Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States

Detailed Program Schedule

Friday, July 17, 1998

6:30 - 7:15	Cocktail Reception in Garden Terrace and Main Dining Room
7:15	Greetings by Robin Radin, Hal Scott and Koji Tsuruoka
	Dinner in Main Dining Room
9:00	Keynote Address: Mr. Lawrence Summers, Deputy Secretary, U.S. Department of the Treasury
9:30 - 10:00	*Meeting of Facilitators and Reporters in the Cape Villa*

Saturday, July 18, 1998

7:00 - 8:00	*Optional Breakfast Meeting for Facilitators in Main Dining Room (tables reserved)*
7:00 - 8:30	Breakfast in Main Dining Room
8:30 - 8:40	Welcome & Opening Remarks: Professor Hal S. Scott and Mr. Makoto Katsura in Pavilion Room
8:40 - 8:50	**Session I: Japan′s Big Bang in Pavilion Room**
	U.S. Panelist: Arthur Mitchell III - Chadbourne & Parke LLP
	Japanese Panelist: Yuji Tsushima - Member of the House of Representatives
8:55 - 10:30	Small Group Sessions 1-5 in Cape Villa Rooms and adjacent lawn (5 minute walk from Pavilion Room)
	Group 1 Facilitators: Tom Cargill & Mitsuhiro Fukao — Reporter: Curtis Milhaupt Group 2 Facilitators: Kunio Hamada & Henry Laurence — Reporter: Mark Ramseyer Group 3 Facilitators: Masahiro Kawai & Robin Radin — Reporter: William Rapp Group 4 Facilitators: Yasuharu Nagashima & Hal Scott — Reporter: Brandon Becker Group 5 Facilitators: Tadashi Iwashita & Phil Wellons — Reporter: David Sneider
10:30 - 11:00	Refreshment Break at Pavilion Room
11:00 - 11:10	**Session II: The Asian Financial Crisis in Pavilion Room**
	U.S. Panelist: Martin Feldstein - Harvard University Economics Department
	Japanese Panelist: Toyoo Gyohten - President, Institute for International Monetary Affairs
11:15 - 12:30	Small Group Sessions 1-5 in Cape Villa rooms and adjacent lawn
	Group 1 Facilitators: Tom Cargill & Akinari Horii — Reporter: David Sneider Group 2 Facilitators: Takatoshi Ito & Hal Scott — Reporter: Curtis Milhaupt Group 3 Facilitators: Phil Wellons & Masaru Yoshitomi — Reporter: Mark Ramseyer Group 4 Facilitators: Seiichi Kondo & Henry Laurence — Reporter: William Rapp Group 5 Facilitators: Akira Kojima & Robin Radin — Reporter: Brandon Becker
12:45 - 2:00	Lunch at Outer Bar
	Keynote Address: Mr. Eisuke Sakakibara, Vice Minister of Finance for International Affairs, Ministry of Finance
2:00 - 2:10	**Session III: International Financial Regulation in Pavilion Room**
	U.S. Panelist: Hal Scott - Harvard Law School

	Japanese Panelist: Toru Kusukawa - Chairman of the Board of Counselors, Fuji Research Institute Corporation
2:15 - 3:30	Small Group Sessions 1-5 in Cape Villa rooms and adjacent lawn
	Group 1 Facilitators: Tom Cargill & Naoki Tabata — Reporter: Brandon Becker Group 2 Facilitators: Akira Ariyoshi & Henry Laurence — Reporter: David Sneider Group 3 Facilitators: Toyoo Gyohten & Robin Radin — Reporter: Curtis Milhaupt Group 4 Facilitators: Toru Kusukawa & Hal Scott — Reporter: Mark Ramseyer Group 5 Facilitators: Mikio Wakatsuki & Phil Wellons — Reporter: William Rapp
3:30 - 7:00	**FREE**
3:30 - 4:30	*Meeting of Reporters at Cape Villa Room*
7:00 - 7:30	Cocktail Reception in Lounge and Verandas
7:30	New England Clambake in Main Dining Room Hosted by Mr. Shinichi Kitajima, Consul-General of Japan, Boston

Sunday, July 19, 1998

7:00 - 9:00	Breakfast in Main Dining Room
7:30 - 9:00	*Breakfast Meeting of Discussion Chairmen and Steering Committee in Main Dining Room (table reserved)*
9:00 - 9:40	**Presentation and Discussion of the Asian Financial Crisis in Pavilion Room**
	U.S. Chair: Kent Calder - Special Assistant to the Ambassador, United States Embassy, Tokyo
	Japanese Chair: Yasuhisa Shiozaki - State Secretary of Finance, Member of the House of Counselors
	Reporter: Phil Wellons - Harvard Law School
9:40 - 10:20	**Presentation and Discussion of International Financial Regulation in Pavilion Room**
	U.S. Chair: Marshall Carter - Chairman & Chief Executive Officer, State Street Corporation
	Japanese Chair: Mikio Wakatsuki - Chairman of the Board of Counselors, The Japan
	Research Institute, Ltd.
	Reporter: Hal Scott - Harvard Law School
10:20 - 10:50	Refreshment Break at Pavilion Room
10:50 - 11:30	**Presentation and Discussion of Japan=s Big Bang in Pavilion Room**
	U.S. Chair: Thierry Porté - President, Morgan Stanley Japan Ltd.
	Japanese Chair: Masahiro Kawai - Chief Economist and PREM Manager, East Asia and the Pacific Region, The World Bank
	Reporter: Robin Radin - Harvard Law School
11:30 - 12:00	**Future of U.S.-Japan Dialogue on Financial System Issues in Pavilion Room**
12:30	Lunch in Outer Bar
	Departure

A Report on the Symposium for Building the Financial System of the 21st Century
An Agenda for Japan and the United States

The Symposium was held from the evening of Friday, July 17 to noon on July 19, 1998 at the Wequassett Inn in Chatham, Massachusetts on Cape Cod. It was organized by the Harvard Law School Program on International Financial Systems and the Japan Institute of International Affairs. It came at a crucial time since the Asian financial crisis, affecting most notably Indonesia, Thailand and South Korea, was still ongoing. And the Japanese financial system was in a prolonged and severe crisis that was deeply affecting the Japanese economy, was contributing to the more general Asian situation, and threatened to affect the United States. Former Prime Minister Hashimoto had resigned and his successor, now Prime Minister Obuchi, had yet to be chosen.

The Symposium brought together more than 100 senior government policy makers, academics, legal experts and bankers to discuss three issues: (1) Japan's Big Bang, which included the general reforms of the financial system as well as devising solutions to the banking system crisis; (2) the role of the US and Japan in dealing with the Asian financial crisis; and (3) whether there was a need for international financial regulation. The complete list of participants and contact information is in Annex I. There were two off the record keynote addresses, one by United States Deputy Treasury Secretary Lawrence Summers, and the other by Eisuke Sakakibara, Japan's Vice Minister of Finance for International Affairs.

On Saturday, the three issues were discussed in five small group sessions after agenda setting introductions by one panelist from each country. Each small group session was led by a U.S. and Japanese facilitator, and one of the participants served as a reporter. The results of these discussions were presented to the Plenary Session on Sunday. The results were commented on by panelists and then considered by the group as a whole. The complete agenda for the Symposium, including the names of the various panelists, facilitators and reporters, is in Annex II. Three papers, in Annex III, were specially prepared for background discussion: (1) Shinsaku Iwahara and Curtis J. Milhaupt, *The Big Bang and Orderly Market Exit for Insolvent Financial Institutions*, (2) Robin Radin, *Japan's Big Bang in Historical Perspective*, and (3) Hal S. Scott, *International Financial Regulation.* In addition, a number of concept papers were prepared by participants. See Annex IV.

This Report discusses the conclusions reached in the small group sessions on Saturday and the discussion of those issues in the Plenary Session.

1. The Asian Contagion

Small Group Discussions

The Asian Contagion refers to the financial crisis engulfing many countries in Asia. In the discussion groups five significant issues were considered. The first issue was what caused the crisis. According to many of the participants, the crisis had no single cause. Indeed, there was not a single crisis but a different one for each of the countries (notably Indonesia, Korea, Malaysia, the Philippines, and Thailand).

Participants did not agree about whether the crisis was primarily of banking or currency markets. As to the role of Japan in events leading up to the crisis, participants recognized that the fall of the yen against the dollar had a profound effect on Japan's neighbors, since suddenly their currencies strengthened against the yen and their exports to Japan became less competitive. But participants also contended that the neighbors made a fundamental policy mistake in pegging their currencies to the U.S. dollar. Had Asian countries been willing to let their currencies fall against the dollar, they would not have encountered price competition problems in Japanese markets.

The role of the IMF was a lightening rod for debate. Many participants argued that the early structural policies required by the IMF fomented panic within the countries. For example, forced closings of some banks prompted people to believe that all banks were at risk, leading to bank runs. This pushed the countries toward economic crisis, which might have been avoided with different IMF policies. Many participants said that the IMF's requirement of tight macroeconomic policies led to higher interest rates, which in turn hurt highly leveraged domestic companies. A further criticism was that the IMF misled markets by letting countries carry out policies that suggested strong performance. For example, the IMF allowed Thailand to maintain an overvalued baht in early 1997, which sent the wrong signals to financial markets. But other participants asked how market players could not have done the economic analysis themselves, which would have allowed them to conclude that the baht was overvalued. Why rely on the IMF? This risk analysis is, after all, a function of the market. Finally, participants debated the question of whether the IMF created moral hazard problems because of its support for countries that bail out their foreign creditors. Indeed, some questioned whether there was over lending to Asia as a result of the Mexican bailout a few years earlier.

A second set of issues related to prevention. How could the crisis have been prevented? What were the one or two most important things that could have been done in the early 1990s to avoid the crisis? Many possible areas for possible action were identified: better macroeconomic policy, different foreign exchange regimes, reducing domestic investment as a share of GDP and changing financial policies, supervision or structures in the Asian countries.

Solutions to the crisis came under scrutiny by the participants. IMF solutions were criticized as often being short-term when longer term solutions were required. In an objective spirit, however, some participants pointed out that the IMF did change its policies. After it became clear that economic contraction was not working, the IMF urged expansion instead. For the future, some participants urged disclosure of how countries used IMF funds, since those uses are not clear now.

Several other important aspects of the efforts to solve the crises were explored by participants. Domestic political change seems to be critical. It preceded, and actually led to, essential structural change in the countries that started to recover, notably Korea, the Philippines, and Thailand, but an inflexible political regime in Indonesia prevented structural change that was needed to resolve the crisis. U.S. markets played a key but potentially unstable role in the solutions to the crisis. Suppose Asian countries want their GDP to grow 8% each year and the U.S. grows only 2% each year. Then the Asian countries' exporters are competing for market share in the U.S. This could provoke a backlash in the U.S., with serious consequences for the world economy.

Participants had little to say about coordination of macroeconomic policy between the United States and Japan. They did observe that markets want stability more than continued downward floats of the yen against the dollar. Some suggested that an acceptable rate would be between ¥120 and ¥125 to the dollar. Opportunities for action by the international private sector were raised, as participants suggested that U.S. firms, Japanese firms, and Japanese banks could return to Asia.

Some participants, considering ways to prevent crises in the future, argued that currency crises might be inevitable since they were built into prevailing foreign exchange regimes operating in global markets. This did not seem to mean that the current level of volatility was inevitable, however, and participants were willing to consider ways to prevent at least extreme volatility in the future.

Three types of action could mitigate or prevent future crises: structural change, regulation, and concerted action by multilaterals. As capital markets grow in relative importance, through the use of securitization for example, the threat of systemic risk through banks should fall in relative importance. Better regulation should take the form of increased disclosure, improved supervision, and a lessening of official interventions that create moral hazard, both by the U.S. treasury and others. For multilaterals, participants seemed willing to revisit the notion of an Asian fund that could co-exist with the IMF, provided the two entities could coordinate their activities and enforce similar conditions. Other participants, however, argued that multilaterals are history, creatures of the past that are now outdated by the markets. Most participants did condemn one proposal, the idea that countries should limit short term capital flows under some circumstances. This, in the general view, would be most inappropriate.

Plenary Session

A major focus of discussion was the importance of Japan's crisis to the more general Asian crisis. There was concern as to whether Japan could act fast enough to solve its problems in order to improve the Asian situation. Three problems, with uncertain solutions, were greatly contributing to the problem: (1) domestic instability in Indonesia and political questions in China; (2) the question of the relationship between the Yen-renminbi exchange rate; and (3) the worsening Japanese economy.

Some stressed that Japan should not be blamed for the Asian crisis. They contended that the Japanese economy had been growing until 1997, and that the Asian crisis preceded the period of negative growth. Further, once the crisis started, the Japanese gave more bilateral assistance to Asia than the United States.

One participant pointed out that there could be a U.S. backlash of protectionism in response to the ever growing current account deficit with Japan. If Japan uses the Asian market as an engine of growth at the expense of the United States, this could cause political problems in the U.S., particularly if the U.S. economy were to take a downward trend. On the other hand, it was contended that the U.S. has the strongest economy and a strong dollar, which inevitably leads to greater imports and higher current account deficits.

With respect to the IMF, there was some comment that the IMF had been too tight in its prescriptions for fiscal austerity and higher interest rates, but others disagreed. The point was made that the IMF is controlled by the G-7, so that any blame of IMF action must ultimately go to the G-7.

2. International Financial Regulation

Small Group Discussions

A major topic for discussion was whether international standards for financial regulation were desirable, with the recognition that what were said to be “international” standards were usually U.S. standards. Participants believed standards for disclosure, accounting and bankruptcy needed harmonization, given the global economy. Increasingly securities are distributed on a global basis necessitating common disclosure standards. International accounting standards were seen as an important part of such common disclosure. Common bankruptcy standards would facilitate evaluation of and reduce credit risk and avoid conflicts arising from the bankruptcy of multinational firms.

There was more skepticism as to whether there could be common prudential standards for banking regulation given cultural and regional differences. Further, there was substantial criticism of the efficacy of the capital standards of the Bank for International Settlements. Doubt was expressed as to the ability of regulators to determine how much capital was needed for various type of credit or market risks. It was argued that the BIS had itself backed off of mandatory standards by allowing banks to use their own models to assess risk and determine needed levels of capital.

U.S. Treasury Secretary Rubin has been advocating more reliance on markets than mandatory regulation. His thrust has been to make sure that adequate information is available in the markets to assess the strength of financial institutions. Some believed that while this might work for securities firms, it was not enough for banks, whose failure could trigger large depositor losses and a chain reaction of bank bankruptcies (systemic risk). They noted that the U.S. had high disclosure standards <u>and</u> strong regulation, and that these two approaches had to work together.

Some doubt was expressed as to whether the IMF, or any other multilateral institution, should be playing the role of international lender of last resort. Some pointed out that the IMF has seemed to assume this role at least with respect to countries, and that IMF policies assuring full repayment of foreign debt had the effect of protecting foreign banks from losses.

There was a strong consensus that international organizations, like the IMF or BIS, could not and should not be entrusted with the enforcement of international standards—instead this must be left to domestic enforcement systems and markets. However, international auditing firms and rating agencies might play a useful role in alerting domestic officials to cases in which local financial firms failed to meet international standards.

Plenary Session

While there was skepticism of international standards, there was also suspicion as to whether we could really rely on markets to discipline firms. One participant pointed out that it was increasingly difficult and highly inefficient for multinational firms to operate efficiently in many countries subject to multiple standards. Yet, the problem remained as to whether the IMF or BIS could really promulgate standards that made sense for 182 countries.

There was more criticism of the BIS capital standards. U.S. banks were said to comply with them because they were compelled to do so, but used different standards when it came to providing capital for their own measurement of their risks. It was argued that we need to move to an incentive system and away from a rigid code. This would mean that banks that were able to successfully estimate their risks and needed capital would be free to do so.

One participant defended the BIS approach, pointing out that the 8% standard was necessary as some control over banks' simply ignoring their credit risks and not providing enough capital. This was particularly true of banks in Korea, Thailand and Indonesia, and contributed to the Asian crisis. In this view, the BIS standard was "the only thing we have." While VAR models can work for market value risk in securities markets, where there is a lot of data and a long history of prices, this was not available for banks, and certainly not on a consolidated basis.

The conclusion from the small group discussions, that markets versus regulation was a false dichotomy, was supported in the plenary session. The U.S. has had the strongest markets and the strongest regulation. A Japanese commentator believed that U.S. regulation was good, and had been imported into Japan, but that it was very difficult to implement those regulations without the benefit of the U.S. legal infrastructure. While people detested lawyers and litigation, this was the only way to make sure the rules were enforced. Japan needed a better court system and more lawyers to insure enforcement.

As for the role of the IMF as international lender of last resort, it was argued by some that while the United States and Japan have the financial resource to act as lender of last resort, they cannot do so individually or in concert, and need to work through the IMF. The IMF should only, however, be the lender of last resort to countries rather than banks.

It was agreed that enforcement of rules had to be done by domestic authorities, although the BIS could set standards through its Core Principles and the IMF could monitor, but not enforce, compliance with these standards. The international community could pressure domestic authorities to enforce international standards.

3. Japan's Big Bang

Small Group Discussions

The first major topic of discussion was the **social impact of financial system change**. Some participants pointed out that financial deregulation and internationalization, and the accompanying shake out in Japan's financial industry, involved a painful historical transition. In this new environment, the forces of the global marketplace were operating, without the array of legal, political and bureaucratic constraints that had previously mediated their impact. These changes, it was argued, were undermining the established mechanisms of bank centered capital allocation, employment security, corporate governance and business and political dependency alliances that had, with much success, prevailed at the core of the economy in the financial system and in the broader society and economy for over 50 years.

Some participants expressed concern about the need to manage the transition in a way that would limit unnecessary social and economic dislocation. Bridge banks, it was noted, might serve such purposes by cushioning the impact of bank failures on dependent borrowers, or by facilitating the reorganization or takeover of viable banks. Others cautioned that the cost of providing a soft landing for otherwise unsustainable banks and bankers might jeopardize the expectations and requirements of an aging society and the prospects of generating new sources of sustainable economic growth.

Views were also expressed on how structural changes in the financial system and in the broader economy created an inherent conflict between the "global way" and what was called the "Japanese way". While generally acknowledging the necessity of building a "free, fair and global" financial marketplace in Japan, as promised in the Big Bang plan, some participants expressed a nostalgia for the old ways of Japanese business culture, which had worked successfully in the past, and a desire to try to innovate an internationally competitive financial system that would also preserve distinctive Japanese characteristics. Although no participant attempted to explain how such a system would be constructed or operate, the sentiments reflected a concern with moving forward in a way that would not damage the social fabric of the country.

The second major topic discussed involved the **dilemmas of sequencing economic reform** initiatives, specifically: (a) the further implementation of financial deregulation and internationalization, (b) dealing with the burden of bad debt affecting both failing and viable banks, and (c) macro-economic stimulus measures. While there was little disagreement over the immediate need to resolve the banking crisis and to enact a "permanent" tax cut, due to the clear linkage of these measures to efforts to revive the Japanese economy, the role and priority of financial system reform was more controversial.

Some participants argued that the imposition of tough disclosure requirements on banks should come only after the banking crisis had been resolved or better controlled, since such disclosure might increase the risk of financial panic, the failure of salvageable banks, or at least the overly hasty, wasteful disposition of bank assets . The U.S. experience of managing the Latin American debt crisis was recalled in which "lie and deny" and "hold and hope" strategies were pursued until circumstances improved. This was countered by the view that the failure to resolve Japan's bad debt problems earlier, or to deal with them through concealment, denial or the artificial escalation of asset values, had handicapped and damaged the Japanese economy for over seven years. Questions were also raised as to whether the bridge bank plan itself was just another means of papering over serious problems in the banking sector, or whether the government would provide the necessary human and financial resources, legal authority and political leadership to make it work.

Other proponents of a go slow approach to deregulation expressed concerns that imposing too much regulatory and competitive pressure on banks would exacerbate the credit squeeze and precipitate greater social dislocation. Some participants even challenged the enforcement of BIS capital adequacy rules and the introduction of international accounting rules as negative contributions to the unique culture of the Japanese banking system. They argued that the old system had worked very successfully in the past, without these concessions to "internationalism."

Many, however, advocated the need to proceed with all three initiatives simultaneously. While the resolution of the banking crisis and the revival of economic growth were accepted as obvious priorities, tough enforcement and the completion of financial market deregulation were viewed as essential to achieving a successful outcome in both areas. Without the tough enforcement of a meaningful disclosure regime, there would be no accurate assessment of the scale and source of the banking crisis. Also, without the benefits of a more efficient and competitive financial system, the prospects of restoring vital growth to the economy would not be promising. Postponing deregulation would risk further squandering of taxpayer funds on banks that were insolvent and could not compete successfully in the future.

The third major issue discussed was **how to manage Japan's banking crisis**. The participants had before them the proposal for the 30 trillion yen fund and bridge bank plan, although serious concern was expressed regarding important gaps in the plan and the lack of detail. Moreover, there was serious concern over whether Japan actually knew the real size of the bad debt problem. Several points were made in the discussions.

(1) Without the enforcement of tough disclosure requirements, the consistent application of international accounting principles, and the public release of audited information, there is no way to determine the very scale or size of the bad debt situation.

(2) Without establishing objective criteria to scale or rank the seriousness of problems affecting different banks, or to differentiate objectively between unsalvageable, marginal and healthy banks, there is no way to prioritize problems or to plan or implement effective remedial measures.

(3) Without the creation of precise mechanisms for shutting down or managing the reorganization of failed banks, and working out the interests of holders of various types of assets and collateral of such banks, the prospects of rehabilitating salvageable institutions and of avoiding

political interference in any workouts will be greatly diminished._ Regulatory authorities need to have the power to replace the senior management of institutions requiring intervention and financial support.

(4) Without the creation of further legal, tax and regulatory incentives and mechanisms for the securitization or other disposition of non performing assets, banks will continue to delay taking necessary action. The provision of public funds may be required to add economic incentives as well to the asset disposition process, it was also argued. There was some controversy among participants as to whether banks burdened by bad assets should dispose of them as quickly as possible, even at fire sale prices, or whether they should maintain those assets with a "hold and hope" strategy. Others pointed out that those decisions should be dictated by the operation of market imperatives and of workout and reorganization mechanisms, which urgently needed to be innovated.

(5) Without a credible plan to strengthen the top 19 banks, or to prepare for the failure and disposition of those that are not salvageable, or the consolidation of those that are, confidence in the credibility of the government's plan will remain low. Since an assumption endures that the top banks are considered by the government as too big to fail, or at least too big to liquidate, there needs to be clarification on whether the large banks will be candidates for the bridge bank program. In the meantime, the public should be informed in detail as to the application of taxpayer monies previously distributed to the large banks from the bailout fund.

(6) Without a financial supervisory regime that is independent, adequately staffed and expert, and sufficiently empowered with clear decision making authority, the effective implementation and management of any banking system rescue scheme will not be feasible. Scores of experts in law, accounting, credit and asset valuation and loan packaging and disposition, among others, will be needed to manage this process, even with the lowest estimate of cases requiring bridge banks, bankruptcy workouts or reorganizations. If such expertise is not available in sufficient numbers in Japan, it will need to be brought in from overseas until domestic resources are further developed.

(7) Without prompt action to rectify the problems referred to above, the crisis will only grow larger and increasingly less manageable.

Finally, participants discussed the **need to strengthen bank management performance**. Bank management is now confronting a new competitive environment in which efficient operation, risk control, superior product and service differentiation, and high return on equity will determine survivability. Even with substantial consolidation in the domestic banking sector, changes in the conditions of competition, including the withdrawal of government protection, the weakening of the keiretsu and cross-shareholding nexus, the integration of financial services markets, the proliferation of corporate finance and investment alternatives accessible in Japan or overseas, and the increasing penetration of foreign institutions, will intensify competitive pressures on Japanese banks and other domestic financial service providers.

While a small number of participants expressed concern for the fate of their institutions and careers in this context, most emphasized the need to fortify the regulatory regime and institutional infrastructure in ways that would help to reinforce the discipline of bank management and strengthen their capabilities to meet these challenges. Important contributions would be made to this effort , it was argued, by enforcing tougher disclosure requirements and improving corporate governance mechanisms.

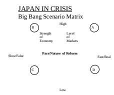
Some participants noted that the cross-shareholding system, while progressively weakening, still helps to undermine the accountability of bank management and requires banks to hold the securities of their cross-shareholding partners regardless of the negative impact on their balance sheets. While market pressures, along with legal reforms permitting holding companies and consolidated tax and accounting treatment will help to accelerate the decline of the system, some believed more proactive efforts need be made. Some suggested tax and capital requirement incentives for the early disposition of long held positions. Liberalizing the legal environment for mergers and acquisitions of financial and other entities, either by foreign or domestic acquirers, would also contribute to improving management discipline, it was argued. While the so-called "Wimbledon effect" was of concern to some, in line with Big Bang priorities, there was greater concern for vitalizing the financial markets than for preserving hollow markets exclusively for Japanese participants.

Plenary Session

Much of the discussion focused on sequencing, by way of comment on the following diagram presented by the discussion leaders. The matrix diagram is intended to demonstrate the interplay between the pace and nature of financial reform, as indicated on the horizontal axis, and the strength or weakness of the economy, as indicated in the vertical axis. A=high growth-fast reform; B=high growth-slow reform; C=slow growth- low reform; and D=slow growth-fast reform. The basic question was whether Japan could strengthen its economy without speeding up reform.

Originally, the government tried to go from C to B to A on the matrix by using fiscal stimulus. But with the exhaustion of fiscal resources and the failure to solve the banking crisis with fiscal policy, some believed it was necessary to move from C to A via D. While this route may involve some risk that the economy will weaken further at the beginning of the process, pushing serious deregulation and banking system rationalization is required to achieve sustainable economic growth on a more durable platform.

One commentator thought that the economy could be improved through fiscal policy without solving the banking crisis, and that indeed a strong economy would make it much easier to deal with the banking problem, a C to B to A sequence. There was argument that the reorganization of the banking system could further weaken the economy, and that the government might lack the political will to complete this strategy under such circumstances. However, many thought the banking crisis had to be addressed from the outset. One person stated that the matrix needed an additional axis reflecting the changing nature of competition.



One commentator stated that it was important to pursue deregulation since this would strengthen the capital markets. This was essential to economic recovery because the banking markets were and would likely continue to perform poorly in the near term. A clean up of the banking system was necessary for foreigners to lend to Japanese banks, to slow the yen outflow and to deal with the fall of the yen-dollar exchange rate. Also, deregulation of the capital markets was essential to solve the bad loan problem, since bad loans could be sold or securitized.

There were several comments about the Postal Savings System, and that its dominant role in the banking system needed to be addressed. Others believed this issue should be deferred until the more pressing issues of the banking crisis and the health of the macro economy were addressed.

With respect to how to deal with the banking crisis, it was argued that it would be necessary to expel the management of failing banks. This might be able to be accomplished by conditioning the use of public funds on the removal of management. The “prompt corrective action” regime must also be strongly enforced. The question was asked as to which of the top 19 banks would be put into the bridge bank framework and whether the supervisory system was strong enough to manage the process. It was remarked that the reason the bridge bank scheme was created is not that the top 19 banks are “too big to fail”; rather it is because they are “too big to liquidate in the short run.”

All agreed that the fundamental changes necessary would be a great challenge to traditional Japanese culture and politics. It was asked whether credible reform required significant pain to consumers. If so, this underscored the political issue of whether a consensus on how to proceed could be arrived at. In the end this may be the most crucial issue of all.

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Wequassett Inn, Cape Cod, July 17-19, 1998

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