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

Bretton Woods, New Hampshire • September 15-17, 2000

Friday, September 15, 2000

7:30-8:00 pm	Cocktail Reception in the Conservatory
8:00 pm	Dinner in the Sun Dining Room **Greetings** by Hiroshi Ota, Executive Vice President, The Japan Forum for International Relations, and Hal Scott and Robin Radin, Program on International Financial Systems, Harvard Law School
8:50-9:30 pm	**Keynote Address*:* Timothy Geithner, Under Secretary of the Treasury, U.S. Treasury**
9:30-9:45 pm	Meeting of Facilitators and Reporters in the Madison-Jefferson Room

Saturday, September 16, 2000

7:00-8:30 am	Breakfast in the Main Dining Room
7:00-8:30 am	Breakfast Meeting of Facilitators and Reporters in the Ammonoosuc Dining Room
8:30-8:40 am	**Welcome & Opening Remarks: Hiroshi Ota, JFIR and Hal Scott, PIFS**, in the Ballroom
8:40-9:00 am	**Session 1: The Interdependence of Japanese and U.S. Financial Markets**, in the Ballroom Japanese Panelist: Yasuhisa Shiozaki, Member of the House of Representatives U.S. Panelist: Marshall Carter, Chairman, State Street Corporation
9:05-10:25 am	Small Group Sessions 1-5

Group	*Room*	*Facilitators*	*Reporter*
1	Gold	Toru Kusukawa & Robert Feldman	Hal Scott
2	Lafayette	Takeshi Ohta & Curtis Milhaupt	Robin Radin
3	Rosebrook	Yasuyuki Tayama & David Asher	Philip Wellons
4	Dartmouth	Akihiro Wani & Alicia Ogawa	William Grimes
5	Madison-Jefferson	Naoaki Okabe & John Makin	Christopher Wells

10:25-10:40 am	Refreshment Break
10:40-11:10 am	**Session 2: Financing the New Economy in Japan and the U.S.**, in the Ballroom Panelist: Jiro Kokuryo, Professor, Keio University Panelist: Takayoshi Hatayama, Advisor, Ito-Yokado, Ltd. Panelist: Sachio Semmoto, Chairman & CEO, EAccess Panelist: Arthur Mitchell, Partner, Coudert Brothers
11:10-12:20 am	Small Group Sessions 1-5

Group	*Room*	*Facilitators*	*Reporter*
1	Rosebrook	Sydney Cone & Mikio Wakatsuki	Hal Scott
2	Gold	Thomas Cargill & Masaru Yoshitomi	Robin Radin
3	Lafayette	David Sneider & Hiroshi Ota	Philip Wellons
4	Madison-Jefferson	Bruce Scott & Akira Nambara	William Grimes
5	Dartmouth	Kent Calder & Akitoshi Takatsuki	Christopher Wells

12:30-1:30 pm	Lunch in the Ballroom
1:30-2:30 pm	**Session 3: Bretton Woods Revisited—The Role of Official Multilateral Organizations,** in the Ballroom

	Panelist: Takatoshi Ito, Deputy Vice Minister of Finance for International Affairs Panelist: Barry Eichengreen, Professor, University of California, Berkeley Panelist: Morris Goldstein, Senior Fellow, Institute for International Economics
2:30-6:30 pm	Free
2:30-5:00 pm	Reporters (from Small Group Sessions) Meeting in the Gold Room
6:30-7:00 pm	Cocktail Reception in the Conservatory
7:00 pm -	Dinner in the Sun Dining Room **Keynote Address: Haruhiko Kuroda, Vice Minister of Finance for International Affairs**

Sunday, September 17, 2000

7:00-9:00 am	Breakfast in the Main Dining Room
8:00-9:00 am	Breakfast Meeting of Discussion Chairmen and Steering Committee in the Ammonoosuc Dining Room
9:00-9:40 am	**Presentation and Discussion of Session 1: The Interdependence of Japanese and U.S. Financial Markets**, in the Ballroom Japanese Chairman: Akinari Horii, General Manager, Chief Representative Office in the Americas, Bank of Japan U.S. Chairman: Hugh Patrick, Professor, Columbia University Reporter: Robin Radin
9:40-9:55 am	Refreshment Break
9:55-10:35 am	**Presentation and Discussion of Session 2: Financing the New Economy in Japan and the U.S** Japanese Chairman: Akitoshi Takatsuki, Professor, Meikai University U.S. Chairman: Thierry Porté, President, Morgan Stanley Dean Witter Japan Ltd. Reporter: Christopher Wells
10:35-10:50 am	Refreshment Break
10:50-11:30 am	**Presentation and Discussion of Session 3: Bretton Woods Revisited—The Role of Official Multilateral Organizations** Japanese Chairman: Akira Ariyoshi, Director, Planning & Legal Division, Financial Services Agency U.S. Chairman: Richard Medley, Founder & Managing Partner, Medley Global Advisors Reporter: Hal Scott
12:00-1:30 pm	Lunch in the Main Dining Room

REPORT: 2000 Symposium on Building the Financial System of the 21^{st} Century: An Agenda For Japan and the United States, Bretton Woods, New Hampshire

The third Symposium was held from the evening of Friday, September 15 to noon on September 17, 2000 at the historic Mount Washington Hotel in Bretton Woods, New Hampshire. It was organized by the Harvard Law School Program on International Financial Systems and the Japan Forum on International Relations, Inc. The Symposium took place against the background of continuing strong U.S. economic growth and a well-performing financial sector. The Japanese banking system has continued to reorganize, through mega mergers and foreign investment, and some of the Japanese securities firms began to show profitability. However, the economic problems remained serious. The international financial system has continued to consider reforms in light of the Asian financial crisis, although the pace of such reform seem slowed by the intractability of the reform issues and the relatively quick recovery of most of the affected countries.

The Symposium brought together more than 80 senior government policy makers, academics, legal experts, consultants and financiers from Japan and the United States to discuss three issues: (1) The Interdependence of Japanese and U.S. Financial Markets; (2) Financing the New Economy in Japan and the United States; and (3) Bretton Woods Revisited—The Role of Official Multilateral Organizations. The complete list of participants is in Annex III. There were two off the record keynote addresses, one by Timothy Geithner, Under Secretary of the Treasury, U.S. Treasury, and the other by Haruhiko Kuroda, Vice Minister of Finance for International Affairs, Japan.

On Saturday, the first two issues were discussed in five small group sessions after agenda setting introductions by panelists from the two countries. Each small group session was led by a U.S. and Japanese facilitator, and one of the participants served as a reporter. The third issue was discussed in plenary session after panel presentations. The results of these discussions were presented by the reporters to the Plenary Session on Sunday and then commented on by panelists and discussed by the group as a whole. We have included in Annex I written versions of presentations made by some of the speakers. In addition, a number of concept papers were prepared by participants. See Annex II.

This Report discusses conclusions reached over the course of the Symposium.

I. The Interdependence of Japanese and U.S. Financial Markets

Starting with the recognition that the growth in both the volume and significance of capital flows between the United States and Japan has increased the interdependence of financial markets in recent years, discussions concentrated on two main areas: the nature of financial interdependence and reforms in the Japanese corporate and financial system.

Financial Interdependence: Trade and Capital Flow Issues

Defining Interdependence

Although this Symposium was not dedicated to measurement issues, it was understood that gross capital flows between Japan and the United States have become extremely large in absolute terms, and have also become large relative to the size of the economies. Because of the multiple pathways for Japanese money to reach the United States, and vice-versa, this point goes beyond easily measurable bilateral flows. While U.S. foreign direct investment (FDI) in Japan has been growing rapidly in recent years, it is still small, and was considered important for its microeconomic, rather than for its macroeconomic, effects. Japanese FDI in the United States has of course had major microeconomic and macroeconomic influences over the past two decades.

Notwithstanding these flows, Symposium participants noted that the mutual vulnerability of macro-economies and financial markets was not at all clear cut. A number of major shocks had not been fully transmitted between the economies –the effects of the1987 U.S. stock market crash did not affect Japan, and Japan's recessions of 1997-99 seemed to have had virtually no negative effect on U.S. growth. On this basis, some participants questioned the actual level of interdependence between the two economies. Despite this skepticism, most participants assumed that mutual vulnerability does indeed exist, and in this context raised two major problems, which became the focus of extensive discussion: first, the sustainability of the U.S. trade deficit, and second, the danger to both economies of the large and growing Japanese budget deficit.

U.S. Trade Deficit

Whether the record-breaking U.S. current account deficit is sustainable in the long-run was raised as an important question. To date, the rest of the world has been willing to finance massive U.S. dissavings, but several people expressed concern that an improvement in economic growth outside the United States or a slowdown within the United States may make foreigners less interested in lending and investing money to American consumers and corporations.

Several points were made in favor of the sustainability of the deficit. The primary argument advanced was that continued robust U.S. productivity growth means that it is sensible for American consumers and corporations to be borrowing to consume or invest now in the expectation that their future income growth will exceed prevailing interest rates. If that is the case, then it is also rational for foreign savers to put their money into the U.S. economy rather than their own, slower-growing economies.

Although most participants agreed that this was an accurate description in the short run, some argued that U.S. economic and productivity growth will inevitably slow down in the next few years, either because the IT productivity revolution will have run its course or because the business cycle will come to an end. As the U.S. economy slows, two fears arise, it was noted. One is that current account deficits will remain high, and foreigners will not want to finance them. This could lead to a serious weakening in the U.S. dollar and/or sharp rises in interest rates that would exacerbate the economic slowdown. Another possible scenario is that declining rates of return in U.S. capital markets relative to other investment possibilities would cause money to flow out of the United States, leading to a crash in asset prices (which have been one of the engines of consumption growth), as well as a weaker U.S. dollar and/or higher interest rates.

For most, the question was not whether the U.S. economy would slow down, but whether there would be a hard or soft landing. Those who feared a hard landing pointed to the apparent lack of expectations in the United States (particularly among households) that a slowdown would ever occur. Such expectations were seen to contribute to excessively high asset prices (i.e. a bubble) and a likelihood that a bursting of that bubble would be jarring both to household finances and to perceptions.

The case for a soft landing rested on four points. First, those who expect a soft landing were more likely to see current savings behavior as rational under the circumstances. Second, while dissaving appears clearly in national income accounts, household wealth is actually increasing due to asset price hikes; ironically, dissaving U.S.

households are seeing much larger wealth increases than Japanese households with high net flows of savings. Third, the U.S. government has shifted from a large structural budget deficit to a structural surplus for the time being, and households are much more able to change their consumption patterns during downturns than are governments. Thus, as growth slows (and particularly as asset price growth slows), household savings rates should increase at least somewhat. Finally, advocates argued that U.S. macroeconomic authorities have far more degrees of freedom than their Japanese counterparts had at the end of the bubble. In particular, many expressed optimism that the Fed would be able to engineer a soft landing through interest rate policy.

A final point regarding the financing of the U.S. current account deficit was the effect of a declining supply of government debt instruments. While some observers were confident that foreign creditors would be happy to hold U.S. corporate debt instruments instead of U.S. Treasury securities, others voiced doubt on two counts. First, if creditors are holding U.S. government debt primarily because it is free of default risk rather than purely for reasons of return or diversification, then corporate debt will be an unsatisfactory substitute. This could mean an outflow of capital, a weakening of the dollar, and/or a rise in U.S. interest rates. Second, some people expressed unease about the political impact of the Japanese government being a major actor in funding U.S. corporations, many of which compete with Japanese firms in product markets or for funds.

Japanese Macroeconomic Issues

Japanese macroeconomic problems may also have a serious impact on capital flows in coming years, it was observed. These concerns focused on the Japanese budget deficit and the continuing problem of non-performing loans throughout the Japanese corporate and financial system. Problems of the postal savings system were seen as contributing to both of these issues.

The big question is how sustainable is the Japanese budget deficit? Most participants were confident that Japan's massive stock and flow of private savings mean that the budget deficit is not anywhere near default danger. But there are some serious warning signs. The sheer size of the deficit (around 40% of central government spending) is clearly one, as is the expectation that severe fiscal consolidation is not yet possible in Japan's still-fragile economic environment – although some participants argued that fiscal stimulus is being fully offset by household savings. Another is the various contingent liabilities of the government. These include underfunded national pension liabilities in the face of a rapidly aging society, off-budget liabilities such as non-performing assets of the Fiscal Investment and Loan Program, and large-scale loan guarantees to both government and private-sector borrowers. The problems of the Japanese budget are reflected in Moody's recent downgrading of government debt, it was noted.

Turning from the macro questions of sustainability, there was some concern over more micro issues of funding – in other words, whether market conditions would allow for continued absorption of JGBs at affordable rates. A major issue is who will be interested in purchasing JGBs. With changes coming in the management of postal savings and other trust funds – currently the largest players in the government debt market – some were concerned over their future disposition.

If government trust funds reduce their investments in government debt – or even if their government debt purchases do not keep pace with the rising deficit – the private sector and/or foreign purchasers will have to take up the slack. Anticipating these challenges, the Japanese government had taken a number of important steps toward increasing the liquidity and attractiveness of the government debt. These include the establishment of an auction system for short-term financing and treasury bills, and the decision to issue JGBs in a wider range of maturities.

Nonetheless, important issues remain. One set of problems arises with domestic private-sector purchases, which are primarily by financial institutions. First, a continued emphasis on JGBs as primary capital assets goes against their need for increased diversification of assets. (The dangers of underdiversification are apparent in the recent JGB price declines. Moreover, the extremely low level of interest rates suggests that JGB prices are far more likely to move down than up.) Second, there is some suspicion that the continuing reliance on JGBs by Japanese financial institutions is in some way coordinated. This raises fears among some of continuing official interference in private financial institution funding decisions; it also suggests that if such coordination ends, JGB demand could be seriously affected.

Foreign purchases are also constrained by policy and other inconveniences. It is generally agreed that foreign private-sector ownership of government debt in Japan is much smaller than in other economies and also quite small compared to the diversification expectations of portfolio theory. Despite the decision to eliminate withholding tax on government securities owned by non-residents that took effect over the course of FY 1999, the certification of non-resident status remains difficult and continues to limit the potential pool of purchasers. While efforts are underway to address this issue, the shape of the final policy remains unclear. Complaints have also been raised about the functioning of the BOJ book-entry system (in which non-residents must register their government securities), as well as inefficiencies in settlements more broadly.

A second macroeconomic issue seen as a threat to patterns of capital flows is the continuing problem of non-performing loans. Some participants expressed strong suspicions that NPLs are again increasing. Major defaults could again have a major negative impact on Japanese growth. This could also mean repatriation of capital from abroad, including investments and loans in the United States.

While there was general concern about the effects of the budget deficit and NPLs on the Japanese economy, there was much less consensus on the implications for the United States. Previous crises in the Japanese economy in the 1990s appear to have had few if any negative impacts on the United States, suggesting that perhaps U.S.-Japanese financial interdependence does not necessarily imply U.S. vulnerability to economic shocks in Japan. Whether this has been the result of short-term factors that led to a "flight to quality" or more enduring lack of mutual vulnerability (or simply the existence of asymmetrical vulnerability) is not yet clear.

More on Capital Interdependence

While capital flows are very large between the two economies, they may be lower than the optimal level due to specific characteristics of the U.S.-Japan economic relationship. Several participants argued that recent private capital flows from Japan to the United States remains lower than it might be because of foreign exchange volatility. Households are seen as particularly reluctant to invest in foreign securities or in funds that hold foreign securities because of the experience of large swings in the yen-dollar rate. Despite much more stable rates over the last year, many investors remain unconvinced that this is a long-term phenomenon.

Meanwhile, U.S. and other foreign portfolio investment has increased considerably in recent years, and has been a major source of new funds for Japan's stock markets. However, such investment also appears to contribute to volatility on the exchanges, because of foreign investors' changing perceptions of Japan's economic growth potential and policy stance. Thus, the movement of foreign capital into and out of Japanese capital markets may magnify the effects of instability in the Japanese economy in general. This appears to be one more example of the asymmetrical nature of U.S.-Japanese interdependence.

Reforms in the Japanese Corporate and Financial System

Another broad area in which financial interdependence was seen as important by participants was in the perceived need for further extensive reforms in Japanese corporate and financial systems. Opinions on the correct extent and shape of these reforms varied: some participants called for rapid and radical reforms in corporate governance, capital funding patterns, and standards, but others argued that the Japanese system still contains many strengths that should not simply be discarded in a mad dash to adopt American practices.

Corporate Reform

A particular concern for U.S. investors is still transparency and accountability in the Japanese economy. Many participants felt that Japanese standards of disclosure still allow for considerable obfuscation on the part of management. If they cannot trust balance sheets, investors inevitably must take on greater risk when investing in the stocks and bonds of a company, thus reducing investment and increasing cost of capital for firms. A number of participants suggested that the disclosure standards of MOTHERS and NASDAQ-Japan fall short of what is needed, and that this will retard their ability to improve start-ups' abilities to obtain needed capital. Disclosure is seen as particularly problematic in financial institutions as well, and some participants opined that this reflects continued collusion between Japanese financial institutions and regulators.

In contrast, a number of participants argued that Japanese disclosure standards have improved greatly, and will continue to do so. Reasons for this include pressures in capital markets and the possibility of the establishment of an accounting standards board that is autonomous from the government. The strengthening of consolidated corporate taxation rules was also seen as an important step.

Other aspects of the Japanese regulatory system also were seen to reduce both the attractiveness of the market for foreigners, and the efficiency of the Japanese economy in general. As in the case of government debt, tax policy appears to be a sticking point for potential investors in private capital markets as well; one example is capital gains taxation. Another complaint by several foreign observers is that bankruptcy law is still ineffective in promoting rapid reorganizations, despite important reforms such as those that allowed nationalization of LTCB and NCB in 1998, and the Civil Reorganization Law. Additional issues in the Commercial Code and other laws will be addressed in the "Financing the New Economy" section.

Regarding investment in Japan's private sector, foreign investors were seen as frustrated by their inability to convert substantial ownership into substantial control over corporate behavior. Despite the opinions of many participants that foreign ownership might force changes in corporate governance – putting shareholders first and reducing control of management – others argued that successes to date are limited. For example, outside directors remain rare. The potential effects of foreign participation on corporate governance appear to be extremely large, but it is probably too early to judge the actual effects at this stage. This is true of the activities of both institutional investors, such as pension funds, and of actual mergers and acquisitions. Some suggested that there may be a role for the government in improving corporate governance, either in its role as institutional investor or as regulator (for example, mandating that banks receiving capital injections appoint outside directors), but this appeared to be a minority position.

What are the obstacles to change? One possible set stems from Japanese corporate culture and the weight of public opinion. A more structural reason is the continuing existence of large-scale cross-shareholding, which some participants argued makes for a continuation of insider control. Cross-shareholding does appear to be decreasing, but not rapidly enough for these participants. Nonetheless, there may be reason to believe that once cross-shareholding unwinds to a certain critical level or "tipping point," its effects will decline rapidly.

Financial System Reform

Two general issues in the Japanese financial system raised concerns about the future path of U.S.-Japanese financial interdependence. First, many participants, particularly from the U.S. private sector, expressed frustration with the continuing lack of harmonization of standards between Japan and the United States. Second, strong concerns were raised about the microeconomic effects of non-performing loans.

With regard to standards, a number of American participants in the Japanese market argued that – despite the considerable progress of financial liberalization – standards of transparency and accountability remain suspect. In particular, the problem of defining and enforcing meaningful accounting standards looms large. While there is some evidence that financial markets are rewarding those firms that have moved toward international standards and consolidation of balance sheets, critics of Japanese accounting standards argued that there is insufficient leadership in either the business or political worlds to overcome the large-scale inertia against adoption of standards of greater transparency. Even foreign-owned firms may not be forcing transparency and accountability in their subsidiaries and borrowers, despite the promise that many had predicted earlier.

Connected to the transparency issue, there appears to be considerable suspicion about whether Japanese banks' NPL problems are actually behind them. The failure of Sogo and the large uncovered exposure of Japanese banks to it, as well as the problems of construction and other firms, show that weak borrowers have continued to receive bank lending. One problem is that many NPLs appear to remain on banks' books even after the recapitalizations and large-scale loan write-downs of recent years. If additional recapitalization proves to be necessary in coming years, it is likely to create widespread public opposition.

An even more worrisome problem for some participants is the belief that banks continue to issue new problematic loans. This may be due to the continuing legacy of relationship banking. It also appears to reflect Japanese banks' inability to move rapidly toward modern credit evaluation procedures. In the absence of effective credit evaluation, it is only rational to lend based on collateral and past relationships; nonetheless, such lending practices are not necessarily good for an economy in the midst of serious structural reform. All of this points to the potential continuing fragility of the Japanese banking system, it was observed.

Possible solutions

To deal with these various challenges to Japanese growth and to U.S.-Japanese interdependence, most participants argued that much faster and more extensive restructuring is a necessary condition. The main targets discussed included:

- Promotion of international (harmonized) standards of accounting and regulation
- Stricter surveillance of bank lending practices
- Better loan-loss provision and credit evaluation at banks
- Promotion of capital markets and non-bank financial institutions in order to bring about more efficient capital allocation
- More rapid unwinding of cross-shareholding

With regard to the question of how such restructuring might come about, possibilities ranged from market forces to U.S. government pressure. Market competition between banks and other sources of financing could force banks to become more efficient, especially if the government refuses to bail them out. More generally, several participants pointed to long-run international trends toward disintermediation, and expressed hope that this would improve financial efficiency in Japan. U.S. government pressure could take the form of a free trade agreement or an agreement on free trade in financial services.

While most participants felt that more reform was of central importance, others argued that Japan must not “throw out the baby with the bathwater.” The Japanese economic system, of which the financial system is an integral part, has served Japan well for most of the post-war period. The current recession may be masking potential growth among strong Japanese firms. In this view, changing the financial system to reflect an American-style shareholder capitalism might threaten the basis of Japan’s stakeholder capitalism – and with it, such benefits as a loyal and motivated workforce. While agreeing with the need for more transparency and better balance sheets, these participants suggested the need for a “Japanese” solution to Japan’s problems.

II. Financing the New Economy in Japan and the United States

Discussions about funding the new economy in Japan and the United States, like the financial interdependence sessions, focused on problems in Japan. In general, participants used comparisons with the United States – whether explicitly or implicitly – to judge the problems of IT development in Japan.

Despite the focus on problems, several participants argued forcefully that Japan has major strengths in the new economy sectors that have been underestimated by many observers. This is evidenced by the success of cellular phone service and wireless broadband Internet access in the Japanese market. To these participants, it is not at all clear that Japanese corporate finance practices are actually a major problem for new economy development in Japan.

New Economy: Obstacles To Start-Ups

Most participants agree that there are considerable obstacles to new economy start-ups in the current Japanese economy. The implications of this judgment varied however, as shall be addressed below. Perceived obstacles to start-ups included cultural and social issues, as well as legal and financial issues.

Several participants argued that present-day Japan has an anti-entrepreneurial culture. As one summed it up, "When Americans hear the term 'creative destruction,' they hear 'creative.' When Japanese hear it, they hear 'destruction.'" This points to a widely perceived risk aversion among Japanese firms and in society. Some pointed to cultural roots, such as stigma for both failure and great success, although others argued that risk aversion is largely a response to economic downturn. In any event, Japan's past history of entrepreneurship – as seen in the successes of companies such as Matsushita, Honda, and Sony – suggested to several participants that structural matters are more important. It also appears that younger workers might be opting for more diversified careers than the traditional lifetime employment model. Nonetheless, as one put it, a major barrier to hiring outstanding mid-career personnel is "wives and mothers" who fear the consequences of business failure and loss of status on family income and reputation.

Other cultural or social barriers to the new economy in general may include a low tolerance for immigration and an educational system that stifles creativity. Here too there was considerable disagreement. For example, while immigrants are not often welcomed into Japanese society, immigration procedures for skilled foreigners are less restrictive than those of the allegedly immigrant-friendly United States, it was noted. As for education, the creativity of engineers in certain established companies may suggest that Japanese education is not as destructive of creativity as some observers argue.

There was broader agreement that education fails to support entrepreneurship in Japan. This includes the dearth of "angels" or other mentors for aspiring entrepreneurs. It also addresses more generally the lack of business education among such entrepreneurs, as reflected in their relative inability to produce viable business plans even for cutting-edge technologies.

Beyond culture and society, legal and financial infrastructure loomed as large issues for many participants. Legal issues can be divided into three broad categories: difficulty of risk limitation, difficulty of incentivizing, and general difficulties of doing business. Some of these issues appear in the following section, but others included perceived inadequacies of rules concerning limited partnerships, and intellectual property protection.

Role of the Financial System

One of the major points of contention concerning financing for the new economy in Japan is whether there is actually a shortage of financing. As one put it, "in the United States, the new economy chased after money; in Japan, money is chasing the new economy." A number of participants spoke of the frustration of venture capitalists in finding appropriate projects in which to invest. The rapid increases in capitalization of listed new economy firms also suggests that there is considerable funding available for appropriate projects.

In analyzing this issue, there is a fundamental difference between funding for new economy start-ups and small enterprises, and funding for major established firms that are engaged in new economy business. Most of the issues of funding concerned smaller firms and start-ups. In this regard, the overarching problem is one of identification of worthy projects for investment and lending.

Identification of worthy projects requires skills that may be in short supply on both sides of the funding decision. On the part of entrepreneurs, we return to the point about the lack of business knowledge and expertise. Without the ability to prepare credible business plans and present them effectively (often to non-Japanese-speaking foreigners), it will remain difficult for entrepreneurs to obtain the kind of funding they need. As for providers of funds, the essential problem is that of evaluation. Japanese banks' dependence on collateral or long-term relations for making lending decisions has meant that many or most have never developed project evaluation skills. With regard to investment, venture capital functions are still poorly developed within Japan. Moreover, the unfamiliarity of foreign venture capitalists with the distinctive characteristics of the Japanese market makes effective project evaluation difficult. Some opined that this may be an area where Americans and other foreigners need to improve their own knowledge rather than complaining about Japanese market conditions.

With regard to potential Japanese investors, a more structural issue may also be important. This is the lack of "fund-type" investment vehicles. Pointing to the importance of pension, mutual and venture funds in funding America's new economy, many participants suggested that Japan also needs to develop these. A common suggestion was for rapid introduction and expansion of defined-contribution pension funds like the American 401(k). By moving Japan's immense pool of savings out of low-yielding deposits at banks with conservative lending practices, the door might be opened for more risk-taking. While most participants agreed that more such funds could be helpful in improving capital allocation and returns on savings in Japan, some, however, were skeptical that Japanese investors would embrace them. Citing various abuses of investment trust funds by Japanese fund managers in the past, they suggested that ordinary Japanese would remain suspicious – and indeed, that such suspicion might well be warranted.

At least three other legal issues were brought up as well. One has to do with rules on stock options. Not only are non-employees, such as consultants and lawyers, not allowed to receive stock options from firms—such persons commonly receive such options in the United States—the rules on accounting and taxation for employee stock options continue to make them unattractive as a means of providing incentives to employees, particularly those of start-ups or rapidly growing firms.

Peculiarities of the Commercial Code, such as high par value requirements, also create problems for liquidity of the shares of young new economy companies. Because stock splits are prohibited if they dilute book value per share below par value, stocks in high-flying new economy firms with relatively few fixed assets are priced extremely high, and trading is limited. Thus, these stocks are subject to wild fluctuations that reflect illiquidity as much as shifts in fundamentals. For most firms, then, even the new exchanges such as MOTHERS and NASDAQ-Japan are problematic as funding sources.

Finally, venture capitalists are prevented from preparing viable exit strategies by the lack of liquid markets – not only are IPOs often prohibitively difficult to carry out, but the lack of a high-yield ("junk") bond market also tends to lock such investors into providing funds on a long-term basis. If they cannot foresee viable exit strategies, venture capitalists will be more hesitant to invest in projects in the first place.

All of these factors led some to suggest that the Japanese model of new economy development might well differ considerably from the U.S. model. These participants pointed not only to obstacles to financing and marketing for start-ups and small firms, but also to the considerable strengths of some of Japan's major firms. These include high levels of employee loyalty and motivation, technological sophistication, and highly-articulated patterns of product development, marketing, and sourcing, among others. Thus, existing major corporations may well be the engine of innovation in Japan's new economy, rather than start-ups as in the United States. In this regard, programs to promote intra-firm entrepreneurship may be a promising means of bringing forward innovations in IT. This argument echoes debates on technology development that date back at least to the late 1980s, and suggests that Americans should avoid triumphalism.

For established companies, it was observed that most of the demand for IT will come from companies outside the typical new economy sectors. In the United States, computing and communications technology have had a profound effect on productivity in finance, distribution, and manufacturing, and the successes of U.S. firms in those areas have further stimulated demand for IT products. In other words, integration of old and new economy sectors is underway. In Japan as well, much of the effect of the new economy will depend on how it effects the old economy – not only in terms of demand, but also in terms of improving productivity in unproductive sectors, and perhaps even drawing more women and elderly into the workforce. (As one panelist suggested, however, existing corporate cultures that emphasize lean production may have a hard time adjusting to the centralization of information and the redundant systems that characterize cutting-edge IT. The coming years will provide evidence to judge the accuracy of this prediction.)

A final point about the Japanese model was the role of the government. Given the credit often assigned to industrial policy and state agenda-setting in post-war economic development, it was notable that there was apparently a strong consensus that the role of the government should be entirely in providing infrastructure, rational regulation, and a stable macroeconomic environment, rather than in technology development or "picking winners." Perhaps ironically, given its history of industrial policy, the Japanese government's involvement in new economy development in the 1990s was perceived by some to be so minimal that IT infrastructure actually lags behind several other Asian countries.

Financing the New Economy: Lessons From the U.S. Experience

While in many ways Japan's model of new economy development has differed from that of the United States and may continue to do so, there may still be lessons from the U.S. experience of the 1990s. Three lessons in particular seemed to stand out.

The first is the powerful influence of the break-up of the telecommunications monopoly on economic growth in the U.S. A number of U.S. participants argued that the telecommunications revolution in the United States dates back to the end of the AT&T monopoly. While NTT has been partially privatized and exposed to competition, most participants agreed that those efforts have not gone far enough. They argue that the move to a holding company structure has had little effect of increasing competition among various NTT units that hold overwhelming shares of various parts of the telecommunications market. Moreover, the high cost of NTT local telephone service and connections fees charged to other carriers appears to have slowed the use of the Internet in Japan.

A second lesson is the importance of economic stability. The successes of the U.S. Federal Reserve in maintaining low inflation and of the Clinton Administration in eliminating budget deficits have created a predictable macroeconomic environment in which the new economy has been able to grow. While many participants maintained that the United States is in the midst of an asset price bubble, most agreed that the Fed and the government have a considerable degree of freedom to maintain relative macroeconomic stability. This was contrasted with Japan's unbalanced fiscal and monetary policies of the past decade, and its lack of a stable macroeconomic environment.

A final possible lesson – albeit one on which there was some disagreement – comes from the rapid expansion of defined-contribution pension plans in the United States. While some suggested that these pension funds have been a major factor in producing a bubble, others pointed to two important microeconomic functions they have fulfilled. The first has been to increase emphasis on shareholder return through the activities of fund managers in choosing stocks and in representing shareholders' interests through their role as major institutional investors. The second has been to reduce the risks to corporations of having to maintain underfunded defined-benefit pensions. Both of these functions would be helpful to the Japanese economy.

III. Bretton Woods Revisited—The Role of Official Multilateral Organizations

While there was considerable – perhaps even surprising – agreement regarding finance issues, sharp disagreements were evident regarding the role of the Bretton Woods institutions – primarily the IMF – and the shape of the international financial architecture. Disagreements centered on the same issues as more public debates in the policy and academic communities. And while there was a general tendency for Japanese participants to favor more activism than U.S. participants, there was by no means unanimity among the participants from either country.

In discussing the international financial system, a number of participants made the point that policy reforms have been more at the level of "interior decorating" than "architecture," despite widespread dissatisfaction with IMF performance in crises since at least 1995. Following the partial progress embodied in the 1999 G-7 Cologne communiqué, they argued, reform had stalled. Most of the discussion focused on what steps still need to be taken, although prescriptions differed considerably in several areas.

Basic Functions of the IMF and Rules of the Road

The central question of the session concerned what role the IMF should play in the international financial system. While some advocated enhanced lender of last resort functions, others called for a much more limited role. Still others felt that the IMF should still have some role in encouraging development and adoption of effective market mechanisms in developing and emerging economies (see "Conditionality" section below). Positions on the role of the international institutions rested on two analytical issues: the nature of the global financial system, and the prevalence of moral hazard as a disruptive force in that system.

First, how do we understand the global financial system? The debate on this issue crystallized around varying explanations of the Asian crisis. One interpretation emphasized the role of economic policies at the national level – excessive dollar-denominated short-term debt, macroeconomic policies that encouraged real appreciation of local currencies, and poor banking regulation created conditions that made speculative attacks possible. In this interpretation, contagion was largely confined to economies with problematic macroeconomic or microeconomic management, and was relatively quickly contained in better-managed economies such as Singapore. Moreover, countries that have carried out meaningful macro reforms, such as Thailand and South Korea, have been quick to heal. All of this suggests that better national policies, rather than an expansion of the functions of IFIs, are the best way to prevent future crises and to stop contagion.

An alternative explanation is that the Asian crisis was a "capital-account crisis," and therefore fundamentally different from other crises that preceded it. That is, the speed and magnitude of global capital flows exceeded available reserves, and it was this speed and magnitude itself, rather than economic mismanagement on the part of the economies involved, that led to crisis. In this view, sudden movements in capital can occur randomly, and then lead to self-reinforcing cycles as withdrawals of capital lower asset and currency prices that in turn motivate more capital flight. The rapid recovery of Southeast Asian economies other than Indonesia after currency stabilization suggests to these observers that fundamental defects in those economies had a limited impact. They point also to the lack of damage to countries that maintained or imposed capital controls through the crisis as evidence that it was the movement of capital itself that created problems. Finally, they see the widespread misery of the poorest segments of the populations in Southeast Asia as an unacceptable cost of financial globalization.

The second major axis of disagreement was over the prevalence of moral hazard in international finance. To what extent does the existence of an "insurer" like the IMF promote irresponsible policies on the part of economic authorities? And to what extent do lenders and investors rely on the likelihood of IMF bailouts to lend to developing country borrowers who might otherwise be considered too risky? While most participants appeared to agree that such moral hazard exists, they differed regarding its effects. In particular, a number of participants pointed out that governments and economies are generally seriously adversely affected by the results of financial crises, regardless of whether there is an IMF-sponsored bailout. If that is true, and governments are aware of that fact, then choices in favor of bad economic policy are unlikely to be the result primarily of moral hazard. There was, however, general agreement that moral hazard is important for lenders, and should be addressed by the international financial architecture or rules of the road.

Leading from these vigorous debates, three main positions emerged: limited lender of last resort, massive provision of capital, and incremental change. The limited lender of last resort plan, associated most closely with the Meltzer Commission and labeled by participants variously as "romantic" and "realist," argues for strict limitations on IMF funds, extremely short-term lending guidelines, and penalty interest rates. These proposals reflect a belief that inappropriate economic policies by governments are the central cause of currency crises, and that moral hazard created by the behavior of the IMF in crises contributes to such inappropriate policies. They also reflect a deep-seated belief that development aid and crisis management are distinctly separate functions, and should be kept strictly separate. While a number of participants expressed intellectual solidarity with the limited lender of last resort position, many if not most suggested that it would be impracticable.

More than impracticable, other participants considered that position to be dangerous. Those who believed that the speed and magnitude of global capital flows were to blame for the Asian crisis see the need for the international system to have a means by which to provide massive amounts of capital in the face of a crisis – thus, the main policy prescription is to dramatically increase the amount of capital available in times of crisis. By halting currency crises before they can spread, it may be possible to prevent economically responsible countries from being unfairly injured by capricious and self-reinforcing capital movements. While conceding that moral hazard may be an issue, this viewpoint emphasizes the greater dangers of contagion, and further suggests that heavy conditionality might actually be dangerous.

Finally, there was also support for a more incrementalist view of the proper role of the IMF. This view essentially mirrors what is already being done in the IMF to increase quotas (as well as the Contingent Credit Line and the Structural Reform Facility), to impose surcharges on large loans, and to alter rules on conditionality to reduce moral hazard in a marginal way. Some examples of ways in which the IMF has been trying to change the financial rules of the road has been by promoting transparency and harmonization of financial regulation, as well as examining ways of “bailing-in” private lenders.

IMF Conditionality

Moving to more specific matters, IMF conditionality was a matter of considerable debate. Conditionality was attacked both by those who envisage a much more limited role for the IMF, and by those who advocate rapid and massive provision of capital into liquidity crises. But still others defended some version of current conditionality policy as a necessary evil.

The limited lender of last resort view sees existing patterns of IMF conditionality as fundamentally wrong-headed. Not only does it get the IMF involved in long-term structural and policy issues instead of short-term liquidity, but it also creates unnecessary obstacles for countries whose responsible economic policies have earned them the right to get emergency liquidity. Instead, this view advocates pre-conditionality – only those countries that are certified under strict criteria of responsible behavior should be eligible for funding, and that funding should be provided without additional conditions when necessary, albeit at penalty rates for short terms.

Some agreed with this view in principle, but pointed to several flaws that make it unworkable in the real world. One is that pre-conditionality is likely to be extremely strict, perhaps too strict for the vast majority of economies that might face currency crises – the short experience with the Contingent Credit Line certification process is one piece of evidence in that regard. A second perceived flaw is that pre-conditionality means not lending to economies that are not pre-qualified even if they are suffering terribly. Not only might this be problematic on humanitarian grounds, but critics suggest that it is also politically unsustainable – even apart from the dangers of contagion effects. Third, it is hard to imagine a mechanism by which loss of pre-conditionality certification would not lead to a run on a given country's currency – this not only makes pre-conditionality less attractive for potential borrowers, but it also would put the IMF in the position of actually setting off crises, rather than defusing them. Finally, it is not clear what the conditions should be.

Advocates of rapid and massive provision of capital also object to heavy conditionality, but for different reasons. They argue that IMF conditions usually create short-term burdens on economies, and that periods of crisis are the times when economies are least able to handle additional burdens. Moreover, since they believe that in at least some cases national economic policies are not primarily to blame, it may be inappropriate to force wrenching changes in exchange for needed help; many felt that conditions imposed on Asian countries in 1997 and 1998 actually exacerbated the crisis. In general, their argument was that crises should not be seen as a "window of opportunity" to force through desired changes that are unrelated to the crisis at hand. Instead, the time for reforms is before (or after) crises, when economies are less fragile and the effects on the poor will be smaller.

Critics of this position point to the general problem of moral hazard. More importantly, they argue that crises are the only time when the international community has leverage to force changes in economic policies – without a crisis, there is no compelling reason for governments to impose politically or economically painful policies.

Finally, the incrementalist camp perceives the problem of IMF policy as one of resolving competing policy needs. Repeated need for IMF financing on the part of some economies suggests longer-term problems that must be addressed even if the IMF mission is to deal with short-term financing. In other words, crisis prevention is a corollary duty of the IMF as an agency charged with crisis management. Thus, mission creep (or "condition creep") is probably an inevitability. However, with an average of 55 conditions for a 3-year program in the 1990s, the number of conditions appears to be excessive –including even stipulating reforestation policies in the case of Indonesia. In general, having many criteria creates difficulties of political sustainability for borrowers, and of prioritization for the IMF in the likely event that not all conditions are met equally. Mission creep means that the IMF is also entering the field of development or legal reform – areas in which it has little expertise and which interfere with the functions of the World Bank and other international organizations – as the limited lender of last resort camp would argue.

"Bailing-in" the Private Sector

Related to the issue of conditionality is the question of how to increase the responsibility of private lenders for absorbing some of the costs of their excessive lending. Most participants seemed to agree that moral hazard for the private sector has at least been a factor in several of the major international financial crises involving developing economies over the past twenty years. The problem has been how to reduce that moral hazard.

In this regard, there appeared to be significant support for collective action clauses in emerging country bonds. Such clauses could obligate bondholders to accept restructuring, rollovers, or temporary standstills on repayments in case of emergencies. While the U.S. Treasury has generally been seen as opposed to such clauses, some participants reported that this position was changing. This was generally seen as a hopeful sign. Collective action clauses on bonds are seen as particularly important because most economies with high foreign currency debt are not dealing with loans from a limited number of banks – where coordination is difficult but frequently possible – but with a large number of bondholders for whom coordination may be impossible. Thus, collective action clauses may provide an important means of adapting to a changed global financial reality.

Capital controls did not prove to be a major topic of discussion. Since soon after the Asian currency crisis began, they have been heavily debated as a means of preventing rapid capital flight, which would presumably also have some of the effects of collective action clauses. Moreover, many in Asia have argued that China's and Taiwan's relatively smooth rides through the crisis had to do with capital controls. Nonetheless, there was no discussion of either the appropriateness of controls in certain cases, nor the proper mechanics of market-friendly capital controls (e.g. the "Chilean model").

Decision-Making in the IFIs

Two points were raised concerning decision making in the international financial institutions. One was that voting rights in the IMF and World Bank do not reflect actual economic weight – Japan and middle-income countries like South Korea are underrepresented, particularly on the Executive Board. It was generally unclear what the practical effects of this pattern of representation might be, but several Japanese participants argued that it disadvantaged Asian economies in particular.

On a related note, there was a brief discussion over the correct governance of the Fund by its Executive Directors. Many participants appeared to agree with the general principle that Executive Directors should be setting policies and that Fund officials should have much less discretion in setting up lending programs and conditionality. This was not a unanimous view, however, as some argued from a practical standpoint that rule-based rescue operations are not practical given the many differences of economic circumstances in the various countries that request IMF funds.

Regional Arrangements – ASEAN + 3

The final debate regarding the international financial architecture was about regional arrangements – in particular, regional arrangements in Asia. Following the strong U.S. opposition to the 1997 Japanese proposal for an Asian Monetary Fund, there have been a variety of regional efforts to try to stabilize the Asian regional financial system. The goal is to push forward greater regional stability and overall economic integration in the long-term.

One of the most notable of these has been the establishment of ASEAN + 3 cooperation (the three non-ASEAN states are China, Japan, and South Korea.). In addition to surveillance as agreed upon in Manila in the fall of 1999, these states agreed in Chiang Mai last spring to establish a comprehensive set of bilateral swap lines to deal with future currency emergencies. The swap lines are still at a very premature stage – as of now, the only bilateral ones are Japan-Korea and Japan-Malaysia. Moreover, the total amount in question is modest – only about $200 million currently for the intra-ASEAN multilateral agreement, although there is some consideration of expanding the total to $1 billion. Existing central bank repo agreements in the region are still much larger in magnitude even than planned swap lines. Moreover, the conditions under which swaps would be activated have still to be negotiated.

The centerpiece of ASEAN + 3 cooperation is supposed to be mutual surveillance. There was some skepticism expressed as to the potential utility of such surveillance, however. One problem will be the question of what criteria should be adopted as goals for Asian economies to meet. As it now stands, there is some monitoring already by various regional and international organizations. Thus, the question arises of whether ASEAN + 3 surveillance criteria will be redundant, or if they will attempt to address new dangers, such as the possibility of new "capital-account crises." Beyond that technical issue, the effectiveness of mutual surveillance in general was questioned, and it is also possible that the relatively low level of similarity and integration in the region will make it even easier for countries to ignore recommendations from their regional partners. A final political question was how Japan and China might share leadership responsibilities.

Nevertheless, a number of participants saw ASEAN + 3 cooperation as an extremely significant step in shaping the regional monetary system, for at least three reasons. One is that it forms a framework for increasing the amount of funds that can be mobilized rapidly to head off currency crises – an obvious benefit if one agrees that currency crises in the region are most likely to be the result of irrational short-term money flows. A second reason is that it brings China into regional monetary affairs. One of the major reasons given for the stillbirth of the AMF idea in 1997 was Chinese opposition to what it perceived as a Japanese bid for regional leadership; China's abrupt change of heart in this respect suggests new possibilities for distribution of power and responsibility in the Asia-Pacific.

The third point is the most controversial: some observers argue that ASEAN + 3 will lead to a challenge to the IMF. Most advocates (and the participating countries themselves) emphasize that whatever regional monetary arrangements develop will be complementary to the IMF, by providing short-term bridging assistance until an IMF program can be put into place. Others remain suspicious, however. They note that many of the countries involved have called for weaker IMF conditionality, and they fear that participating countries might go to their regional partners instead of to the IMF. The result could be weaker conditionality for regional provision of funds that will in turn weaken the credibility of the Fund.

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