 85% of TPP-wide GDP, which effectively means the US, Japan, and four others.

Hope that negativity is just temporary

Optimists argue that much of the immediate reaction is temporary, the result of a misplaced view by some business sectors, like pharmaceuticals, that the Obama administration "sold us out" in order to get a quick deal that could be ratified during his term, which meant early in 2016. But in reality, as a clued-in Washington-based business source pointed out, "Reaching agreement was a case of now or never. The other countries were adamant that this had to be the last ministerial meeting." Japanese sources told us the same.

Nonetheless, according to several sources, many in the GOP feel that US Trade Representative (USTR) Michael Froman made the deal, not because it was "now or never," but in order to make sure Obama got credit for the achievement. These GOPers feel the US could have gotten a better deal if only Obama had taken more time. That distrust adds a highly-charged emotion to the GOP resistance.

The hope among TPP proponents, including many in the business world, is that the frustration and resentment will blow over, and that the deal's detractors will recognize that half a loaf is better than none at all. Some of the disgruntled business sectors, and their GOP allies, have convinced themselves that they can force a renegotiation, either under Obama, or his successor, if the latter is a Republican. They point to the Korea-US Free Trade Agreement, where the US went back three times for changes after the initial signing. But Korea was just one country. Eleven countries will not tolerate such antics. The Washington business source considered the notion of renegotiation a complete fantasy. What incentive would other countries have to make even more concessions to the US? "This was absolutely the best deal the US could get given the bargaining situation," said our business source.

Froman says that the pact will eliminate 18,000 tariffs and quotas other countries have imposed on US exports and the United States will eliminate 6,000 of its own. Those trade changes, estimated the Peterson Institute for International Economics (PIIE), mean that, 12-15 years from now, American exports would be 4.4% higher than otherwise, imports would be 3.7% higher and GDP a negligible 0.2% higher.

A *Wall Street Journal* editorial concluded: "The question is whether this TPP is the best the U.S. can do." We've got our own problems with TPP (www.foreignaffairs.com/articles/asia/2015-05-12/trade-trials), but now it's either this TPP or no TPP at all. The real question is whether the benefits of this TPP outweigh its flaws, and whether rejection now would lead to better pact later.

All politics is special interests

As many as a couple dozen Republicans who voted for the Trade Promotion Authority (TPA) that empowers Obama and his successor to conduct negotiations now strongly resist voting for what they dismiss as "Obamatrade." The level of distrust is so high that a few among this group contend that Obama is somehow going to use TPP to impose gun control on the US.

With the vote so close—TPA would have failed if just six members of the House had changed sides—it doesn't take much to tip the balance. In an election year, what Republican House member wants a primary opponent accusing him of supporting Obama's policies? The resignation of House Speaker John Boehner—resulting from accusations of insufficient combativeness toward Obama—does not bode well for TPP.

Anti-Obama emotions are only a small part of the problem. The more important background context is the long-term erosion of the post-WWII free trade consensus on both sides of the political aisle. Even more pivotal at this particular moment is the immense veto power over Congress of assorted well-connected and well-heeled special interests, from tobacco to pharmaceuticals to dairy to sugar. If Tip O'Neil famously said, "All politics is local," now he'd have to say, "All politics is special [interests]." In the indispensable balance between the national interest and legitimate special interests, the pendulum has swung too far toward the latter on both sides of the aisle.

While the majority of Congressional Democrats are openly critical of free trade, too many of those in both parties calling themselves "free traders" use the term to mean, not a two-way street in which the US helps promote the prosperity of itself by promoting that of its partners, but a one-way street in which others open their markets to favored US business sectors, while the US does not sufficiently reciprocate. Lack of reciprocity by Washington was a chronic complaint among many of the other 11 TPP countries. (In some cases, even though the charge had some validity, the countries involved used it as a pretext to continue their own protectionism.)

Biologics

Consider Senator Orrin Hatch (R-UT), who as the chair of the Senate Finance Committee would be the point man on TPP passage. He lamented, "While the details are still emerging, unfortunately I am afraid this deal appears to fall woefully short." That harsh language doesn't leave a lot of wiggle room.

Hatch is upset because the US pharmaceutical industry did not get its demand that all TPP countries agree to the US standard of 12 years of "data exclusivity" for biologics, a class of drugs based on living organic tissue rather than chemicals. Instead, in order to conclude the deal, Froman had to compromise with Australia and others who wanted no more than five years, in order to make drug prices affordable. Some countries have zero years. According to the *Wall Street Journal*, the eventual compromise was that, "Countries can offer either eight years or five years with a 'plus up' of three extra years if drug makers make certain price and access commitments. The US will be allowed to maintain 12 years of protection." It's unclear to us how much of a change, if any, that will mean for US biologics producers. In any case, Hatch had warned for months that failure to have everyone go to 12 years could be a deal-killer. Will he really let the entire deal fail over this one issue?

While "big pharma" claims that twelve years of protection are necessary to promote innovation, a 2009 report by the US Fair Trade Commission found that biologics are so expensive and difficult to emulate that producers don't need any years of data exclusivity to avoid a flood of cheap generics. Ordinary patents are enough.

Dairy

Even more disappointing to the pro-TPP crowd was what one Washington trade expert called "the surprising neutrality" of Paul Ryan (R-WI), chair of the Ways and Means Committee and point man in the House. Ryan could not come up with a single positive word. Instead, he lamely commented, "I am reserving judgment. I hope that Ambassador Froman and the White House have produced an agreement that the House can support."

Since Ryan is regarded as an ardent free trader, one expert speculated that he may not have wanted to get too far ahead of his GOP colleagues. But it is worth noting that he hails from the dairy state of Wisconsin, and the dairy lobby has threatened not to support the deal if it opens the US market to too many imports. Reportedly, House Agriculture Chairman Mike Conaway had been pressing negotiators last week to protect dairy and sugar producers.

Unlike the beef and pork lobbies that are supporting TPP because it opens more export markets, the dairy lobby has been more focused on limiting imports. A week before the agreement was reached, The National Milk Producers Federation and US Dairy Export Council sent a letter to Congress, saying that they had "grave concerns" about a possible deal that would give New Zealand more access to the US market but not adequately open Canada's market. "We are deeply concerned that the…USTR intends to reach an agreement that the US dairy industry may not be able to support." After the deal was concluded, both organizations said that they will "carefully review the agreement's dairy provisions in the coming days."

Tobacco

The USTR agreed that tobacco products would be exempted from a dispute-resolution mechanism, called ISDS, that lets multinationals sue countries before arbitration panels dominated by lawyers who represent corporations in other cases. The poster child for abuse of this process was a series of suits by Philip Morris and R.J. Reynolds against countries for insisting on plain packaging in order to make cigarettes less enticing. For some countries, refusal to exempt tobacco was a deal-killer.

Senate Majority Leader Mitch McConnell, who hails from the tobacco state of Kentucky, has suggested several times that exempting tobacco could be a deal-killer for him. After the agreement was reached, he stated, "Serious concerns have been raised on a number of key issues," without specifying what they were. House Agriculture Chairman Mike Conaway also objects to the tobacco carve-out, while Senator Thom Tillis (R-NC), who voted for TPA, says he will actively fight against TPP over this issue. Hatch commented, "I hate tobacco, but I still realize what's important to get the votes, and I'm very concerned about that." Cal Cohen, president of the Emergency Committee for American Trade, a member of the pro-TPP business coalition, declared that the tobacco settlement, "would be counterproductive in that it would open the way for other exemptions for other rules to be put in place."

Imagine a deal being touted as a key to

THE ORIENTAL ECONOMIST
REPORT

Editor Richard Katz
Chief Correspondent Takao Toshikawa
Washington Chris Nelson
Contributing Editor Yoshisuke Iinuma

Design December Design, Inc.

The Oriental Economist Report is published monthly by Japan Watchers LLC
450 Seventh Ave., Suite 2000 New York, NY 10123
Chairman: Takao Toshikawa
Editorial information: Tel: (212) 868-4380
Fax: (212) 868-4392
e-mail: rbkatz@orientaleconomist.com

Annual subscription price is $100 in all countries for e-mail delivery in PDF format

Subscription information:
(US) 212-868-4380
(Japan) (03) 3263-0419
e-mail: sales@orientaleconomist.com
http://www.orientaleconomist.com

21st century growth and national security being lost over plain packaging of cigarettes.

Given the division within the business community—some support this deal and others oppose it—not a single one of the major business federations could come up with a positive statement of support.

One would have expected fulsome praise from the Trade Benefits America Coalition, an alliance of 275 business associations and important firms whose whole raison d'être was to promote TPP. Instead, it issued a blandly neutral statement: "We look forward to reviewing the details of today's agreement and continuing to work with Congress and the Administration on the TPP." The US Chamber of Commerce and the National Association of Manufacturers, both members of the coalition, issued similar remarks. Most knowledgeable observers expect that these federations will end up energetically lobbying for TPP, but they cannot do so without first going through the process of consulting their membership.

One-way street 'free trade'

What is most concerning is the "one-way street" attitude of many of those who call themselves "free traders." Some in business and Congress contend that America is already so open that there is little left to do. That's, at best, a self-consoling illusion, one that causes intense resentment among America's trading partners.

The latter point to a host of issues, some of which the US did not even allow to be discussed in the "gold standard" TPP talks. Some were GOP issues and some were Democratic issues, but all of the following examples are, in our opinion, "special interest" issues: "Buy America" provisions of many state procurement laws (limiting access to a $1.4 trillion market); the Jones Act, which requires that all goods transported by water between US ports be carried on ships constructed in the United States, owned by US citizens, and crewed by US citizens and permanent residents; the protectionist "yarn forward" rule in textiles that particularly hurts poor countries like Vietnam or Mexico; the high import barriers on sugar (where the US will allow more imports from Australia by cutting those from Mexico) and dairy (the latter particularly upsetting to New Zealand since dairy comprises a third of its exports and it is the world's largest dairy exporter); and tariffs on Japanese trucks (25%), cars (2.5%), and parts (mostly 6-10%) that will not be lifted under TPP for 30, 25 and up to 15 years, respectively (and yet Ford Motor still opposes TPP).

American leadership rests on others' perception that it is a "benign hegemon." By undermining that perception, one-way-street notions of free trade post a far greater threat to national security than any Free Trade Agreement that China could create in Asia. (RK)

TPP and Japanese growth

Prime Minister Shinzo Abe has repeatedly pointed to the Trans-Pacific Partnership (TPP) as a key catalyst of "third arrow" reforms aimed at boosting growth. The claim is that TPP will promote reform of backward sectors like farming, while giving Japanese multinationals a boost vis-à-vis competitors regarding both exports and overseas investments. Despite purported economic gains, many in the Liberal Democratic Party (LDP) fear the deal will hurt the party in the July 2016 Upper House elections, and, according to *Nikkei*, "want ratification postponed until after the election."

How much additional growth?

We certainly agree that Japan is better off with TPP than without it, but believe the benefits are being oversold. The Abe Cabinet Office's own 2013 study said that TPP would in a decade or so make the level of GDP just 0.66% higher than it would otherwise be. A 2012 study by the Washington-based Peterson Institute for International Economics (PIIE) predicted that, after 12-15 years, Japan's level of exports would be 14% higher with TPP than without it, and that imports would be 14.3% higher. If that forecast is correct, PIIE estimates that the expanded volume of trade would make GDP a measly 0.2% higher, while boosting the income of people plus firms by a more substantial 1.4%.

Both of these studies make the conservative assumption that expanded trade creates a one-shot improvement in the level of GDP. In reality, a higher ratio of trade to GDP tends to stimulate a higher growth rate on an ongoing basis, but Peter Petri, one of the PIIE authors, said that was hard to estimate.

Professor Yasuyuki Todo of Waseda University tried to make that estimation. He cited a cross-country study showing that an increase in the ratio of trade to GDP by 1 percentage point will increase the growth rate of GDP per capita by 0.027 of a point. If the PIIE is right about how much TPP will expand Japan's trade, then Todo says that, after a decade or so, TPP would increase Japan's per capita GDP growth rate by 0.18 of a point. He comments, "This increase is significant given the nearly 0.8% [annual] growth rate in Japan's real GDP per capita over the past 20 years."

Both Petri and Todo make heroic assumptions for TPP's benefits on the assumption that it will massively raise the level of Foreign Direct Investment (FDI) into Japan. Todo estimates that this, plus outward FDI, will raise annual growth by another 1.3 points beyond the trade effects. So, TPP would take an economy growing 0.8% per year and make it grow 2.3% a year, a rate above Prime Minister Shinzo Abe's 2% target. This seems rather fanciful.

How much reform?

Expanded trade and FDI make better growth possible, but they do not guarantee it. It all depends on how much expanded trade and FDI lead to fiercer competition and therefore better productivity growth in laggard sectors, from farming to assorted manufacturing and service sectors. There is no guarantee that Abe and/or his successors will use TPP to catalyze broad-based structural reform even though many officials at the Ministry of Economy, Trade and Industry (METI) hope and/or expect that they will.

If, for example, Japan increases imports from Japanese affiliates overseas, that boosts productivity by much less than an increase in imports from companies like Samsung, a process that pressures the Japanese firms to improve or die. Farming is the poster child for how TPP will supposedly catalyze reform. However, Kazuhito Yamashita, a former Ministry of Agriculture official who is now a Research director at the Canon Institute for Global Studies in Tokyo, told the *Financial Times* that, "This [TPP] deal may not affect Japanese agriculture much at all." He pointed out that the reduction in tariffs was limited and slow, while the government would continue to buy up rice to support domestic prices. Yamashita had previously argued that Abe's reform of *Zenchu* (Japan Agriculture) would somewhat weaken the power of that lobby, but not really change farming itself.

TOKYO INSIDELINE

by Takao Toshikawa

JCP willing ally with others to defeat LDP in UH poll

Security bills hurt Abe

A qualitative transformation of Japanese security policy has occurred with the passage of Prime Minister Shinzo Abe's security legislation by the Upper House, and hence the Diet as a whole, early on the morning of September 19.

Cries that the bills were "unconstitutional legislation" and "war bills" came from the opposition parties, as well as some media outlets, constitutional scholars and other intellectuals, young people such as Students Emergency Action for Liberal Democracy (SEALDs), young mothers, and Japanese baby boomers who had experienced the 1970 Japan-US Security Treaty protests back in their own student days.

After their voices were exhausted and they had despaired of defeating the legislation, the protests outside the Diet Building turned to chants of "Let's have an election!" and "Vote them out!" This issue will inevitably arise as an important one in next summer's Upper House election.

Regarding the constitutionality of the legislation, a movement to form a 10,000-strong group of plaintiffs, led by constitutional scholars, to bring a lawsuit against this legislation has begun.

To Abe, it was the achievement of a cherished desire, so he seems not to care about the national criticism. Even so, if the Liberal Democratic Party (LDP) is soundly defeated in the Upper House election, it is possible Abe could resign in order to take responsibility, signaling the end of the road for his long Government.

Public opinion polls since passage of the legislation have not all come out yet. In an *Asahi* poll taken on the 19th and 20th, 30% approved of the new security laws, and 50% opposed them. A survey by a TV Asahi news program (September 19-20) found a support rate for the Abe Cabinet of 37.1% (down 2.7 points from the last poll) and a non-support rate of 45.4% (up 6.7 points). The prevailing view among political experts is that the next polls could find the Cabinet support rate down by close to 10 points.

JCP gambit and the UH election

The Japan Communist Party (JCP) is considering a major change of policy that could seriously hurt the LDP in next summer's Upper House election. Thirty-two single-seat, mostly rural districts have proved the swing factor in recent UH elections. As long as the opposition parties remain divided, it is fairly easy for the LDP to win. But now the JCP appears to have decided that, instead of running its own candidates in every district, as it always does, it will seek to have a unified slate of all the opposition parties, so that, in each district, there is only one candidate opposing the LDP.

The JCP has never done this in its entire history as a legal party after World War II. It is doing so now because it says there is a need to protect the Constitution, including Article 9, from Abe and the LDP. In order to protect the Constitution, the JCP feels the need to bring down the LDP and is willing to resort to any means to do so, including supporting a unified slate of candidates from all opposition parties.

I have received inside information that this change was promoted via a secret agreement between former JCP chief Tetsuzo Fuwa, an octogenarian still seen as a "god" by the rank-and-file, and none other than Ichiro Ozawa.

Hints of the change were given by the current JCP President, Kazuo Shii, in an exclusive October 3 interview with *Nikkei*. In that interview, Shii talked of realizing a list of unified candidates among opposition forces to overturn the recently passed collective security legislation. "I was there protesting in front of the Diet when the bills were under debate. There was an immense desire to see that war legislation stopped and the current government knocked out of power. Citizens want to see the opposition band together into a single force to achieve those goals, and we must answer their call. We need to change how we do things, too. During next summer's upper house election, the opposition needs to unite, sweep out the LDP-Komeito coalition, and ride that momentum in a lower house race. We opposition parties will be able to triple or quadruple our numbers if we join forces. There are a number of ways that the alliance could run in the election. I plan to work toward a group capable of sweeping all 32 of the single-seat upper house districts."

Ironically, the JCP in Osaka is going to endorse the LDP candidate for mayor in the upcoming Nov. 22 election. That candidate is Akira Yanagimoto, the secretary-general of the Osaka chapter of the LDP. That chapter is fairly independent of the central party. The JCP apparently considers the LDP a lesser evil than the even more nationalist party of former Osaka Mayor Toru Hashimoto, the Osaka Restoration Party. The local LDP is very strongly opposed to Hashimoto whereas Abe is trying to reach a deal with Hashimoto to help amend the Constitution after the 2016 Upper House elections. As the saying goes, in Osaka, the JCP and LDP "sleep in the same bed, but dream different dreams."

Suppressing Noda's election effort

As expected, Abe's reelection was a relatively minor affair with most of the major players kept in place. The most interesting new feature is that LDP Policy Research Council Chairwoman Tomomi Inada was reappointed to her post as head of the LDP Policy Affairs Council. For reasons we'll investigate, she failed to be named to a high-level Cabinet Post, such as Minister for Economy, Trade and Industry, a typical pathway on the road to higher things. It is well known that Abe has talked about her as his successor; if that occurred, she would become Japan's first female Prime Minister.

On September 8, Abe won his third term as Liberal Democratic Party (LDP) president, without the need for a vote (LDP rules do not allow another term when this one ends in September 2018). Former LDP General Council Chairwoman Seiko Noda had indicated interest in running until just before the election, but abandoned the attempt when pressure from LDP leaders made it impossible for her to gather the required 20 endorsements from other Diet members. Noda complained, "It's inexplicable, but there were people who tried to stop my candidacy."

On September 2, there was a story conveyed to the Kantei (Prime Minister's Official Office) and the LDP leadership that the Noda camp had asked the party presidency election managing committee if the "list of recommenders" could be turned in before the campaign opened. Fear grew that the Noda camp already had the 20 needed recommenders. On the 5th, a story made the rounds of Nagatacho (Japan's political district) that Noda had told former Upper House Vice-Chairman Hidehisa Otsuji, who was being cited as one of Noda's recommenders, "We have 18 people so far." This story blew up into former LDP Secretary General Makoto Koga backing Noda, along with former Chief Cabinet Secretary Hiromu Nonaka, and former Secretary General Taku Yamasaki, with Chief Cabinet Secretary Mikio Aoki joining in to use Noda's candidacy to manipulate the autumn political agenda (so as to get rid of Abe).

Factions and machinations

The Abe Kantei had long hoped for an unopposed reelection. If another candidate had entered, Abe would have had to tour the country on an election campaign up to the voting on September 20. That would have affected debate and passage of the security legislation. A busy foreign policy schedule awaited at the end of September. Those close to the Prime Minister also wanted to avoid a vote because of Abe's less-than-perfect health.

The Noda camp narrowed its aim to the LDP's dovish faction led by Foreign Minister Fumio Kishida, as a place to find prospective recommenders. Flustered Kishida faction leaders fanned out to make sure that the younger Diet members in the faction remained under control. This was successful, and in the end, there were reportedly only six or seven Noda recommenders. Ultimately, it was all just a tempest in a teapot.

Abenomics no longer popular

The Abe government's only road to a long-lasting tenure is a rising economy, specifically, an economy characterized by rising stock prices. Stock prices, however, must be left up to the market. Clumsy government intervention could lead to a repeat of the Shanghai Stock Exchange debacle.

The reputation of Abenomics in Japan and abroad has certainly fallen back to Earth. The Nikkei Stock Average, which was above 20,000 at one point, fell below the supposed psychological line of 18,000 for a few weeks, but has now recovered into the low 18,000s. Amidst a joking conversation, Deputy Chief Cabinet Secretary Seko said the following to me. "I have met and talked with a large number of foreign investors. Rather than just talking about Abenomics, they're now interested in Japanese politics in general." Investors who hedge against risk must gather all kinds of information. Even getting official government opinions first-hand does not generally go beyond what is already known, and so may be of little help for investors.

A friend who is a reporter for the Nikkei Shimbun makes the following bold prediction. If the Nikkei Average is not back above 20,000 by the end of the year, the landscape will change starting at the beginning of 2016. Fears will rise inside the LDP about the Upper House election in July and the theory that Abe will bow out after hosting the May 2016 Group of Seven summit in Ise-Shima, Japan will look more realistic. Abe may be left with no options to escape from that situation, except going all in on a double Upper House and Lower House election next summer.

Abe's press conference

On September 24, Abe held a press conference regarding his reelection as party President. Discussing how he will govern from now on, Abe emphasized his thinking on bringing economic recovery and improved social security to the fore, saying that, "The economy will be my highest priority. We have to put the brakes on the low birthrate and aging population."

Abenomics is to "enter stage 2" soon, with the "new three arrows" of a strong economy, support for child-rearing, and social security. Specific goals are: 1) nominal GDP reaching ¥600 trillion, a 20% increase from today's level; 2) achieving a hoped-for fertility rate of 1.8, up from today's 1.4, but still below the 2.07 needed just to keep the population from falling; and 3) no one being forced to quit working in order to provide family medical care. Additionally, he has firmly committed to raising the consumption tax to 10% in April 2017: "In order to maintain the trust of the international community, we will implement it as planned, barring the occurrence of another event like the Lehman Shock."

Because the eyes of the public have been focused on the unpopular security legislation, the Abe Kantei was enthusiastic about their campaign to turn the public's gaze once more to economic policy. While there are no clear numerical targets, last year's nominal GDP was 491 trillion yen, and the highest ever was 521 trillion in FY 1997. Criticism that these numbers are only good for empty slogans swiftly arose in the media.

In any case, the Abe Kantei is undoubtedly devoted to stock prices breaking free from their current stagnation. Before labor-management negotiations on raising base pay begin next February, Abe aims to: 1) fire a surprise "Kuroda Bazooka III" at the Bank of Japan policy meeting on October 7; 2) pass a large supplemental budget of 4-5 trillion yen during the fall extraordinary Diet meeting; and 3) accelerate the planned cut in the corporate tax in December. Setting aside whether or not these will work as revival measures, for now Abe has no choice but to concentrate on the economy.

Foreign efforts don't lift approval

The anticipated rise in Abe's support rate through foreign policy successes did not occur as hoped. Japan's foreign policy concerns are relations with China, Russia, and North Korea. Difficulties with China continue because of the latter's claims of sovereignty over the Japan-held Senkaku Islands in the South China Sea. With Russia, there is still the signing of a peace treaty for WWII and the return of the "Northern Territories" (four small islands) to pursue. With North Korea, there is achieving the return of the abduction victims.

A "Deep Throat" source inside the Foreign Ministry informed me that Prime Minister Abe personally instructed them to concentrate on a Japan-China-South Korea summit and Japan-Russia relations. My source said, "The Prime Minister is thinking so hard about the Japan and Russia relationship. He is determined to accomplish a peace treaty and the return of the Northern Territories while he is in office. He believes that it will be impossible to achieve this unless he negotiates directly with Putin." Abe strongly desires a state visit to Japan by Putin before the end of the year. He met with Putin on the 28th in New York as the prelude to that.

Japan-North Korea relations are also on the rocks. As I have reported more than once, North Korea's reinvestigation report differs little from what was previously said. The ball is in Japan's court as to whether or not to accept it. Will Abe still be able to use a confident foreign policy to come up with results that will gain the public's support?

TOSHIBA

by Yoshisuke Iinuma

Broader implications for corporate governance

Toshiba scandal

Toshiba, the huge electrical manufacturer that deals in everything from semiconductors to nuclear power plants, has been rocked by scandal: it "cooked the books" to inflate its reported profits. This is shocking for a company that has produced numerous chairmen of the Keidanren business federation and the Japan Chamber of Commerce and Industry. Having discovered the fabrication this February, the company took until September 7 to reveal it had overstated its profits by ¥224.8 billion ($1.9 billion) over the past seven years.

Toshiba had initially planned to announce its results at the end of August, but it was forced to postpone further because internal reports of improper accounting kept coming in, even after the July release of the results of an investigation by a third-party committee of attorneys and accountants. The amount of overstated profits ballooned from the ¥156.2 billion ($1.3 bil.) reported by the third-party committee in July.

On September 30, Toshiba submitted its revised accounts to an extraordinary shareholders' meeting, together with nominations for seven outside directors (including three noted business people, an attorney, two certified public accountants, and a management scholar) and four internal directors. Except for one outside director and two internal directors, the other nominees will be new to the board. Toshiba also established a committee made up of three outside attorneys to look into the responsibility of current and former officers. The most recent three presidents of Toshiba have already resigned for causing the falsification of accounts by pushing for unrealistic profit targets, but an outside investigative committee has been created to probe their specific responsibilities as well as that of other officers. The Securities and Exchange Surveillance Commission (SESC), Japan's equivalent of the American SEC (Securities and Exchange Commission), has launched a full-fledged investigation. Toshiba has also set aside ¥8.4 billion ($70 million) in anticipation of fines.

Won't end here

Toshiba's attempt to draw a line under the scandal will likely be frustrated. First, outside observers say Toshiba's balance sheet may still not be accurate. Second, because Toshiba has used US accounting standards, and published its results in English-language annual reports, the company may be exposed to a more stringent investigation and harsher penalties from the American SEC than from the Japanese authorities. The results of any SEC investigation could implicate not only Toshiba, but also Ernst & Young ShinNihon (which audited Toshiba's books) and even the state of market regulation in Japan.

Two issues have been raised in regard to the first point. The first is the possible overvaluation of Westinghouse, which Toshiba acquired for roughly ¥600 billion ($5 bil.) in 2006. Orders for nuclear power plants have fallen precipitously since the Fukushima disaster. Quite a few accounting experts believe that Toshiba's valuation of Westinghouse is no longer realistic since it was based on bullish expectations for nuclear power at the time of its acquisition. Consequently, Toshiba needs to book an impairment loss of several hundred billion yen from the Westinghouse book value. Secondly, reserves allocated for future retirement payments to employees may be short by around ¥200 billion ($1.6 bil.); more on this below.

Toshiba scandal or Japan scandal?

There are two ways of looking at the nature of Toshiba's accounting scandal.

The first view, which was outlined in the third-party committee report and has been adopted by most media outlets, is that Toshiba's overstatement of profits was the run-of-the-mill window dressing that could be seen in many Japanese companies. From this perspective, the Toshiba case is not the same type of scandal as the Olympus case of 2011, where the decision to cook the books was made by a clear order of top management and a small number of accounting executives, who colluded with outside financial experts to employ complicated techniques to try to hide losses. Toshiba's top management continuously applied pressure to increase profit figures beginning in President Atsutoshi Nishida's tenure (2005-09), and various business departments cooperated in response to that pressure. The group mentality of Japanese corporate culture became the breeding ground for accounting fraud. Even when there were no specific orders, employees inferred the top management's intent and manipulated the numbers. The manipulation itself took the form of extremely common methods such as making costs appear lower by putting losses on orders off to the future, or by booking excessive inventory, or manipulating the price of parts transactions. This view holds that this is exactly the usual type of accounting scandal that occurs under the collectivist mentality in the Japanese business culture. Some minimize the seriousness of the offense by saying it is no worse than typical.

In a case like Olympus, in which the illegal activities were led by top executives, removing them resolves the problem. However, if manipulation of accounts has become habitual throughout the organization, simply lopping off some heads won't uproot the syndrome. In the Olympus case, seven people were arrested. The three who went to trial and pled guilty were given suspended sentences, as is typical in such cases. Things have not progressed that far with Toshiba yet, in part because the specific actions of individuals are still being investigated.

A very different view is held by Yuji Hosono, a certified public accountant. In the September issue of *Sekai* magazine, Hosono wrote that Toshiba first began falsifying its accounts under President Nishida during the fiscal year that ended in March 2009 because it had fallen deeply into the red following the collapse of Lehman Brothers, and the company was in a life-or-death situation. Financial institutions, he contends, might have demanded that it repay its entire debt in bulk. The window dressing was intended to help Toshiba receive a ¥500 billion ($4.2 bil.) capital increase to avoid such a crisis. Because it had to improve its balance sheet to qualify for the capital increase, Toshiba reduced the apparent "present value" of its retirement payment obligations. It disguised ¥230 billion ($1.9 bil.) in obligations by raising the expected return on investments used to fund those obligations.

Hosono sees this as the genesis of

Toshiba's accounting scandal. Once top management took that path to meet the crisis, then the entire company became continuously involved in falsifying accounts to push back reported costs over the following six-year period.

Failure of governance reform

Regardless of the origin of Toshiba's malfeasance, this fraud will have an enormous impact on the Japanese capital market in that it will raise serious questions about the corporate governance reform movement now being widely touted (see article on pg. 8).

Toshiba had been seen as a paragon of corporate governance reform. It had installed outside directors ahead of other companies, and in 2003 it built a seemingly cutting-edge corporate governance system consisting of a nominating committee (to nominate the next top management candidates), compensation committee (to decide officer compensation), and audit committee dominated by those outside directors.

None of this prevented Toshiba from continuously manipulating accounting figures in disregard of compliance rules. Moreover, another aim of corporate governance reform—to increase growth—was completely unsuccessful. Toshiba has been incredibly reluctant to divest itself of divisions, like laptops, that bleed red ink. This is also evident from a comparison with former rivals Hitachi and Mitsubishi Electric, which were much quicker in the restructuring of their business lines.

Although a nominating committee's function is to select the most appropriate CEO, at Toshiba it simply approved the person chosen by the old boys' club of former company presidents who still retain the most internal influence. Outside directors were unable to resolve the feud between Atsutoshi Nishida, the third most recent president, and Norio Sasaki, the second most recent president, a feud that prevented flexible decision-making. Until their joint resignation in July, Nishida and Sasaki wielded their remaining influence at Toshiba as an advisor and vice-chairman, respectively.

Although the personal computer and television divisions had been generating huge losses, Nishida, who had, in the past, nurtured Toshiba's laptops into being among the best in the world, blocked the company from scaling back or retreating from the PC business. Although outside directors held a majority of seats on the audit committee, their knowledge of finance and accounting was insufficient, and they also had no support staff versed in accounting. Thus, the actual form of the accounting manipulation was concealed from the outside directors. Toshiba had an internal "whistleblowing" system, but that also did not function well. Ultimately, after a number of years, the fraud was finally discovered due to an insider's report to the Securities and Exchange Surveillance Commission.

As part of the corporate governance reform movement that is currently underway, listed companies are now required to install two or more outside directors. However, the Toshiba scandal proves that simply adopting these reforms is no guarantee that they will have the desired effect. Over the past 10 years, Japan has strengthened its regulations that compel companies to effectuate a number of systems to ensure compliance with laws and regulations. Accordingly, compliance-related costs have also risen many times over.

Nevertheless, as the Toshiba scandal demonstrates, adopting a certain form of governance does not necessarily guarantee its effectiveness. That requires reliable enforcement of internal control rules in individual companies. However, in a Japanese corporate world that still sees very few employees changing jobs between companies, the influences of a particular corporate culture can easily win out over the normative power of compliance rules in the wider business culture. In order for compliance to spread throughout a company, it is necessary for top management to be resolutely ethical in business, but that was lacking at Toshiba. It can hardly be said that this lack of ethics is limited to Toshiba.

Where were the auditors?

In Toshiba's case, outside financial auditors say that they were unable to penetrate the window dressing. ShinNihon, the Ernst & Young affiliate that carried out the audits, contends that it could not find improprieties in those books that were accessible to outsiders. Even when they asked questions, they could not get accurate answers because underlying data was so falsified.

However, attorney Nobuo Gohara has questioned whether that was really the case. "The core of the accounting fraud has not yet been completely uncovered," he says. "We don't know whether the audit company was really fooled or just overlooked the fraud, or what kind of materials Toshiba submitted to the audit company." Gohara is a former prosecutor who has taken the lead in speaking out against compliance problems, including his service on the third-party committee that investigated the Olympus scandal.

The fact that ShinNihon could not see through the methods Toshiba used to window-dress its accounts, despite those methods being incredibly common, means that this same type of fraud could occur anywhere, which could greatly undermine confidence in accounting audits. The Certified Public Accountants and Auditing Oversight Board, which falls under the umbrella of the Financial Services Agency, and the Japanese Institute of Certified Public Accountants have both launched inspections of Ernst & Young ShinNihon. It is still unclear what the results of those inspections will be and what kind of punishments, if any, will be handed down.

In 2006, ChuoAoyama Audit Corp. (an affiliate of PricewaterhouseCoopers and one of the four major audit companies at the time) received a disposition from the Financial Services Agency (FSA) suspending its business for two months, which ultimately drove the company to dissolve. In 2005, three of ChuoAoyama's certified public accountants who were working with Kanebo led the falsification of accounts that caused that company's scandal. The following year ChuoAoyama was also involved in the fraud at Livedoor. Since these were only some in a long history of problems at ChuoAoyama, an exceptional punishment was given to a major auditing firm in Japan.

Ernst & Young ShinNihon also handled audits at Japan Airlines, IHI, and Olympus, all of which used some window dressing to cover fraudulent accounting. A list to which we can now add Toshiba. The most important developments to watch for now are the FSA report from its inspection, and what kind of reforms the FSA will bring about in the character and methods of accounting audits in Japan.

With the direction of the Securities and Exchange Surveillance Commission's investigation into Toshiba and the FSA's investigation into Ernst & Young ShinNihon remaining unclear, the kind of action the US SEC takes or does not take in response may also have a major impact. The Toshiba scandal runs the risk of growing into a bombshell that will rock corporate culture, capital markets, and the state of regulation in Japan.

CORPORATE STRATEGY

Nicholas Benes:

'Governance a big deal'

Nicholas Benes is Representative Director of The Board Director Training Institute of Japan, which trains directors as a government-certified "public interest" nonprofit. Since 2010, he has chaired the Growth Strategy Task Force of the American Chamber of Commerce in Japan.

The Japanese government and the Tokyo Stock Exchange have taken a number of steps aimed at improving corporate governance on the assumption that this will not only improve returns for shareholders, but also improve corporate efficiency and growth prospects.

The Japan Company Law was amended so that firms were urged to add at least one outside director to their boards under a "comply or explain" rule, as is used in many countries, such as the UK. These outsiders had to be true outsiders, not people currently working at affiliates or allied firms.

A Stewardship Code for investors, also using the "comply or explain" procedure, was promulgated by the Financial Services Agency (FSA). Investors who choose to sign up need to explain things like their policies for engaging with firm management, as well as their policies for voting their proxies at the shareholders annual meetings; they cannot continue to just turn over blank proxies to management and let the latter vote for them.

The Tokyo Stock Exchange then created a Corporate Governance Code, once again based on the "comply of explain" principle, according to which firms are recommended to follow global best practices in governance, but are free to work out the details. In theory, firms that don't follow the "comply or explain" rule could be delisted from the exchange.

Finally, an advisory committee to the Ministry of Economy, Trade and Industry (METI) urged that firms target a Return-on-Equity ratio (i.e., the ratio of profits to the value of all the shares held in the firm) of at least 8%.

We asked Nicholas Benes, who has been pushing for these kinds of reforms for decades, to discuss their impact.

TOE: How important are these governance innovations?

Benes: The most important thing is that the government has made it very clear that productivity and profitability matters, and that it believes that corporate governance is important for achieving that. The government is basically saying, "We need to make sure your pension fund is worth what it's supposed to be in 30 years." That's a very different message than the government has ever sent out in the last few decades.

Taken together the two Codes will mark the beginning of the end for cross-shareholdings and similar "stable (i.e., "silent") shareholdings." Over the past 5-10 years, such holdings have come down very significantly. But now, after the new Codes, the banks are reducing their shareholdings in companies in accelerated fashion.

TOE: Will "comply or explain" be effective or will it let firms get away with just "talking the talk"?

Benes: Most countries use a "comply or explain" approach. The US is an outlier in taking a mandatory approach. By forcing companies to either comply or explain, you give investors a lot of detailed disclosure that reflects each company's situation. It is then up to investors how much they actually engage in dialogue with the companies to nudge them forward, and praise those who show progress while criticizing the laggards publicly. A certain level of public shaming or praising leads to change.

TOE: ROE has got a numerator and a denominator. So, even if your profits stay the same, you can buy back a bunch of shares, and lower the amount of equity. In that case, your ROE number may look good, even though your productivity as measured by return on assets may not have improved at all.

Benes: You can only pull that trick so many times before investors wake up to it.

TOE: How are all these innovations actually going to improve corporate performance? You mentioned earlier the resistance of the industrial community.

Benes: In regard to resistance, I am referring particularly to the Keidanren [the chief business federation]. The business community itself has actually become much more fragmented and diverse on these issues than 10-15 years ago. Keidanren tends to reflect the lowest common denominator. Keidanren is sort of a club of people with great seniority who don't want to offend other senior people too much.

Within many firms, the reaction has been quite positive. There has been a strong level of interest at middle management levels, where we do some training. Many of these people want to take advantage of these governance changes in order to accelerate the company reforms that they wanted for a while. It's elevated the internal discussion that is very important in Japanese companies. The top guys often will not take leadership on these issues, but if it bubbles up from below enough, they won't say no.

TOE: You had written previously that, up to now, most of the "outside directors" were "friendly cocker spaniels, instead of Dobermans." How will outside directors have real impact if senior management really doesn't want to listen to them?

Benes: I borrowed that expression from Warren Buffett, who was talking about US directors. At very few firms will outside directors become Dobermans, no matter the country. What you want is cocker spaniels who bark when necessary.

And you want at least three of them. If there is just one, it's very difficult for him or her to say anything which runs against the thinking of ten other people. But if that one person on the board says, "We ought to think harder about XYZ," and if the person next to him says, "Yes, he's got a point," and the person next to him says, "Yes," that's really all you need to start a meaningful discussion. So firms' concerns with their reputation can lead to the kind of board that companies should want to have.

TOE: Will outside directors have an important say on issues like compensation of executives and nomination of new directors?
Benes: Not necessarily, and that's a problem. You need the outside directors to take the lead in helping to make decisions where the interests of executives might conflict with the best interests of the company.

TOE: What was your involvement in all this besides your role in training directors?
Benes: I proposed that a Corporate Governance Code be part of the government's growth strategy in conversations with Diet member Yasuhisa Shiozaki, who was a key leader of the growth committee of the Liberal Democratic Party (LDP). This was back in late 2013 and early 2014. At first, Mr. Shiozaki hoped to get a mandatory requirement for one outside director put into the company law. My advice was that it would be better to legitimize the concept of "comply or explain" in that law so that we could build something with much more impact—a governance code—on that foundation. There had been arguments about the outside director rule for almost four years and I felt that sticking to a mandatory requirement would just result in years of further argument, since Keidanren refused to accept it. Shiozaki readily understood the benefits of this approach. He grabbed the ball and ran with it and convinced the FSA to start this process. And he pushed it ahead to its conclusion.

I then immediately took the FSA's point man on this—Motoyuki Yufu [Director of the Corporate Accounting and Disclosure Division]—to dinner and gave him a memo with my ideas of what should be in the governance code. He had spent time at the OECD and was familiar with governance issues, but he had never sat on a board. He appreciated that the advice that I was giving him was based on my years of experience on various boards. And learning about practices in other countries was one of the things most useful to Mr. Yufu.

TOE: Did you find it striking that a top member of the Diet and a top official were willing to take advice from a member of the foreign business community?
Benes: I have been here for 30 years, and have been doing nothing but working on this issue for the last six years. It was the ACCJ's Growth Strategy Task Force that I led in 2010 which had proposed many features of the "third arrow," especially the urgent need to raise productivity. So, it's not odd. What's odd is that there are not more Japanese people who see it as in the interests of their own country to make detailed proposals.

TOE: A friend of mine, who is not Japanese, has been an outside director for a few months. His impression is that outside directors only make a difference if management genuinely welcomes an outsider, because he can offer a different perspective from those inside the firm. If management doesn't really want that input, they may go through the motions, but, in substance, they'll ignore him. He thought that, out of the 1,600 companies in the First Section of the TSE, perhaps 100 really wanted to take advantage of outside directors. Over time, he felt this would grow and become tremendously important.
Benes: I'm not going to argue whether it's 100 vs. 300, but the number of digits is right, as opposed to 1,000 or 1,200. But I think that would be true in any country. These changes always take time.

TOE: So what will be the driver for outside directors having a real impact?
Benes: In any country, it largely depends on shareholders. Shareholders have a lot of rights in Japan, under the company law, more than in the US. If they raise their voices—as they are expected now to do under the Stewardship Code—that can change things. Management likes to get high shareholder approval ratios at their annual meetings.

Beyond that, the Corporate Governance Code includes the concept of director training, one of the things I most wanted to include. Most companies don't have any meaningful director training program for all those inside directors. Perhaps 500-600 do engage in some sort of meaningful training, but it's all internal. It's kind of like the student writing his own test and then taking it. You will not come up with new practices that the President might not like. The more training that occurs, the more that directors understand what is expected of them. People here tend to act according to what is expected by society.

Creating boards that are not just rubber stamps requires getting the important strategic topics to the board sooner so there is a real chance to meaningfully engage in a back-and-forth with management.

I think we'll see a lot of changes over the coming five years.

TOE: Back in 2006, you had written that Japan was at a tipping point in terms of corporate governance. Not that much has happened since then. Why will this time be different?
Benes: I disagree with your premise. I think a lot has happened since 2006, and it is precisely those changes that enabled me to propose the governance code and other measures to get it approved. "Tipping point" doesn't mean everything is going to happen at once. It means a point beyond which there is no return, and the next stage will definitely unfold. A lot of the changes since 2006 were under the radar and slower. An increasing number of leading companies started to self-improve their governance in order to survive in a competitive environment. We saw more disparities among companies in terms of governance and corporate strategies, more corporate restructurings. Most of all, society here now sees the necessity for reform, which was not the case 10 years ago.

TOE: Japanese companies are now so flush with cash they don't really need to raise a lot of equity to fund investments. They can fund them internally. Can the shareholders really have power over management when the company does not need their money?
Benes: This is the key question in Japan. What made Japanese corporate governance effective in the past was that they had to go back to the banks for capital. Still, the government has made a very, very strong public message that shareholders have authority.

In the past, if a shareholder went to XYZ company, and talked about the dormant cash lying around—and asked whether the firm had plans to invest it productively or to give it back to the shareholders as dividends—he risked being labeled as an "activist" and maybe avoided. Companies would avoid meeting with investors who talked that way too much.

But nobody can label you an "activist" now, because the new Corporate Governance Code talks about using capital efficiently and you can point to the Stewardship Code and say, "I am sorry to have to ask these questions, but I am required to do so by the Stewardship Code."

Praising and shaming have a big effect here. There will be articles in Japanese magazines about firms with low ROEs or poor governance structures, or the firms most highly-rated by foreign investors. This kind of peer pressure—how do we stack up against our archrivals?—is going to be an extremely strong motivator.

TOE: Corporate governance may end up being better for shareholders in terms of higher ROE or higher dividends. But to what degree does corporate governance translate into better management or better strategy? At least by American standards, Canon's corporate governance was not good, but it has been a superb firm mainly, in my view, because 70% of its sales were overseas and so competition disciplined the firm and kept it focused on core competencies. We'll have to see how it deals with the smartphone challenge. On the other hand, Toshiba had four outside directors.
Benes: I think you are right. Competition is one of the best forms of medicine. Good governance doesn't always translate directly into good management. There are hundreds of other factors which affect the success of your management strategy. We cannot measure the contribution of governance in the overall success of a firm. But it is also true, that rigor in one area, such as governance, often leads to rigor in other areas. Also, better governance assures investors that monitoring of management is taking place, so that a manager might not be promoted if he is mediocre. Without that, we tend to get what we had in the last couple decades, i.e., people climbing the ladder in lockstep. That promoted a bureaucratic risk-averse attitude where managers avoided sticking their necks out and firms just sat on cash.

Across the world, corporations are at a very primitive stage regarding governance practices and structures. Notions of governance only came into discussion about 50 years ago.

TOE: There was the scandal at Olympus over cooking the books and much of the Western press talked about it, not as a scandal at Olympus, but as a scandal of corporate Japan. The same is true regarding the Toshiba scandal. By contrast, people don't talk about the much worse scandal at Volkswagen as a German problem. Are the Olympus and Toshiba scandals typical or untypical of Japanese firms?
Benes: I don't think it is typical in the sense of accounting fraud, but I think the habits and structures that made this possible are quite common. People do not have a flexible labor market so that, if the corporate culture stinks at one firm, managers cannot go to another firm that acts more honestly. The hierarchical structure can go in a good direction if you have a rigorous, excellent leader as is the case with Kyocera. Or, it can sometimes go in a bad direction like Toshiba, because people obey orders almost as if it were a military organization.

At Toshiba, there were nine members of the board who were insiders in the firm. Many of them must have known that a lot of the stuff was going on, or sensed it, or heard things from friends over drinks at night. But they didn't report it to the board and didn't report it to independent members of the audit committee, as far as I know. These directors had a legal duty to report any information that might result in large damage to the company to the audit committee, and to the board as well. What prevented them from doing that? Hierarchy.

When I do compliance training with the middle-level people, I ask them: Could you report anything that you find ethically wrong or potentially harmful to the company? They all say: I could probably report it to my immediate boss because I know him personally and can trust him. But above him, probably not. I don't personally know those people. They might go directly to the president and I might suffer some kind of retaliation.

TOE: Toshiba also had outside directors, and it was listed on the JPX 400 exchange, one of whose criteria is good governance. What does that tell us?
Benes: It tells us that director backgrounds, skill-sets, competency, and training matter. At Toshiba, the former Chief Financial Officer (CFO) chaired the audit committee. If he doesn't want to give information to the others, it's not going to flow to the outside directors very easily. Another member of the audit committee was the former head of Toshiba's legal department, and such people don't usually know much about finance or accounting. Two of the outside directors on that audit committee were former diplomats. The only outsider who had much knowledge about finance was Kiyomi Saito. She used to work at Morgan Stanley, had gone to Harvard Business School, and runs her own company, which is a listed company. I think that, had she known about doubts about the accounting treatment, there would certainly have been much earlier discussions at that committee. But, even in that case, it probably would have been extremely difficult to have a very healthy discussion if she was the only one with that sort of background (see pg. 6).

TOE: Do you think the situation in Japan is worse than what we saw at Enron, MCI/WorldCom, etc.? In the Olympus case, I saw no evidence that directors who were stealing from the stockholders put a single yen in their own pockets.
Benes: That's right. It certainly is not worse in that sense.

TOE: Do you think it's harder to be a whistleblower in Japan than in the US?
Benes: I think the tendency of directors not to be sufficiently aware enough of their own legal duties and not to act on them is worse in Japan. When they get promoted to the board, they're still really thinking of themselves as executives in a hierarchy, where the President is their boss.

That is a different issue from whistleblowing in the general case. Former Olympus President Michael Woodford, who was ousted when he tried to investigate the accounting fraud, often says that Japan lacks a whistleblower culture. But Olympus was a case where a whistleblower actually went to somebody, in that case *FACTA* magazine. Toshiba was a case where the revelations came about because a whistleblower went to the SESC [Securities and Exchange Surveillance Commission], the equivalent of the American SEC [Securities and Exchange Commission]. And there are statistics showing an increase in the number of whistleblowers who go directly to the authorities because they don't trust their own hierarchical structure not to retaliate, and because they have enough conscience to report the problem.

So, here in Japan there is an ethical base which I think is at least as good as in the US. What we don't have in Japan is something that was put into the 2009 Dodd-Frank banking bill in the US. That law prescribes not only a prohibition on retaliation, but also that whistleblowers will get a reward if any fines result from their whistleblowing. The fact that Toshiba whistleblowers went to the SCSC—despite the lack of either protection or a reward in that case—speaks to the good ethics at the middle levels of Japanese companies.

EDUCATION

by Jeff Kingston

Japanese universities blunting attacks

Liberal arts at risk

Jeff Kingston is Director of Asian Studies at Temple University Japan, and author of *Asian Nationalisms Since 1945* (2016), and editor of *Press Freedom in Japan* (2016). He is a Contributing Editor to the *Asia-Pacific Journal*, from which this is excerpted; see http://japanfocus.org/-Jeff-Kingston/4381/article.html

On June 8 the Ministry of Education, Culture, Sports, Science and Technology (MEXT) sent a directive to all 86 national universities in Japan, apparently calling on them to abolish or reorganize their humanities and social sciences (HSS) departments. I use the word "apparently" because the letter is ambiguous.

Nonetheless, the *Yomiuri* reports that 26 of 60 public universities operating HSS departments have agreed to stop accepting students into these programs or reduce relevant electives. By contrast, top national universities, e.g., the University of Tokyo and Kyoto University, are not shutting down HSS, demonstrating that powerful institutions with sufficient funding are not beholden to MEXT.

Many in Japan have criticized MEXT's initiative, including Keidanren, the big business lobby. This directive has also prompted a petition campaign by European scholars. And yet, some scholars in Japan say that the HHS departments, and many colleges in general, do not provide the kind of education needed in today's world and say MEXT appears to be trying to address that problem.

In response to the critics, Education Minister Shimomura Hakubun told a news conference in late July, "We do not mean to treat the studies of humanities lightly. We also do not put special priority just on fields of practical sciences that immediately become useful in society." Yet that priority is exactly what PM Abe emphasized in a May speech at the OECD.

Japanese officials are concerned that Japan's universities don't come out well in international rankings and apparently believe that focusing on STEM (Science, Technology, Engineering and Math) will get more Japanese universities into the top 100.

The latest QS World University Rankings rank just five Japanese universities in the top 100: Kyoto University (38), University of Tokyo (39), Tokyo Institute of Technology (56), Osaka University (58) and Tohoku University (74). By contrast, Singapore boasts two universities in the top 15, while China and Hong Kong each have four and South Korea has three in the top 100. Prime Minister Shinzo Abe has targeted getting 10 Japanese universities into the world's top 100 by 2025. However, he has been better at setting unrealistically ambitious targets than actually doing what is necessary to achieve them. Moreover, this anti-intellectual salvo from Abe's government fits into a larger pattern of dumbing down education, whitewashing textbooks, promoting patriotic education and stifling dissent.

Power shift

In 2015 the government tabled legislation that will concentrate all decision-making power in university presidents' hands while downgrading the role of faculty councils, a major shift that is consistent with Keidanren's lobbying on the topic. Currently the faculty is in charge of hiring new faculty and appointing department heads, but that power would shift to the president, who also stands to gain greater control of discretionary funding in the form of MEXT block grants. This proposal is aimed at making it easier to impose changes from above that the faculty has been resisting.

Financial crunch

All of this comes in the context of a financial squeeze at the universities. Between 2001 and 2009, basic subsidies for national universities dropped 29%, while support for basic expenditures out of total allocations dropped from 86% in 2001 to 71% in 2009, marking a shift to competitive resource allocation that favors universities that meet MEXT performance criteria. In 2014 the OECD found that Japan's public expenditures on higher education amounted to 0.5% of GDP, lowest in the OECD, compared to an average of 1.1% among member nations.

Meanwhile, the number of 18-year-olds has plunged from 2 million in 1990 to 1.5 million in 2000 and 1.2 million in 2010. In addition, only half of Japan's high school graduates enter universities (excluding junior colleges), well below the OECD average of 62% and far below Australia where more than 90% do so and South Korea where the university enrollment rate for high school graduates is 82%. There is an oversupply of universities in Japan with 86 national universities, 90 universities run by prefectures or municipalities, and 606 private institutions, so consolidation is inevitable.

Private universities complain that they enroll roughly 80% of freshmen undergraduates while national universities get nearly 80% of government funding. This disparity is the source of vigorous lobbying by private universities to spread the funding more equitably and to downsize national universities, a pitch that plays well with a conservative government eager to cut budgets and rely more on the private sector.

Japan needs HSS

Takamitsu Sawa, President of Shiga University, a national university, condemned the MEXT proposal in a *Japan Times* column, drawing a parallel to the wartime exemption from conscription accorded to students in natural sciences and pointing out that Nobusuke Kishi, Abe's grandfather and prime minister from 1957-1960, also favored science and practical training. Sawa argues that, "A majority of Japanese political, bureaucratic and business leaders today are still those who studied the humanities and social sciences. This is because those who studied these subjects have superior faculties of thinking, judgment and expression, which are required of political, bureaucratic and business leaders. And the foundation for these faculties is a robust critical spirit."

Koichi Nakano, a political scientist at Sophia University, describes the proposed changes as "an utter disaster. Liberal arts education is what Japan needs more of, not less." Nakano adds, "The government may be trying to silence academic opposition to its policies by threatening and undermining the subject areas that produce and hire those critical voices." Indeed, HSS faculty members constitute the vast majority of signatories of a scholar's petition opposing Abe's unpopular security legislation and have been prominent at rallies protesting the unconstitutionality of the laws.

Relatively few of the roughly 300 core members of Students Emergency Action for Liberal Democracy (SEALDs) who have taken to the streets to protest PM Abe's security legislation, are students at national universities, but most are in the humanities and social sciences. With their social media savvy, they have inspired similar protests all over the nation, mobilizing well over a million protestors since June. Their ability to initiate, improvise and motivate is striking. Moreover, they demonstrate excellent cross-cultural communication, marketing and design skills. For example, they designed placards that like-minded groups can print out at any convenience store. Surely they are exactly the kind of people Japan needs more of, embodying the virtues of a liberal arts education.

Some of Japan's liberals see downsizing HSS as an attack on democracy. But many conservatives view these protestors as troublemakers. Back in 2012, when these students were protesting Abe's proposed State Secrets Act, Shigeru Ishiba, then Liberal Democratic Party (LDP) secretary general, called the demonstrators "terrorists."

Keidanren vs. MEXT

Higher education at its best prioritizes critical thinking and prepares students to engage in an increasingly globalized workplace. Hence, business executives are also dismayed about plans to marginalize HSS. Keidanren said MEXT's emphasis on science and vocational skills is misguided and "exactly the opposite" of what employers want. In its September 9 statement, Keidanren emphasized that liberal arts education imbues future employees with problem-solving skills and the ability to understand other cultures and societies. Indeed, in June 2013, Keidanren made a proposal for fostering global talent, writing "it is necessary to enhance liberal arts education for better training of global citizens."

It also called for more interdisciplinary studies to break down barriers between HSS and STEM, expanded overseas student exchanges and international collaboration, introduction of a gap year for students to broaden their experience and perspectives, and improvement in English skills and teaching capabilities of educators. Apparently Keidanren felt that critics of MEXT were blaming employers for pushing the latest reforms toward a utilitarian education and sought to clarify that Keidanren fully supports HSS.

In July, the Science Council of Japan, a national organization of some 2,000 scientists, also expressed "profound concern over the potentially grave impact" of the MEXT directive, saying that, "Any disparagement of the HSS may result in higher education in Japan losing its richness." The Science Council calls for maintaining liberal arts education because it promotes critical thinking, nurtures "global human resources" and promotes understanding of, "the human and social contexts within which scientific knowledge operates."

Foreign firms in Japan often lament that it's hard to recruit suitable employees because most candidates lack strong critical thinking skills, have poor English, and are overly passive, waiting for instructions rather than taking the initiative. Liberal arts education is no panacea, but downplaying its role in university education is more likely to exacerbate than rectify such deficiencies.

Japan is hardly the only advanced industrialized country attempting to downplay HSS in favor of "more practical" areas. Academic associations in Britain and the US also complain of budget cuts aimed at HSS.

Education reform is needed

Not every educational expert sees the MEXT proposals as wrong-headed. Bruce Stronach, Dean of Temple University and former president of Yokohama City University, thinks that the MEXT directive might serve a useful purpose. Traditionally, he says, "faculty saw themselves as intellectuals and not necessarily as educators." In this system, "students could go through university basically doing nothing…because companies spent years educating and training them once they became company employees." Today, however, "Rapid advances in technology, communications and science have created a greater need for specialization, and as financial problems cut down on lifetime employment and corporate education, budget adjustments had to be made."

In his view, "What is necessary today are critical thinking, communication with others, diversity, flexibility, lifelong learning, IT, etc., skills that will help us cope with the rapidity of changes on a global scale in a global context and in a global language…If the attempt is to eliminate the arts and humanities at national universities, then that is obviously a horrible policy. I say 'if' because it is not clear to me that this is the real intent here. When Japanese talk about global human resource development, that means creating graduates who are able to communicate, understand and deal comfortably with others unlike them. In order to do that they have to blend what are traditional elements of the liberal arts into their curricula. This is a recognized component of MEXT policy, and they have spent one helluva lot of money doing just that."

Philip Seaton, a professor of history at Hokkaido University's International Student Center, believes that MEXT is nudging universities to undertake overdue reforms that are in their own interests in a climate of declining student numbers and educational budgets. He argues that, "There is a big difference between universities at which the humanities/social sciences (HSS) play a key role in other strategic goals and universities at which the HSS are relatively isolated. For example, when HSS are central to an inbound degree program or international student exchange program (which contributes to internationalization and/or rankings strategies) they are not in danger of being cut. But, if the departments are providing education mostly to Japanese students and enrollment is declining, then pressures to reorganize are somewhat inevitable."

Conclusion

At this point it is too soon to draw conclusions because the impact will only begin to become apparent in 2016 when universities' initial responses take effect. Given MEXT's power of the purse, early reports that many universities are complying to some extent with the directive regarding HSS are not surprising. However, there are also signs that coping strategies by national universities will cushion the impact and preserve HSS, at least for now. As older faculty retire and administrators use new powers to redirect hiring and funding, the impact could become far more profound. Will MEXT's reforms improve the poor level of education that currently prevails at too many Japanese universities? On that score, there seems scant reason for optimism.

INTERVIEW

Barry Eichengreen:

China financial turmoil

Barry Eichengreen is a Professor of Economics and Political Science at Berkeley and a former senior adviser to the International Monetary Fund. His 2010 book, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, focused on the issues we are discussing here.

TOE: You have long believed that the international monetary system would do better with more than one reserve currency, not just the dollar.
Eichengreen: The foundation for international monetary systems is safe and liquid assets. For many years, that has meant US treasury securities. As the world continues to become less US-centric economically, it has to become less US-centric financially. The US cannot all by itself provide enough safe and liquid assets to meet the global economy's needs.

A multi-currency system means that exporters will price more of their exports in euros or Chinese renminbi (RMB), as well as settle their trade and financial transactions in those other currencies. Central banks will hold other currencies as part of their reserves. Corporations will hold some of their liquidity in securities that are denominated in other currencies.

TOE: What would be the consequence if we did not move into more of a multi-currency-based system?
Eichengreen: A global liquidity shortage. Central banks would not be able to accumulate the reserves they need to feel secure and to intervene in international financial markets. Corporate treasurers would not be able to accumulate and hold enough of the internationally accepted liquid assets they need for foreign investment and trade finance. 21st century globalization would be at risk.

TOE: To what extent is this evolution already occurring?
Eichengreen: It is occurring, but at a glacial pace. The share of central bank reserves held in dollars has fluctuated at a little more than 60% for the last couple of decades. Adjusting the short-term exchange rate fluctuations, the dollar's share may have fallen by a 1 or 2 percentage points over this period. The dollar is involved in about 85% of all foreign exchange transactions worldwide. That's down a little bit from the late-1980s, when this data was first collected. The dollar still accounts for nearly 80% of total trade financing worldwide and 45% of the world's exports are still priced in dollars.

TOE: Is it meaningful that less than half of exports are denominated in dollars?
Eichengreen: Not really. Europe has always done a lot of invoicing in its own currencies.

TOE: The failure of this to change—even though people have been saying for decades that it should and would change—raises the question: maybe, it doesn't need to change.
Eichengreen: The reason those expectations have been disappointed is the failure of the obvious candidates for alternatives to make faster progress. 15 years ago, everybody said the euro would rival the dollar, but the euro has been deeply troubled. Now, the story is similar for the Chinese RMB. China is trying to build deeper and more liquid financial markets, but in the last few weeks, it's tightened a variety of capital controls because of the weakness of the currency and the instability of financial markets. On the other hand, up to now, the US has avoided the worst. We have raised the debt ceiling on Treasury debt and avoided alienating bondholders.

TOE: Let's assume the US Congress doesn't do something crazy, like refusing to raise the government debt ceiling. Do you see the adverse consequences as a slow corrosion of the system, and therefore slower global GDP and trade growth than with a multi-currency system? Or, do you see it resulting in some sort of crisis?
Eichengreen: Either scenario is possible. During the 1930s Depression, we saw the latter scenario as Britain devalued the pound in 1931, which caused a panic on foreign exchange markets and we got a global liquidity crisis. On the other hand, disenchantment about US budget deficits, US monetary policies, and disappointing US growth could play out more as a kind of slow motion grinding down of growth if other currencies did not play a growing role.

TOE: A couple decades back, people talked of the yen as a reserve currency.
Eichengreen: A true international currency has to have three attributes: size, stability, and liquidity. The yen didn't make it because it didn't have the stability. In the 1990s, the Japanese financial system didn't have the stability and now there are questions about the stability of the yen exchange rate with the push for depreciation. But there's also the issue of the size of the platform. The reason that the US, the Eurozone and China are the three most logical candidates is that their issuers are engaged in a lot of international merchandise and financial transactions. Japan has not been a growing economy for a while now. I think there can be a subsidiary role for subsidiary currencies, like the Swiss franc and the yen.

TOE: The *Wall Street Journal* had a front page article pointing out that world trade growth has been slower than global GDP growth for three years in a row. That is unusual compared to the last few decades, when globalization has led growth.
Eichengreen: This is a major mystery and I don't have a satisfactory explanation. There are a few factors to point to. There has been some murky protectionism. Trade credit has become harder to obtain in a variety of countries. China's slowing growth has a lot to do with this because China imports components in order to export final goods, and we count both the import components and the export of final goods. I think the logic for trade growing faster than GDP—a growing international division of labor—remains intact and we should expect to see trade growing faster than GDP again. The current aberration is a bit perplexing.

TOE: The International Monetary Fund

(IMF) has said that the RMB is no longer undervalued.

Eichengreen: The RMB looks appropriately valued at this point. China's current account surplus [the broadest definition of the trade surplus] has shrunk. The RMB has strengthened an awful lot on a real effective basis [i.e., adjusting for the difference between price changes in China and price changes in its trading partners].

The Chinese are serious about wanting to rebalance their economy away from excessive reliance on a trade surplus and move toward domestic spending. So, a weak exchange rate is no longer integral to their growth and development strategy as it was in the past. They have been saying this for long enough and consistently enough that I think they really mean it.

Right now, we're having a test. A weaker currency will do a little bit to boost their exports and boost their economic growth. Do they care more about economic growth or about rebalancing the economy? I think they are serious about the rebalancing part.

TOE: One of the things we learned from the 1997-98 Asian financial shock is that, when you want to do financial liberalization, sequencing is extremely important. There have been calls for China to liberalize the capital account on RMB movements [i.e., allowing people to freely buy and sell the RMB for capital and other financial flows, not just for trade]. That's one of the things the IMF says China has to do if the Chinese want the RMB to play a big international role. How do you think the sequencing would best be done?

Eichengreen: The best way is for China to go much further in strengthening domestic financial markets and regulation before opening the capital account further. The Chinese are going slow on capital account liberalization and trying to go as fast as possible with financial strengthening and development.

I do worry about any attempt to use capital account liberalization and RMB internationalization as kind of a lever to force faster domestic reform. There are people who say: open the capital account, let foreign banks in, because this will force the Chinese banks to modernize and respond to the chill winds of competition. I think that's dangerous. The Chinese would be better advised to first bring the shadow banking system into the light, privatize the state banks, make their stock market more transparent, and create a proper corporate bond market. After all that, then liberalize the capital account.

The Chinese leadership basically has the same view that financial strengthening at home must come first, but I worry that they have erred a bit in going too fast on the capital account liberalization and too slow on domestic financial reform. Still, Chinese policymakers have studied the 1997-98 financial storms, and they drew the right lessons.

TOE: One of the interesting things—which is being ignored in the US Congress—is that the Chinese spent an estimated $120 billion in August, and perhaps another $40-50 billion so far in September, to prevent the RMB from falling. So, they seem to prize stability. If they were to open up the capital account before strengthening their domestic financial system, would money flow in and raise the level of the RMB, or would it flow out and cause the RMB to fall?

Eichengreen: Many studies have concluded there's no way to tell. Until this summer, my view was that inflows and outflows would be pretty evenly balanced. At present, there's no question that the money would mainly flow out. Not so many people want to invest in China right now, and lots of Chinese have noticed that foreign financial markets are more stable, more liquid, and more transparent than their own. We would have the ironic situation where Congressional pressure on China to free its capital account would just lead to a weaker RMB.

TOE: I think there is a Chinese proverb: be careful what you wish for. In the absence of domestic financial strengthening, would we see a lot more volatility in net inflows and outflows, and therefore in the RMB rate, and whatever consequences that has for Chinese interest rates?

Eichengreen: Yes. More than a century of historical experience teaches that open capital accounts can be an engine of volatility, that capital flows can reverse on a dime, and that financial markets, economies, and political systems can find it hard to cope with the consequences. For an open capital account to be a positive for economic development, you need strong financial markets, strong financial institutions, and a strong political system.

TOE: What does all this mean in terms of timeframe for the RMB becoming a major global reserve currency?

Eichengreen: In my 2010 book *Exorbitant Privilege*, I said I could imagine that, by 2020 or so, the dollar might account for less than 50% of global foreign exchange reserves and other transactions; the euro maybe 30%; and the Chinese currency maybe 10-15%. I was too optimistic; it will probably take longer.

TOE: Is a multi-currency system sort of like fusion power: no matter when you make the forecast, it's always a couple decades away?

Eichengreen: If that's true, then I would worry where we will get the liquidity needed for global financial markets and global trade. It cannot only come from the US forever.

TOE: In their efforts to control both the RMB rate and the stock market, the Chinese government has not only intervened in markets, but also arrested investors and journalists. Do you think such actions stabilize things? Or, do they end up destabilizing them because they show how worried the government is, and how you can lose your ability to withdraw money just when you really want to?

Eichengreen: There is no question that, in the longer run, those steps are counterproductive. They will discourage international participation in Chinese financial markets. There may be some stabilizing effects in the short run. But, if you're trying to build deep, liquid, transparent, and credible financial markets, the Chinese actions are the opposite of what one would want.

Every first class international currency in history—and there have only been a few of them—has been a currency of a democracy or republic governed by the rule of law. People will tie up their money in the currency of a country only if the state cannot arbitrarily change the rules of the game overnight. I don't know whether the Chinese political system is compatible with their international currency ambitions. If not, how modestly or radically would the political system have to change?

TOE: Is that a question of having democratic elections, or just the rule of law?

Eichengreen: It's fundamentally a question of the rule of law. Are democratic and non-democratic political systems equally capable of enforcing and respecting the rule of law over time? I don't know the answer.