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Presents

**Creating Competition in
Japan's Telecommunications Market**

A Japan Information Access Project Working Paper

by

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Creating Competition in Japan's Telecommunications Market

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I. EXECUTIVE SUMMARY

In the current U.S.-Japan telecommunications dispute, the United States can credibly claim that it is promoting the broader interests of Japan, not the narrow interests of American business. American industry will benefit substantially from the liberalization of Japan's \$30 billion telecommunications market, and so will Japanese industry, Japanese consumers, and the Japanese economy as a whole.

The Office of the United States Trade Representative (USTR) announced March 30, 2000 that it would consider taking its case to the World Trade Organization (WTO) if the Japanese government does not make sufficient progress in liberalizing telecommunications markets by July 28, 2000. Specifically, the U.S. wants Japan to reduce Nippon Telegraph and Telephone's (NTT) interconnection charges by 22.5 percent in two years and to demonstrate impartiality in telecommunications regulation.

Japanese opinion leaders recognize that Japan lags substantially behind the United States in the all-important area of information technology, and many business leaders strongly support the U.S. position in favor of bolder telecommunications reform. Lowering access charges would enhance competition, boost demand for Internet and other information services, promote innovation, and substantially contribute to Japan's economic recovery.

The U.S. must reach out to Japanese opinion leaders, industry, and telecommunications users as well as policymakers. In doing so, it will benefit from the new realities of Japanese politics: a ruling coalition vulnerable to challenges from the opposition, a battered bureaucracy with diminished public authority, and newly emboldened opinion leaders demanding fundamental economic reform.

Japanese officials fear that cutting interconnection charges will push NTT East and West into the red, forcing the two companies to lay off workers, abandon universal service provision, reduce investment in telecommunications infrastructure, or raise other telephone charges. In fact, the Japanese government can reduce interconnection charges without such dire consequences by further restructuring NTT, leveraging the benefits of NTT's holding company structure, and increasing government investment in the telecommunications sector.

Japanese politics has transformed from the heyday of U.S.-Japan trade friction in the 1980s. Japanese leaders are now under intense pressure to enact structural economic reforms given Japan's dismal economic performance. The United States should take advantage of the new political context in Japan by targeting public opinion, cultivating political allies, and generating market and political pressures for further reform.

This Working Paper examines the historical, political and competitive context of telecommunications reform in Japan. It provides background analysis on the evolution of these dynamics, both domestically and in its relations with the United States, as well as strategic recommendations for both Japan and the U.S. on soliciting reform outcomes that can bring

increased competition and enhanced consumer opportunities to Japan's telecommunications market.

II. JAPAN'S TELECOMMUNICATIONS REFORM

Background

Japanese telecommunications reform from 1980 through 1995 shared common features with Japanese regulatory reforms in other sectors, and differed strikingly from telecommunications reforms in the United States and Britain over the same period. The Japanese government promoted competition selectively, carefully controlling new market entry and preventing exit. The central ministries retained both policy and regulatory functions, rather than devolving authority to independent regulatory agencies. And the ministries maintained considerable discretion in making regulatory decisions.¹

Within this basic pattern, however, the telecommunications case had its own peculiarities. In particular, the Ministry of Posts and Telecommunications' (MPT) approach to reform was powerfully shaped by its rivalries with the Ministry of International Trade and Industry (MITI) and the Nippon Telegraph and Telephone Public Corporation (NTT). The latter rivalry grew out of postwar bureaucratic restructuring.

After World War II, the Ministry of Communications was divided into a Ministry of Telecommunications and a Ministry of Posts. Then, in 1952, the Ministry of Telecommunications became NTT, a public corporation with a monopoly over domestic telecommunications. The Ministry of Posts became the MPT, with supervisory responsibilities for NTT. NTT rather than MPT emerged as the dominant force in Japanese telecommunications. NTT itself set technical and safety standards for equipment, handled relations with the Diet on telecommunications policy, and controlled the telecommunications R&D system. Meanwhile, MPT only maintained a small Telecommunications Supervision Office, with a staff of 30-40, to oversee the mammoth NTT. The few MPT bureaucrats in this office gradually became frustrated with their lack of authority, and this frustration ultimately motivated their drive for reform.

The Evolution of Reform

The greatest strength of the telecommunications regime born in 1952 was that it facilitated concentrated investment in a unified network. Its weakness was that it lacked the flexibility to satisfy the diverse needs of its users. Over time, the weaknesses became more pronounced as the regime failed to keep up with changes in the marketplace. In 1970, about 100 young MPT bureaucrats organized a set of eight study groups to consider reforms in telecommunications policy. In June 1971, they completed a report recommending the liberalization of value-added service markets and even questioning whether NTT should retain a monopoly at all.

They proposed a "reorganization" of NTT, although they did not directly mention privatization. Even at this early date, these MPT officials saw reform as a way to reinstate MPT in its proper role as the lead agency in telecommunications field. MPT elders all but ignored the report

¹ Steven Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Ithaca: Cornell University Press, 1996).

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because they were not prepared to undertake a reform of such proportions at that time. Nevertheless, the core group of reform-minded bureaucrats held on to their desire for change. When they gather these days, reports one member of the group, they congratulate themselves on the fact that almost all of their recommendations were put into effect—only 15 years after the fact.

Major reform did not become a credible option until the 1980s, when U.S. reform combined with Japan's administrative reform campaign to transform the debate. In 1982, the Second Provisional Council on Administrative Reform (*Rincho*) announced a proposal to allow competition in all sectors of telecommunications services and privatize and “reorganize”—meaning break up—NTT. The Japan Telecommunications Workers Union (*Zendentsu*) officially opposed privatization, but actually was more favorable. Union leaders realized that they could use the opportunity to push for the right to strike, greater flexibility in wages, and higher overall wages.

Two powerful groups related to NTT were more negatively disposed: retired NTT executives and NTT “family” manufacturers. NTT's retired executives or “Old Boys” (*OBs*) were the most virulent in their opposition, because they saw privatization as the undoing of their legacy. They believed that the concentration of money, brains, and technology in a single public monopoly was responsible for the sector's success, and one should not tamper with this formula.

The equipment manufacturers appreciated NTT's role in funding R&D and providing a secure market for their goods. Nonetheless, they hesitated from lobbying too openly, because the American government might see opposition to reform as an effort to keep out imports, and this could threaten the increasingly lucrative business of exporting equipment to the United States.

Within MPT, those involved in the 1971 study group on telecommunications policy strongly favored privatization, seeing this as an opportunity to enhance the Ministry's status. Others feared that a private company might not be devoted to public service, and might not invest sufficiently in infrastructure. Communications Policy Bureau officials eventually took a vote in July 1982, and the proponents of reform won.

Reform Laws of 1984

The Japanese Parliament (Diet) passed three reform laws on December 20, 1984: the Telecommunications Business Law, the NTT Law, and the Background Law for the Telecommunications Law, and these took effect on April 1, 1985. The government then issued the first block of NTT shares in October 1986. The 1985 reforms produced a new telecommunications regime with three primary characteristics.

First, MPT seized power as the dominant force in the sector. Regulatory authority shifted in three fundamental ways: control over the budget and personnel shifted from the Diet to NTT with MPT supervision, responsibility for price and service regulation shifted from the Diet to the MPT, and responsibility for technical regulation shifted from NTT to the MPT.

Second, MPT took up industrial policy. In June 1995, for example, MPT announced plans to bolster its ability to finance the telecommunications infrastructure. Among other measures, the

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Ministry proposed using the proceeds from NTT privatization to make low-interest loans to telecommunications and cable television operators.

Third, MPT adopted an unusually interventionist approach toward managing competition. It orchestrated the entry of new competitors into each market segment, and micro-managed the competition between NTT and these new competitors by evaluating every price or service change in terms of its potential impact on the competitive balance.

According to the NTT Law, the question of NTT's breakup was to be reviewed in five years. When time for the review arrived in 1990, MPT came out in favor of breakup, while MITI, NTT and the NTT union all opposed. MITI officials claimed their MPT neighbors were only in favor of breakup because they wanted to wreak further revenge upon NTT. MPT officials countered that MITI was only opposed because MPT was in favor. The Ministry of Finance (MoF) proved to be the decisive force in this debate. MoF strongly opposed breakup for fear it could threaten the share price of NTT stock, two-thirds of which the government still owned.

NTT's status was then due for a second review in 1995. As with the first review, MPT and NTT engaged in a full-fledged political battle, although MoF stayed on the sidelines this time. In March 1996, after much wrangling, Prime Minister Ryutaro Hashimoto postponed the decision for another year, safely beyond the upcoming general elections (eventually held in October 1996).

In their election effort, Hashimoto and his colleagues hoped to enlist the financial support of NTT "family" equipment manufacturers, who strongly opposed the break-up as well as the electoral support of the NTT unions, who were equally opposed. The unions were a critical support group for the Liberal Democratic Party's (LDP) major coalition partner, the Social Democratic Party of Japan (SDPJ), and Hashimoto hoped to pull some union support to the LDP as well.

Over the summer of 1996, MPT and NTT began to consider a creative compromise. Independently of the NTT breakup issue, the government had begun to consider lifting the ban on holding companies. This presented a new option: "break up" NTT in form but maintain unified ownership through a holding company structure.

By late 1996, Prime Minister Hashimoto and top LDP leaders were increasingly interested - in NTT being allowed into the international telephone service market. MPT had not been particularly eager to allow NTT into this market, because the Ministry sought to promote competition in the domestic market first. It worried that NTT would quickly decimate KDD (Japan's long distance carrier) and the new international carriers. Prime Minister Hashimoto was more concerned that Japan needed to have a national champion in the international market, and NTT was the only company with the resources to fulfill that role.

MPT hammered out a deal whereby NTT could enter the international telephone market, but would be divided into three companies: one company for long-distance and international services, and two regional companies, within a holding company structure. This would force

NTT to separate its accounts, and might promote greater competition in local and long-distance markets, but fell short of MPT's original goals.

III. U.S.-JAPAN TALKS

Focus of the Talks

The U.S. government did not play any role in the privatization and break-up of NTT. The focus, was to work actively on reforms in specific areas related to market access for U.S. firms. Washington was more interested in broader issues of competition-enhancing policies. Specifically, the U.S. was focused on increasing market access for foreign companies in Japan as proposed through a range of trade discussions since the 1970s²

The most recent discussions under the "Framework Agreement" and the "Enhanced Initiative" addressed structural reform and sectoral issues of regulatory and administrative reform to help foreign companies as well as Japanese consumers. For the telecommunications sector, these included NTT procurement policies and the liberalization of the cellular telephone market. In fact, an example of the success of the Framework Agreement was the American Chamber of Commerce in Japan (ACCJ) rating the 1994 cellular telephone agreement as one of the most successful U.S.-Japan trade pacts since 1980, rating a 10 on a scale of one to ten.³

In the current round of negotiations, the U.S. government has focused on NTT interconnection charges, the fees that other service providers pay to connect to NTT's local network. Washington contends that NTT sets these charges at rates from 2 to 10 times higher than NTT's counterparts in other countries, impeding Japanese and U.S. service providers from competing with NTT.

High interconnection rates not only cut into competitors' profits and make it harder for them to match NTT prices, but they make it virtually impossible to challenge NTT's near-monopoly in local service. This in turns means that NTT can leverage the benefits of cross-subsidization: using local service profits to finance cuts in long distance and Internet charges. MPT has committed to lowering NTT's interconnection access charges, but disagrees with the United States over technical issues regarding the calculation of these charges and the pace of their reduction.

In May 1998, the two countries issued a joint statement under the *Enhanced Initiative on Deregulation and Competition Policy* whereby Japan agreed to switch to a Long-Run Incremental Cost (LRIC) model for calculating interconnection rates by this year. Japan had been using a historical cost model, in which NTT included the past cost of building up its telecommunications infrastructure. Under the new model, which is common in most other industrialized countries, it would calculate these charges solely on the basis of future expected investment costs.

² For full text of these agreements see the homepage of the U.S. Trade Representative: <http://www.ustr.gov>

³ *Making Trade Talks Work: Lessons From Recent History. A summary and evaluation of trade agreements between the United States and Japan from 1980 to 1996*, Tokyo: The American Chamber of Commerce in Japan, 1997, 29.

A Flawed Model?

The Japanese government has developed an LRIC model in compliance with the 1998 agreement, but the U.S. side contends that the model is seriously flawed. Specifically, the USTR argues that the Japanese model includes costs that should not be incorporated in interconnection charges.⁴ MPT thus proposed reducing interconnection charges by 22 percent over four years, whereas the USTR demanded a 40-50 percent reduction over two years. MPT claims that it cannot accelerate the reduction because this would push NTT East and West into the red, forcing them to lay off workers and possibly even abandon their commitment to providing universal service. The Ministry suggests that this is not simply a problem for NTT, but for telecommunications users, because NTT would have to raise some telecommunications charges in response.

The American side counters that it is inappropriate for the Japanese regulator to base its decisions on the business conditions of the dominant carrier rather than on objective criteria. The U.S. side would like to see Japan implement administrative reforms and policy changes to ensure impartial regulation.

In the course of current negotiations, the two sides presented compromise positions but ultimately failed to reach agreement. The U.S. government suggested that Japan could cut interconnection by 22.5 percent over two years, rather than 40-50 percent, then moving to deeper cuts after that. The Japanese government offered to front-load substantial cuts in the first year, but stuck to its framework of 22.5 percent cuts over four years.

IV. U.S.-JAPAN TRADE DYNAMICS

High Ground?

Within the present (2000) negotiations, the two sides played a subtle game of seeking the "high ground." Which was really representing the Japanese consumer? To its credit, the U.S. government made a greater effort to cultivate domestic Japanese allies than it has in the past, arguing that lowering interconnection charges is essential to promote competition in telecommunications markets and propel Japan's information technology (IT) revolution.⁵

Meanwhile, the Japanese side tried to separate the American trade agenda from other issues, stressing that a reduction in interconnection charges would not directly affect Internet access charges, which many feel are critical in spurring growth in Internet-related businesses. Lower interconnection fees would bring down prices in long-distance and international service, it argued, but not in the local charges that are most important for Internet users.

In the short term, of course, the Japanese side has a point in that lower interconnection charges do not directly lead to lower Internet access fees. In the longer term, however, lower

⁴ *United States Comments on MPT Study Group LRIC Model for Interconnection* (March 3, 2000): <http://www.ustr.gov/new/dftcmnt.html>.

⁵ *Submission By the Government of the United States to the Government of Japan Regarding Deregulation, Competition Policy, and Transparency and other Government Practices in Japan* (October 6, 1999), <http://www.ustr.gov/reports/99subml.html>.

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interconnection fees are critical in reducing NTT's ability to cross-subsidize and otherwise promoting competition throughout telecommunications markets.

A Masterful Move

In the process, the Japanese side played masterfully one card, with NTT dramatically lowering its Internet access fees. In February 2000, NTT cut rates for subscribers with ISDN service from ¥8000 to ¥4500 per month (and ¥2900 for certain users) in Tokyo and Osaka, and pledged to extend this rate to other areas as well. This demonstrated that NTT could bring down Internet access rates without a change in interconnection fees. It also put the United States in an awkward position because NTT Internet access rate cuts actually make it harder for American service providers to compete in Japan. The U.S. government was not in a position, however, to protest a measure which helps Japanese users and appears consistent with the deregulatory trend.

To further complicate matters, both sides are bound by election-year politics. The Clinton Administration hopes to demonstrate progress in the trade arena, and has targeted telecommunications talks with Japan as one area in which it might be able to deliver results. Japanese political leaders are reluctant to offer concessions to the United States prior to the Lower House elections on June 25, 2000.

Telecommunications policy specialists in the LDP's Communications Tribe (*tsushin zoku*) are committed to protecting the interests of NTT, its powerful union, and the NTT "family" equipment suppliers. A large group of LDP Diet members have forged a broader anti-deregulation caucus to appeal to constituent groups opposed to reform, including small businesses, construction firms, and farmers.

V. THE JAPANESE POLITICAL CONTEXT

Over the longer term, however, Japanese domestic political conditions are growing more favorable to telecommunications liberalization. The prolonged economic crisis combined with a series of political and bureaucratic scandals have challenged the authority of the ruling party and the bureaucracy, prompting calls for bold reform.

Japanese officials are not naturally inclined to view economic liberalization as the answer to the economic crisis. The failure of other measures, the apparent success of the U.S. model, and a newfound sensitivity to the views of foreign investors, however have made them more receptive to liberal reforms. Political and business leaders recognize that they lag substantially behind the United States in information technology development and use. Rapid growth in this sector is viewed as maybe the best hope for sustained economic recovery.

Liberalization Over the Long Run

Japan now has a powerful constituency behind telecommunications liberalization. These include: the Federation of Economic Organizations (Keidanren) and other large business groups; existing and potential NTT competitors, including many new Internet firms; business leaders in related fields, such as computers and electronics; journalists, economists, and other opinion leaders; corporate telecommunications users; and some household consumers.

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Even MPT is committed to liberalization over the long run. As noted above, for many years MPT aggressively promoted telecommunications competition, including the break-up of NTT. MPT officials have only slowed the pace since the break-up settlement, probably for two reasons. First, having broken up NTT, they now feel some responsibility to make sure that NTT East and West survive.

In fact, some analysts suspect that the MPT may have pledged to keep the two companies profitable for at least three years, and this might explain why it is so reluctant to lower rates in a shorter time frame. Second, they have come to accept the reality of NTT's political clout, so clearly manifested in the breakup settlement. The MPT is now playing a classic role for a ministry in Japanese politics: that of a political intermediary between competing interests. In the Ministry's view, then, it has offered the best deal that it could, given domestic political realities.

The foreign pressure (*gaiatsu*) game now hinges on precisely this point: can the United States get Japan to suspend its normal political balance, and tilt a bit further toward reform? In the case of telecommunications reform, the above factors suggest that the answer is yes. The remaining questions are: How far? How soon? And most important, how?

VI. RECOMMENDATIONS FOR JAPAN

For the benefit of Japan's IT sector and the country's economic recovery more broadly, Japan should reduce interconnection rates as quickly and as deeply as possible. Japanese authorities do have legitimate concerns in three areas: a deterioration in NTT East and West's finances; the possibility of negative side effects, including price hikes; and a weakening of NTT's ability to invest in infrastructure expansion and otherwise fulfill its industrial policy function. Fortunately, these problems can be alleviated in two ways.

1. **Restructure NTT.** As part of the NTT breakup settlement, NTT transformed into a holding company with separate companies for the two regional operating areas (East and West) and a long-distance company. The authorities are concerned that reducing interconnection charges will put NTT East and West (especially West) into the red.

Closer examination shows that part of the problem stems directly from the way in which NTT was dismantled. That is, NTT had some leeway in how to allocate assets and functions between the regional operating companies and the long-distance company, but it chose to distribute these in ways that increased the cost structure for the regional companies and decreased it for the long-distance company. The holding company could redistribute these costs to alleviate cost pressure on the regional companies, and ease the employment problem by enhancing efforts to reallocate workers from declining to expanding business units.

The Japanese government is already working on one possible solution: allowing NTT East and West to enter the mobile phone business and to differentiate local calling rates across geographical areas (depending on the actual costs of providing service in these areas). This would improve the operating company's profitability, making it easier for them to survive deep cuts in interconnection charges. Unfortunately, the government will not be able to package such

a deal very quickly, because this would require elaborate political negotiations as well as further revisions to the telecommunications laws.⁶

2. **Shift NTT's industrial policy functions to the government.** During the course of the breakup debate, NTT and its supporters argued that dismantling NTT would prevent it from playing its traditional public interest role of providing universal service, investing in R&D, and building up an advanced infrastructure. MPT hoped for a simple solution to this problem whereby the Ministry would gradually take over this function, increasing its budget in the process.

The Ministry's ambitions faltered in the face of financial reality. NTT had simply much deeper pockets. Over the long term, however, the government should assume this role of supporting IT development. The government's ongoing effort to stimulate the Japanese economy offers an opportunity to invest in Japan's telecommunications infrastructure.

Economists argue that Japan's fiscal stimulus packages have been poorly designed. They tend to rely too much on spending increases and too little on tax cuts. The packages target spending on declining sectors where they will not have the desired effect rather than expanding sectors such as telecommunications. Japan should redesign remaining spending programs to target growth in the IT sector.

VII. RECOMMENDATIONS FOR THE UNITED STATES

The U.S. government should continue to press the Japanese government to further liberalize telecommunications markets, bearing in mind the following basic guidelines.

1. **Appeal to the Japanese public.** The U.S. government can substantially strengthen its case by convincing the Japanese public that telecommunications reform serves Japan's own interest. Specifically:

- A) Use *Naiatsu* not *Gaiatsu*. In the past, the United States relied on intense *gaiatsu*, or "outside pressure," to resolve trade disputes with Japan. Today, cooperation with forces within Japan, or *naiatsu*, promises greater results.
- B) The U.S. government should take the "high road" and stress broader measures that benefit Japan as a whole more than specific measures designed to benefit American producers.
- C) Washington should capitalize on the current Japanese deregulation campaign, encouraging Japan to move forward with deregulation in those areas that would promote U.S. interests most substantially. For example, where appropriate, the U.S. government can point out how existing regulations that restrict U.S. companies' access to the Japanese market are also inconsistent with the Japanese government's own deregulation program.
- D) Washington should maintain internal consistency as much as possible. The Japanese media has a field day every time an American firm or an U.S. government official advocates a position that appears to increase regulation or government control—even

⁶ *Nihon Keizai Shimbun* (April 21, 2000), p. 5.

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if there is actually a valid rationale for it. In these cases, the U.S. government should consider whether the specific demand justifies undermining U.S. credibility more broadly. For example, the U.S. government was wise not to protest NTT's cuts in Internet connection fees, even though one could argue that these cuts reflect unfair cross-subsidization.

- E) The United States should stress good public relations: cooperating with liberal opinion leaders, including journalists, economists, and various experts.

2. **Target specific Japanese allies.** Beyond these opinion leaders, the U.S. government should work closely with three groups of allies.⁷

- A) **Business leaders.** Keidanren, which represents many large telecommunications users, has endorsed bold liberalization.⁸ Prominent leaders in computing and electronics, Internet service companies, and the multitude of potential entrants into telecommunications markets support the U.S. position.
- B) **Opposition Diet members.** Among the opposition parties, Ichiro Ozawa's Liberal Party has taken the strongest stand in favor of liberalization. Unfortunately, the party split on April 1, with half of the party joining the ruling coalition as the new Conservative Party (*Hoshuto*). Even so, Ozawa remains a major figure in Japanese politics, and he could be an important ally in challenging the government's position. The Democratic Party (*Minshuto*) relies on support from NTT unions, so it is much less favorable toward liberalization, but individual party members could break rank on this issue. In any case, the debate over financial reform demonstrated that the opposition parties can push the LDP further toward liberal reform than it would otherwise go. They could play a similar role in telecommunications as well.
- C) **MPT itself.** This may seem counter-intuitive, for MPT has strenuously opposed the U.S. position in recent bilateral talks. But given the history outlined above, the Ministry remains committed to promoting competition over the long run. Some within the Ministry would undoubtedly prefer to move forward more aggressively. Thus, the U.S. government should continue to try to work with the MPT, not against it, and to cultivate allies within the ministry.

3. **Strengthen the American voice within the Japanese policy process.** The MPT has already improved the access of U.S. officials and companies to the Japanese regulatory decision-making process. The U.S. government should encourage further steps toward greater openness and transparency in the regulatory process, and press for better representation in Japanese industry associations, ministerial working groups and advisory councils, and government-wide deregulation policy councils where appropriate. It should have the opportunity to comment not only on broader policy issues, but also on technical standards, protocols, etc.

⁷ For a more in-depth look at possible U.S. strategies to forge alliances within Japan, see Leonard Schoppa, *Bargaining With Japan: What American Pressure Can and Cannot Do* (New York: Columbia University Press, 1997).

⁸ *IT kakumei suishin ni muketa joho tsushin hosei no saikosaku ni kansuru daiichiji teigen* [Primary Proposal on the Reform of the Telecommunications Laws to Promote the IT Revolution] (March 28, 2000): <http://www.keidanren.or.jp/japanese/policy/2000/012/index.html>.

4. **Employ “the 1-2 punch”: reform measures that beget further reforms.** The U.S. government should target liberalization measures that will improve the prospects for further reform by unleashing new market forces, shifting political dynamics, or altering public attitudes. Lowering interconnection rates this year will generate further pressure for reform because it will bring new entrants into the market and foster products and services that pose new challenges to the existing regulatory regime. It will also strengthen the political coalition for liberalization by bringing in new market entrants, and it may help make consumers more aware of the benefits from reform. Furthermore, in one year's time, the United States will be able to argue that NTT was in fact able to lower interconnection charges without the dire consequences predicted by opponents. In any case, technological change in this sector is likely to be so profound that discussion of interconnection 3-4 years down the line becomes much less important than maximizing progress this year.

In Sum, given these circumstances, the U.S. government should strive for an agreement that brings the deepest cuts possible in interconnection rates for this year, and defer negotiation on longer-term cuts for another year. Ideally, Japan would accept a 22.5 percent cut this year, but the United States may have to settle for something less than that. A year from now, it is very likely that the political and market context may have changed so much that Japanese authorities can and will make further cuts with or without pressure from the United States. The U.S. side gains some leverage by wielding the WTO threat at this point, but actually referring the case to the WTO can not help much because a dispute resolution panel could deliberate for a year or more.

For once Washington has many allies in Tokyo. This is an opportunity that should not be lost.

VIII. ABOUT THE AUTHOR

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IX. APPENDIX

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