DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

[redacted]

BRIEFING

APR 2 5 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Senior Deputy Assistant Secretary Geithner

SUBJECT: Briefing for Your Meeting with Hiroshi Mitsuzuka, Minister of Finance, Japan

Date & Time: Sunday, April 27, 1997 at 10:30 - 11:15 am

Location: Small Conference Room

PARTICIPANTS:

Treasury:
Secretary Rubin
Deputy Secretary Summers
Assistant Secretary Lipton
Senior Deputy Assistant Secretary Geithner
IMI Director Gagnon

Japan:
Finance Minister Mitsuzuka
Takatoshi Kato, Vice Minister of Finance
Eisuke Sakakibara, Director-General, International Finance Bureau
Ambassador Saito, Embassy of Japan
Tadashi Iwashita, Head of Finance Section, Embassy of Japan
Tetsuo Kanai, First Secretary, Finance Section, Embassy of Japan
Interpreter

BRIEFING: Overview

BACKGROUND: [redacted]
Tab 2: Japan: Economic Outlook
Tab 3: Japanese Bank Update
Tab 4: The Japanese Big Bang
Tab 5: Press Guidance for Rubin-Mitsuzuka Meeting
Tab 6: Liquor Tax

cc: Lipton

OVERVIEW
MEETING WITH HIROSHI MITSUZUKA
April 27, 1997

OBJECTIVES:

Finance Minister Hiroshi Mitsuzuka will probably emphasize the Hashimoto government's commitment to structural reform and its confidence in domestic-demand-led growth without a rebound in the current account surplus. Mitsuzuka also may discuss Japan's fiscal consolidation, financial system and exchange rates.

You should reiterate our concerns about the risks to a domestic-demand-led recovery and a significant increase in the current account surplus. This meeting will provide an opportunity to emphasize the need to continue to implement measures to strengthen the financial system and show support for "Big Bang" financial reforms.

MAIN ISSUES:

1. **Economic Prospects.** We remain concerned about the prospects for Japan's economic recovery and current account surplus. Growth is expected to slow sharply in 1997, primarily because of large tax increases and expenditure cuts that will significantly reduce domestic demand growth and increase the current account surplus. We expect the strong economic growth of the fourth quarter of 1996 will carry over to the first quarter of this year; any evidence of a slowdown will not be apparent until second quarter results are reported this fall.

The Prime Minister has publicly committed himself to fiscal consolidation as a major priority for his administration. Our objective is to build a case for contingency planning -- e.g., a supplemental budget to boost growth -- should any signs of a slowdown appear.

Key Points:

- Have made significant progress over past four years on current account adjustment and market access. Strengthened support for bilateral relationship. Must remain vigilant to safeguard hard won gains.

- Pleased you share objectives of promoting strong, domestic-demand-led growth and avoiding significant increase in current account surplus.

- Concerned about risk of sharp increase in Japan's external surplus. Sharp rise would undermine progress made and increase protectionist pressures here.

- Understand stakes for you associated with fiscal deficit reduction. Ask only that you be willing to take appropriate steps should current account surplus start to rise significantly.

- Important to publicly reaffirm Japan's commitment to promote strong domestic demand-led growth.

2. **Banking System.** The banking system, weakened by an overhang of bad loans, is vulnerable to an economic downturn. The risk of a slowdown in Japan's recovery makes it even more imperative that the Japanese authorities not lose momentum in their efforts to strengthen the banking system.

Key Points:

- Concerned by problems in your financial system. Our experience suggests that the costs of the problem rise with delay. I hope you will act to put this problem behind you as quickly as possible.

- Important to continue implementation of measures to strengthen banks, including strengthened supervision, and enhanced disclosure and transparency.

3. **Financial Reform and Deregulation.** Our interest in structural reform centers on promoting opportunities for foreign firms, improving transparency and disclosure and reducing systemic risk.

Key Points:

- Fully support far-reaching deregulation, structural reform that achieves real market access. Important not only for Japan's future but to prevent trade disputes.

    - Suggest more active discussions on deregulation under the Framework to achieve concrete deregulation measures in Japan that bring increased market access. Focus on specific sectors and structural issues.

    - Suggest working out details by Denver summit.

- Reform should promote competition, innovation and business diversification, and improve financial stability while reducing systemic risk.

    - Clarity on details of reform plans would reduce uncertainty.

- Welcome your Big Bang reform of the Japanese financial system and encourage you to move forward without delay.

- While welcoming rapid implementation of reform, deregulation not likely to address our concerns about rising current account surplus this year or next. In such an environment, it is particularly important that we work together to address trade problems in effective, timely manner.

4. **Anti-Corruption Efforts.** We want to urge the Japanese to help provide leadership at the May OECD Ministerial to urge governments to implement last year's mandate to eliminate tax deductibility of foreign bribery and to adopt a strong recommendation for member states to criminalize bribery. We also want to encourage the Japanese to join the U.S. in providing the OECD with information on their own practices to deal with corruption.

Key Points:

- Urge you to strongly support May OECD Ministerial mandating member states to enact national laws criminalizing bribery of foreign officials, setting a clear timetable for rapid implementation, and providing for an effective OECD monitoring mechanism.

5. **Financial Services Negotiations**. In our view, Japan's active engagement is vital for a positive outcome to these negotiations.

Key Points:

- We are happy that Japan is taking a strong lead in encouraging a strong WTO Financial Services Agreement.

- Without positive movement by several key Asian countries, we cannot succeed.

- Japan's position as chair of the negotiations is very important.

- Pleased with outcome of APEC Finance Ministers' Statement on WTO financial services negotiations.

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We are predicting real GDP growth of 2.0% (saar) in the first quarter of 1997 due largely to a temporary boost in consumer durable outlays ahead of the consumption tax hike on April 1. After the hike, real GDP is expected to fall 0.9% (saar) in the second quarter.

Recent Statistics

Recent economic indicators have been mixed, suggesting relatively good growth in the first quarter of 1997, followed by a slower second quarter due to fiscal consolidation.

- Industrial production slowed in February, rising 3.1% y/y after growing 8.9% y/y in January, reflecting a sharp drop in production of transportation equipment that had been boosted in January by strong domestic demand in anticipation of the April 1 tax hike.

- Capacity utilization fell to 76.1% in February, down from 79.0% in January, but up from 73.9% for 1996 as a whole.

- Retail sales fell 1.9% (y/y) in February but passenger car sales accelerated slightly, growing 14.1% (y/y) in March after 13.1% (y/y) in February.

- The unemployment rate remained at 3.3% in February but is down from the record high of 3.5% in June 1996.

- Housing starts fell 1.5% in February over a year earlier.

- Public construction expenditures declined 39.4% (y/y) in February, following a 26.2% drop in January.

Prices

Inflation remains flat to negative due to past weak economic growth and the long-term appreciation of the yen.

- Consumer prices in February 1997 had risen 0.6% over a year earlier but were slightly below the level of three months earlier.

- Wholesale prices rose 1.6% year on year in February 1997.

  -- Domestic prices fell 0.2% (y/y) in February 1997. However, export prices rose 5.4% (y/y) and import prices rose 16.5% due to the depreciation of the yen.

- The increase in the consumption tax will result in a temporary spike in measured inflation. As a result, we expect consumer prices to rise 2.1% in 1997 and 1.7% in 1998.

Monetary Policy

The tight government budget, weak economy, and banking sector problems have dampened fears of tighter monetary policy. On the short end:

- The overnight call rate remains at about 0.5%, where it has been since the government lowered the discount rate to 0.5% in September 1995. The interest rate on three month government bills is only 0.34%.

- Interest rates are expected to remain low throughout 1997. The interest rate on the three month September 1997 future contract currently stands at 0.80%, while the interest rate on the three month December 1997 future is only 0.96%.

On the long end:

- The yield on the 10-year benchmark bond is now 2.1%, down from 3.2% a year ago.

Narrow measures of the money supply are growing rapidly but broader measures are growing more slowly.

- M1 grew at a 9.5% rate in March 1997 (year-on-year) and an annualized 12.2% in the last three months.

- The closely watched M2+CDs grew 2.7% in March (y/y) and at an 2.4% annual rate in the last three months.

Fiscal Policy

We expect fiscal measures to reduce the budget deficit by more than 2% of GDP and slow growth by 0.8% of GDP in FY97. The main elements of fiscal consolidation are:

- Elimination of the ¥2 trillion income tax rebate at the end of 1996 and an increase in the consumption tax from 3 to 5% on April 1.

- Spending declines as existing fiscal packages run their course. Some of these declines will be offset by the FY96 supplemental budget passed on January 31, which contains about ¥1.8 trillion (0.4% of GDP) in "real water" spending.

- The IMF estimates Japan's structural deficit will fall from 3.3% of GDP in 1996 to 1.7% of GDP in 1997.

Exchange Rate and the Current Account

Appreciation of the yen between 1990 and 1995, stronger growth, and structural changes have contributed to a decline in Japan's current account surplus.

- Japan's real trade weighted exchange rate appreciated 49% between April 1990 (its lowest point since the Plaza Agreement) and April 1995. The lagged effects of this appreciation helped to lower Japan's current account surplus from \$132 billion (3.1% of GDP) in 1993 to \$66 billion (1.4% of GDP) in 1996.

- Since its high in April 1995, the yen has depreciated 29% on a real trade weighted basis, reversing 88% of its appreciation since the April 1990 low.

We project that the depreciation of the yen and slower growth in Japan in 1997 will boost Japan's overall current account surplus to \$88 billion (2.1% of GDP) in 1997 and \$126 billion (2.9% of GDP) in 1998. The Fed and OECD project a similar increase and the IMF has a smaller but still significant rise (to 2% of GDP in 1998). So far, the Consensus forecast sees only a slight increase in Japan's surplus.

- In yen terms, Japan's exports rose 8.2% in 1996 to ¥43.6 trillion while imports rose 23.5% to ¥34.5 trillion.

- Export volumes rose only 0.7% while yen export prices rose 7.4%. Import volumes rose 9.9% while yen import prices rose 12.4%.

Japan's bilateral trade surplus with the United States also fell: from \$59.1 billion in 1995 to \$47.7 billion in 1996. But the bilateral surplus will likely rise in line with the forecast rise in Japan's overall surplus.

- U.S. exports to Japan last year rose 5.0% to \$67.5 billion, while U.S. imports from Japan fell 6.7% to \$115.2 billion.

Banking System and Financial Reforms

See attached papers on Japan Bank Update and Big Bang Financial Reforms.

COMPARATIVE FORECASTS

	Real GDP Growth (%)			Inflation (CPI %chg)			Current Account ($bn)		
	1996	1997	1998	1996	1997	1998	1996	1997	1998
Treasury	3.6	1.7	2.4	0.1	2.1	1.7	66	88	126
IMF		2.2	2.9		1.3	1.2		78	90
OECD		2.3	2.9		1.5	1.0		85	112
Fed		2.3	2.2		1.1	0.5		90	120
Consensus		1.6	2.4		1.3	0.8		69	75

Source: April 1997 forecasts (except March for Fed). Consensus forecasts not sensitive

JAPANESE BANK UPDATE

Summary

With the close of FY 1996 on March 31, the overall Japanese bank situation is stable, but the system remains vulnerable to the impact of an economic downturn. While the banks recorded record operating profits, lower stock prices have squeezed bank capital and slowed the pace of write-offs on problem loans, and the gap between stronger and weaker institutions has grown wider. The authorities moved on April 1 to address the difficulties of two of the major banks -- Nippon Credit Bank and Hokkaido Takushoku -- but the NCB restructuring has not appeared to assuage market concerns regarding NCB's long term health.

Nippon Credit Bank Restructuring

On April 1 MOF and BOJ announced a restructuring plan for NCB involving: bankruptcy for non-bank affiliates, ¥300 billion in new equity and ¥250 billion in bad loan write-offs. NCB is the 15th largest Japanese bank, with assets of roughly ¥16 trillion, or $133 billion (2.7% of the assets of the 20 major banks).

In response to this plan, market pessimism regarding NCB has increased. The secondary yields on NCB 5-year debentures leapt from 4.77%, on March 3, to 6.90% on April 21. NCB debentures trade at a 524 basis point premium to Industrial Bank of Japan debt and yields have more than doubled thus far this year. On a more positive note, the Japanese life and nonlife insurance companies announced that they had agreed (or more likely they finally gave into MOF pressure) to convert subordinated loans to NCB into ¥150 billion of new equity.

NCB also became the first major Japanese bank to fail to meet the 8% BIS risk-weighted capital adequacy ratio, with a ratio of three percent. This was expected: as part of its MOF-backed restructuring plan, NCB announced that it would withdraw from international markets for a minimum two year period, and thus will not need to meet the BIS standard.

Major Banks Meet BIS Capital Standard

The Nikkei estimates that 19 of the top 20 Japanese banks will meet the 8% minimum BIS capital adequacy ratios standard as of the end-fiscal-year (March 31). (Actual figures are not released until May 24.) The average capital-to-risk-weighted assets ratio of the top 20 banks is estimated at 8.9%, down 77 basis points from six months ago and down 44 basis points from a year ago. The decline is due to a drop in unrealized stock gains. Unrealized gains held by the top 20 banks are just one-third the level reported a year ago; reflecting the 16% decline in the Nikkei Stock Index.

Japanese Bank Condition

Japanese authorities may increase interest rates reflecting concerns about capital outflows due to international interest rate differentials (although Finatt Tokyo does not expect any rate hike until late in the year), ultimately affecting bank profitability. However, economic recovery, of which there are early Spring-like signs of, could take the strain off banks by reducing the decline in asset quality.

Japanese bank premium. The average Japanese bank premium remained relatively stable over the month of March, with strong banks paying a premium of just over 10 basis points for three month dollar funds and weak banks are paying closer to 20 basis points.

Japanese bank stocks. As of April 16, the Topix bank index posted a three-month decline of 24.4%, compared to 9.3% for the overall Topix index. The substantial decline in Japanese bank stocks since late November is attributable to concerns that financial deregulation will adversely affect financial firms and others that benefit from government intervention; falling expectations for Japanese GDP growth in FY 1997; and January's change by Moody's in the ratings outlook for the four weakest banks.

Ongoing/Medium Term Challenges Facing Japan in Managing the Banking Sector Problem

Passage of the financial system stabilization legislation last June by the Japanese Diet succeeded in lowering anxiety about the stability of the banking system by reducing political risk. However, it will take several years of concerted effort by the banks to complete write-offs. The system is still vulnerable to an economic downturn and MOF still has a full agenda ahead:

Ensure the economic recovery remains on track so that problem loans do not increase and ensure that interest rates are kept low so that bank operating profits will remain high. In the first six months of FY 1996, operating profits of the city banks and long term credit banks fell by 36% and 28% respectively, while trust bank operating profits increased by 28% (adjusted for the effect of releasing trust reserves) due to lower funding costs. Profit margins on new loans are very thin, reflecting excess capacity in the banking sector and very modest loan demand.

Orchestrate an orderly increase in bank capital ratios through increases in Tier I capital. The Japanese stock market is not enthusiastic about absorbing the 3 trillion yen in new equity which the banks would like to issue. Japanese insurance companies, experiencing financial difficulties of their own, are not interested in these offerings.

Orchestrate restructuring of several large banks and closing of a large number of smaller institutions. Nippon Credit and Hokkaido Takushoku were the two most pressing problems. The planned implementation of rule-based prompt corrective action procedures in April 1998 will increase the pressure on the weakest banks.

Oversee the disposal of real estate collateral without prompting a further fall in asset prices. It is not clear yet that land prices have bottomed out. Hashimoto has instructed MOF to produce a set of measures to reliquify the real estate market.

Implement measures to improve disclosure and strengthen banking supervision. The measures in the June legislation are being implemented but there are still major problems with transparency and disclosure. It is not clear that the resources of the deposit insurance fund will be sufficient to permit the closure of all insolvent commercial banks, increasing the risks that regulatory forbearance will continue.

Cope with the impact of institutional changes in financial supervision. The ruling parties have agreed that responsibility for banking supervision will be shifted out of MOF (but MOF will retain policy authority), effective April 1998, to a financial inspection and supervision agency reporting to the Prime Minister. The transfer of supervisory responsibility out of MOF is likely to complicate efforts to manage the banking system problems during the transition period. The head of the new agency is not expected to come from MOF.

Cope with the impact of financial sector liberalization (Big Bang) on the banking sector. Big Bang deregulatory measures will expose the banks to stronger competition, posing additional problems for weaker banks over the medium term. The city banks, with their strong retail networks, are in the best position to resist competition from securities firms. The long term credit banks, which specialize in corporate finance and wholesale markets, may face the greatest difficulty maintaining a competitive position (MOF disagrees with this assessment). Several of the trust banks are likely to be purchased by the city banks for their asset management businesses, which may be facilitated by passage of legislation permitting holding companies.

Revise the BOJ law to provide it with greater independence. BOJ reform legislation aimed at making the BOJ more independent from MOF has gone forward to the Diet.

Drafted: GBuckley/IMB
April 23, 1997

THE JAPANESE "BIG BANG"

Overview:

On November 11, 1996, Prime Minister Ryutaro Hashimoto announced that his government will undertake sweeping deregulation of Japan's financial system by 2001. The goal is to make Japan's financial market comparable with those of London and New York by utilizing three principles of "free, fair and global". Specific objectives outlined in the announcement included:

- Greater cross-entry among banking, securities and insurance sectors
- Introduction of new products and services
- Liberalization of commissions
- Expanded use of derivatives
- Relaxation of foreign exchange controls
- Review of asset management regulations
- Internationally consistent accounting standards
- Enhanced disclosure
- Greater penalties for rules violations
- Enhanced global supervisory cooperation

State of Play:

After the announcement, five government advisory councils were tasked with producing recommendations by June 1997 for specific measures that would carry out the Big Bang objectives. The councils are in the process of drafting these recommendations in coordination with one another.

The first action to be undertaken will be the reform of the Foreign Exchange Law, which had already been under consideration prior to the Big Bang announcement. If enacted as proposed, the Forex Law revision will greatly improve the environment for cross-border capital transactions by eliminating the "authorized foreign exchange bank" system and prudential limits on foreign exchange positions. The revision was approved by the Cabinet and submitted to the Diet on March 4, with the changes to be effective April 1, 1998.

The sequencing of the rest of the reforms is as yet unclear, and awaits the final reports of the advisory councils.

Analysis:

The sentiments underlying the Big Bang announcement are laudable, and consistent with what we and others have been saying for years is needed to enhance the competitiveness of Japan's financial markets. There is a widespread sentiment in Japan that the old system doesn't work any more and that a new approach is needed, which creates a more positive climate for reform than in the past. A consensus exists on the need for action of some kind -- for example, to lower the barriers to cross-entry, liberalize brokerage commissions, and abolish forex controls.

However, the GOJ has issued sweeping "action plans" and reform proposals in the past that ultimately failed to be implemented or, where notionally implemented, failed to change the way things are done in practice. Despite the recognition by some high-level MOF officials of the need for liberalization, micromanagement of the financial system remains one of the primary sources of MOF bureaucrats' power and prestige. Moreover, removal of numerous tax impediments will be essential to a successful Big Bang, yet the powerful Tax Bureau has shown little inclination to support tax changes that may benefit the financial system, but would have an adverse impact on revenues. In league with the MOF bureaucrats to preserve the old system are the vested interests who benefit from the current system and the weak institutions who will be adversely affected by increased competition. And as always in Japan, the devil is in the details. Even in the areas in which MOF is likely to take action, it remains to be seen how far these changes will go and what effect they will have in practice.

Incorporated in the Big Bang are a number of tough policy questions that the Japanese will have to face, including the balance between the benefits of deregulation and the danger of systemic instability.

U.S. Interests:

Our interests encompass both the commercial issues and the systemic objectives. On the commercial side, U.S. firms would clearly benefit from greater ability to introduce new products and services, relaxation of foreign exchange controls, deregulation of asset management, and expanded use of derivatives.

In terms of the structural and systemic objectives of the Big Bang, enhanced disclosure and internationally consistent accounting standards are clearly to be applauded. Enhanced global supervisory cooperation, if it goes hand in hand with enhanced domestic prudential and supervisory regulation, is also laudable.

However, there are some areas where the benefits for U.S. firms are less apparent, and/or where the impact is primarily domestic. These include the proposed changes to Article 65 (analogous to U.S. Glass Steagall provisions), and the elimination of the ban on holding companies. While the Japanese might welcome a dialogue on our experience with these issues, specific requests or recommendations might be considered in the same light that the U.S. would entertain foreign opinions on the reform of Glass-Steagall, or our anti-trust laws. Another area where our interests are not clear or may be adversely affected is the liberalization of commissions, insofar as our firms benefit to some extent from the current regulated regime and may be harmed by an uneven and prolonged deregulation process.

Tax reform is another area that we would have to carefully approach. There are several tax issues that have real impact on the commercial prospects of our firms; however, the domestic objectives of tax policy -- notably, "fairness" and revenues -- are likely to carry more weight, and it may be unproductive for us to weigh in on these issues.

FINATT Tokyo/April 23, 1997