SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR JAPAN AND THE UNITED STATES

GOTEMBA, JAPAN • OCTOBER 3-5, 2003

Friday, October 3, 2003

18:00 Cocktail Reception in Main Lobby

19:00 Dinner in Room A

Greetings

Motoo Kaji, Chairman, The International House of Japan, Inc.
Hal Scott, Nomura Professor & Director, Program on International Financial Systems, Harvard Law School
Robin Radin, Associate Director, Program on International Financial Systems, Harvard Law School

Keynote Address

Haruhiko Kuroda, Special Advisor to the Cabinet

Saturday, October 4, 2003

7:00-8:30 Breakfast in Fuji View Room
7:00-8:30 Breakfast Meeting of Facilitators and Reporters in Fuji View Room

8:30-8:40 Welcome & Opening Remarks in Room A
James Abegglen, Trustee, The International House of Japan, Inc.
Hal Scott, Program on International Financial Systems, Harvard Law School

8:40-9:00 Session 1: Global Deflation, Interest Rates and Exchange Rates
Panelist: R. Glenn Hubbard, Columbia Business School
Panelist: Masaru Yoshitomi, JBIC Research Institute

9:05-10:25 Small Group Sessions

Group	*Room*	*Facilitators*	*Reporter*
1	B	Robert Fallon & Mitsuhiro Fukao	Hal Scott
2	C	Jeffrey Young & Hiroshi Ota	Robin Radin
3	D	John Vail & Masahiro Kawai	William Grimes
4	E	David Asher & Masaru Yoshitomi	Peter McKillop
5	Main Lobby	Bernard Munk & Yasuo Kanzaki	Christopher Wells

10:25-10:40 Refreshment Break

10:40-11:10 Session 2: Corporate Governance Standards and Capital Markets
Panelist: Arthur Mitchell, Asian Development Bank
Panelist: Yasuhisa Shiozaki, House of Representatives

11:10-12:20 Small Group Sessions

Group	*Room*	*Facilitators*	*Reporter*
1	B	Richard Medley & Hiroyuki Kamano	Hal Scott
2	C	Alicia Ogawa & Hiroshi Ota	Robin Radin
3	D	Cliff Shaw & Nobuo Tanaka	William Grimes
4	E	Wilbur Ross & Akihiro Wani	Peter McKillop
5	Main Lobby	William Seidman & Shuji Yanase	Christopher Wells

12:30-13:30	Lunch in Fuji View Room Keynote Address His Excellency Howard Baker, Ambassador Extraordinary and Plenipotentiary of the United States of America to Japan	
13:40-14:10	Keynote Address in Room A Hiroshi Watanabe, Director-General of the International Bureau, Ministry of Finance	
14:10-15:10	Session 3: Industrial Revitalization in Japan: Mechanisms and Obstacles	
	Panelist:	Shinjiro Takagi, Industrial Revitalization Corporation of Japan
	Panelist:	Wilbur Ross, WL Ross & Co.
	Panelist:	Tomoo Tasaku, PricewaterhouseCoopers Financial Advisory Services
	Moderator:	Richard Gitlin, Gitlin & Company
15:10-18:00	Free time	
15:10-17:00	Reporters (from Small Group Sessions) meeting	
18:00	Cocktail Reception in Main Lobby	
19:00	Dinner in Room A Keynote Address John Taylor, Under Secretary for International Affairs, U.S. Department of Treasury	

Sunday, October 5, 2003

7:00-8:30	Breakfast in Fuji View Room	
8:00-8:30	Breakfast Meeting of Discussion Chairmen and Steering Committee in Fuji View Room	
8:30-9:30	Presentation & Discussion in Room A Global Deflation, Interest Rates and Exchange Rates	
	Japan Chairman:	Akinari Horii, Bank of Japan
	U.S. Chairman:	John Makin, Caxton Associates
	Reporter:	Christopher Wells, White & Case
9:30-9:40	Refreshment Break	
9:40-10:20	Presentation & Discussion in Room A Corporate Governance Standards and Capital Markets	
	Japan Chairman:	Akira Ariyoshi, Ministry of Finance
	U.S. Chairman:	Thierry Porté, Morgan Stanley Japan Limited
	Reporter:	Peter McKillop, JP Morgan (Asia-Pacific Region)
10:20-10:30	Break	
10:30-11:20	Presentation & Discussion in Room A Industrial Revitalization in Japan: Mechanisms and Obstacles	
	Japan Chairman:	Reese Harasawa, The Bank of Tokyo-Mitsubishi
	U.S. Chairman:	Hugh Patrick, Columbia Business School
	Reporter:	Hal Scott, PIFS, Harvard Law School
11:30-13:30	Closing Lunch in Fuji View Room	

Building the Financial System of the 21st Century:
An Agenda for Japan & the United States

Gotemba, Japan, October 3-5, 2003

The fifth Symposium was held at the Keidanren Guest House in Gotemba Japan, amid improving stock prices in Japan and the United States, reported reductions in the stock of non-performing loans in Japan, and an apparent strengthening of the position of Japanese Prime Minister Junichiro Koizumi. Economic growth appeared to be on an uptrend in both countries, but concerns persisted about sustainability. Opinions about the Japanese economy ranged from pessimism to guarded optimism. With regard to corporate governance, Japanese firms were seen not to have yet achieved a definitive shift in behavior. Meanwhile, there were some afterthoughts regarding the wisdom of the Sarbanes-Oxley Law and other aspects of post-Enron corporate governance in the United States.

Session 1

Global Deflation, Interest Rates and Exchange Rates

Overview

The first session addressed issues of deflation and exchange rates. While participants agreed that global deflation was not a serious threat at this time, there was continued concern regarding persistent deflation in Japan. Exchange rates were addressed in the context of dealing with deflation, reducing international payments imbalances, and competitiveness issues.

Deflation

There was a general consensus that the United States had likely escaped deflation, due largely to aggressive monetary policies. Some participants pointed also to the importance of the Bush Administration tax cuts or of the recent weakness of the dollar, though these views were not universally shared. With regard to the dollar weakness, there was a common view that it was the conscious goal of the U.S. government, with the G-7's call for currency flexibility at Dubai given as evidence of an intentional shift from a "strong dollar" policy. (See below for more on exchange rate issues.)

As for Japan, it was generally agreed that significant improvements had been made in the macroeconomic environment since the 2002 Symposium at Warrenton, Virginia. Quantitative measures of prices were looking better, although still deflationary. There was also a general sense that Japanese consumers and firms were feeling more confident about the situation, which was buttressed by a few quantitative measures (such as the *Tankan* and consumer sentiment surveys) as well as anecdotes and direct observation.

The reduction of deflation was seen as a positive step forward for the Japanese economy. Lower real interest rates (although still relatively high for a recovery phase) could make borrowing more attractive. Moreover, the improving price picture reflected less of a shortfall in demand in the economy. This was reflected in higher profit rates, reduction in non-performing loans (NPLs), and higher stock prices. These changes were of particular importance to Japan's beleaguered banks and other financial institutions.

The recent reduction in NPLs was seen as particularly significant. There was a sense among many participants that banks were finally getting NPLs under control. This was partly due to the overall improvement in corporate profits, but was also seen to result from more vigorous corporate restructuring at the behest of lenders. This development was seen to be important not only for banks' health, but also more broadly. Improvement of banks' balance sheets could lead to both more efficient credit allocation and better monetary policy transmission.

A key question was whether the apparent movement toward recovery in Japan was sustainable or merely cyclical. On the optimistic side, participants noted that base money was again expanding rapidly, and some also argued that rises in profits were due to the positive effects of serious restructuring and cost-cutting among many firms. They felt that the slowdown in deflation reflected an improvement of demand and a reduction of the output gap as capital and labor came to be better employed. Pessimists were more skeptical of the extent or importance of restructuring to date, and felt that there was still substantial excess capacity in the Japanese economy. Some attributed part of the problem to the rapid growth of production in China, though most focused on the weaknesses in the Japanese economy itself.

Despite the presence of a relatively optimistic camp (the first in several years at the Symposium), virtually no one was very optimistic. Most agreed that it would be inappropriate to say that Japan had recovered from its decade-long stagnation until employment returned to its natural level and Japan saw above-trend growth for a sustained period.

With regard to the importance of deflation, a number of Japanese participants were less concerned about its effects than U.S. participants. Their relative lack of concern reflected several points. First, Japan's deflation has been moderate, so real interest rates were not extremely high. Second, there was an argument that since Japanese consumers did not foresee continuing deflation, they would not be postponing their consumption in the way economic models have predicted. Third, some argued that this mild deflation reflected productivity gains and the effects of Chinese imports, and so it was not necessarily a bad thing. Fourth, there was a sense among some participants that Japanese people had learned to live with deflation over the course a number of years, and so it was not an urgent problem.

Opponents of this point of view focused on several counterarguments. They argued that real interest rates remain too high in Japan to create incentives for new investment. Moreover, the extremely low nominal interest rates make creditors indifferent to whether repayments are made now or in the future. This means that there is little incentive either to force serious restructuring of weak borrowers (as opposed to just stretching out payments) or to cut losses by selling off loans or forcing bankruptcies. And finally, banks in particular are hurt by deflation, and that leads to a breakdown in credit allocation throughout the economy. Another problem cited was the intergenerational transfer of wealth from younger people with higher propensity to consume to older and wealthier people with lower propensity to consume. (This effect is compounded by the large government deficits, which will have to be paid through future taxes, as well as the aging of Japanese society.) All in all, these participants agreed with the Fed point of view that the costs of mild deflation are much larger than the costs of mild inflation. They were dismayed that Japanese policy makers appeared not to be sufficiently concerned about deflation, but expressed support for the Fed's proactive monetary policy.

Macro Solutions

Since most participants agreed that deflation and insufficient demand were indeed a problem (although the severity was much more in question), the question arose of how best to address them. For many, there was a role for both fiscal and monetary policy, although some participants disputed the effectiveness of one or the other.

The greatest disagreement was on the fiscal side. Some participants believed that fiscal stimulus was no longer effective, since Japanese households were offsetting its effects through Ricardian savings. They argued that fiscal stimulus has not worked in Japan, and that the only effect to new attempts would be an unsustainable increase in public debt. Most did not see a full offsetting, but still there was some dispute as to the most effective means of stimulus. There was a general consensus that public works spending would not be an appropriate policy, as it would create no lasting benefit. The only increased spending that gained any support was to expand the social safety net for displaced workers, in the form of expanded unemployment insurance and worker training.

Thus, fiscal policy would have to mean tax cuts. There was a division in this respect between those who felt that tax cuts should be focused on corporations or on households. Advocates of the supply side stimulus pointed out that Japanese corporate tax rates remain high. They also noted that firms were unwilling to invest in new productive capacity or improvements, and suggested that reductions in capital gains taxes would have a positive effect in improving productivity and creating new opportunities for employment. Advocates of consumer-oriented tax cuts, on the other hand, argued that deflation implied underconsumption and excess supply. Thus, they felt that corporate tax cuts would only add to the existing problem of excess capacity.

With regard to monetary policy, most were critical of the Bank of Japan's performance over the previous decade, but some felt that more recent policies showed positive signs. There was general support for more quantitative easing ("printing money"), although the actual mechanics of easing were less widely agreed upon. Three issues in particular were matters of dispute. One was the utility of inflation targeting. While advocates felt that it was an essential element of monetary policy, as long as the central bank were able to establish credibility, opponents denied that the BOJ would likely be able to meet the targets it set – thus further eroding its credibility. Second was whether monetary instruments should be expanded to include extraordinary measures, such as purchases of equity funds or REITs. This was not a major topic of discussion, but clear disagreements were in evidence. The third issue was over the role of exchange rate intervention in overcoming deflation, which is addressed below.

Finally, there was some discussion of more psychological aspects of deflation-fighting. A number of participants raised the point that the BOJ's policy has actually been fairly expansionary for the last several years, but that Governor Hayami had dampened its effectiveness as a result of his public skepticism about the Bank's efforts at easing. In this respect, they felt that Governor Fukui and his deputy governors inspired much greater confidence in the public, even though some denied that there was a meaningful change in the policies being pursued. Also with regard to the psychological dimension, some participants suggested that a confident political message would be helpful, calling on the example of Ronald Reagan following after what president Carter had himself called the "malaise" of the U.S. economy during his administration. At the least, it was agreed that the BOJ would have to regain its reputation for credibility with financial markets.

Exchange Rates

Exchange rates were a major area of debate in the first session, with the main focus being on whether they had a role in causing or resolving deflation. The discussion also proceeded in the context of recent developments in foreign exchange markets, including dollar depreciation, massive Japanese intervention, and statements by the G-7 and U.S. Treasury calling for greater exchange rate flexibility.

<u>The Renminbi</u>

In contrast with public statements by members of the Japanese government, few participants felt that Renminbi undervaluation was a meaningful factor in Japanese deflation. Many suggested that the RMB was in fact undervalued, but agreed that Japanese deflation was largely home-grown. Those who felt that China was in fact exporting deflation to Japan and the rest of the world concentrated not primarily on the exchange rate, but rather on China's role in the expansion of worldwide capacity. There was some debate as to whether the profound impact of Chinese and Indian growth on relative prices could in itself cause deflation or if, as a number of participants argued, the price level of an economy is entirely determined by monetary policy. One factor put forth as a reason why China's competitiveness might have a larger deflationary impact on Japan than on the United States was that the U.S. economy has had much more flexibility in its labor markets, and thus has been able to respond to the relative price shifts more quickly and effectively than Japan.

While many felt the RMB to be overvalued, there was a great deal of skepticism regarding the U.S. government's call for movement toward a more flexible exchange rate regime. Some suggested that it was a political effort to satisfy certain manufacturing interests in the United States. More generally, there was a feeling that this may not be the most effective way to deal with China. A number of participants argued that, given the limited leverage the U.S. and Japanese governments enjoy over China, they would be better off using it to push for stricter compliance with WTO rules. Also, the issue of sequencing arose. Experience with other developing countries suggests that a number of preconditions must be met before a country should shift to a floating exchange rate regime, including improvement of the domestic financial markets and removal of current and capital account controls. In this respect, China is still several years from being able to shift to a float, although in the interim it could widen the band or voluntarily revalue the RMB.

The Yen

With regard to the yen, most Symposium participants were less alarmed than the Japanese media and politicians. This was partly because the real effective exchange rate had moved less dramatically than the nominal yen-dollar rate over previous weeks. Also, there was a general feeling that exchange rates should be less a target than an effect of monetary policy.

The crux of the debate was whether foreign exchange market intervention was an effective means of quantitative easing for the Japanese economy. There was widespread agreement with the basic macroeconomic point that large-scale unsterilized intervention could have a profound effect in directly increasing the money supply, although some cautioned that the United States might not be willing to accept a major yen depreciation against the dollar. (On the other hand, a number of participants argued strongly that the U.S. government would be willing to accept a substantial devaluation by Japan if it were in the context of attempting to pump up the money supply rather than simply gain a competitive advantage for its exporters.)

Noting the immense amount of intervention carried out in 2003, a natural question was whether it was indeed having effects on the money supply. There was some debate over the extent to which the BOJ was sterilizing MOF intervention, as it generally has at other times of large-scale accumulation of foreign exchange. There was a near consensus that the BOJ had been allowing much more currency intervention to go unsterilized in recent months (whether fully unsterilized, some participants stated, or not). It was suggested that this accounted for a considerable amount of the acceleration in base money creation in recent months. Only a few argued that there was not a meaningful change in BOJ sterilization policy. There were several interpretations offered for the change. The most hopeful was that MOF and BOJ were effectively coordinating economic policy rather than simply offsetting or ignoring each other's actions. A more cynical view was that the Bank of Japan was unwilling to take clear responsibility for the easing policy, and so was letting MOF take the lead on it – but at least not standing in the way. In either event, the broad consensus appeared to be that this was a positive step toward quantitative easing, and that intervention was aimed primarily at money creation rather than purely at trying to maintain export competitiveness.

The Dollar

Finally, there was some debate over the meaning and implications of current U.S. government policy on the dollar. A majority appeared to feel that the rhetorical switch from a "strong dollar" line to one emphasizing market prices based on economic fundamentals was in fact aimed at depreciating the dollar. Many of these participants were concerned about the possibility of competitive depreciations, and some felt that the U.S. action was irresponsible. Going against the majority view, a few participants argued that the change in rhetoric was in fact the most sensible and responsible way to define currency policy in a world of floating exchange rates. Regardless of their views of the wisdom of the change, participants generally agreed that it had contributed to at least a moderate and short-term depreciation. The major reason for dollar weakness, however, was seen to be economic fundamentals of aggressive monetary easing by the Fed, large budget and current account deficits, and remaining excess capacity in the U.S. economy.

It was also pointed out that conditions of excess capacity dogged many of the world's economies, however, and it was obvious that they could not all depreciate simultaneously. Those who emphasized the global problem of excess capacity argued instead that what was needed was not necessarily depreciation, but rather more inflationary monetary policy to stimulate demand in the United States, Europe and Japan. Since only the United States was actually seen to be aggressively doing so, it was natural that the dollar would depreciate relative to the other currencies until they did the same. (The increased unsterilized intervention by Japan might of course reduce this tendency, but the ECB remained conservative.)

Session 2

Corporate Governance Standards and Capital Markets

As in previous meetings, especially the 2002 Symposium in Warrenton, issues of corporate governance were a major focus. In Gotemba, there was less discussion of specific proposed regulatory issues; rather, participants spoke mainly about general principles, their application in Japan and the United States, and the role of markets for corporate control.

Models of Corporate Governance

Most participants agreed that the role of corporate governance regimes is to ensure that corporations are managed for the benefit of owners rather than other stakeholders such as management, labor, creditors, customers, or suppliers. While in some cases maximizing shareholder value might coincide with the interests of one or more of these other actors, they agreed that owners must improve their control over firms.

While the ultimate criterion of good governance was generally understood to be maximization of profits, most discussion of corporate governance revolved around rules that should or should not be in place to ensure that the interests of shareholders would be respected. Laws and regulatory enforcement were seen as often concentrating only on the issue of reducing fraud at the expense of other aspects of proper corporate governance, such as maximizing profits. Rules meant to prevent improper behavior by management might choke off risk-taking, innovation, and entrepreneurship at the same time. Thus, corporate governance regimes must be set up with a realization of this trade-off.

Is the U.S. Model Appropriate For Japan?

Beyond this broad consensus, there was considerable disagreement on the actual elements that U.S. and Japanese corporations should include in their governance regimes. Several important distinctions were drawn by various participants between U.S. and Japanese systems of corporate governance, including the role of capital markets, the importance of "outsiders," and the ways in which Japanese-style management might be integrated within an owner-oriented corporate structure.

The U.S. system was characterized by most participants as being based on several key pillars, including dominance of corporate boards by outside directors, incentive pay for executives, rigorous and independent audits, and an active market for corporate control. Many participants felt that this was generally an appropriate model, even if not all firms achieved the ideal of owner-oriented management. The major criticisms offered had mainly to do with poor execution. For example, it was noted that in many cases, boards – including compensation and audit committees – have been functionally appointed by chief executives rather than by owners, calling into question the independence of boards. Similarly, a number of participants were skeptical of whether programs meant to pay executives based on performance have actually done so, given the high pay of many executives whose companies had been unsuccessful relative to their industry peers. Many Japanese participants in particular were skeptical that large executive pay packages were necessary to ensure good performance.

With regard to regulation, there was a growing feeling among participants that the Sarbanes-Oxley Law and New York Stock Exchange rules had gone too far in trying to prevent malfeasance by managers and inattention by directors. Several participants expressed the view that punishment by capital markets is more likely to improve governance than legal sanctions. Moreover, since regulations are less flexible than capital market judgment, there was a fear that they would be unable to respond to changing circumstances or innovations in governance. Finally, some argued that such regulations have made U.S. corporations risk-averse – CEOs fearful of making mistakes would not only be less innovative, but would also waste valuable time on compliance issues that could better be spent on managing their firms. While these concerns were not universal, they were strikingly more prevalent than at the Warrenton Symposium in 2002, where participants had been generally approving of the new rules.

Japanese corporate governance was characterized quite differently by most participants, although there was a general sense that it had moved closer to U.S. ideals and practice over time. In particular, many participants argued that Japanese firms still favor stakeholders over shareholders, and that this has impaired their competitiveness and profitability. These critics argued that the inability of Japanese firms to shed unnecessary workers or to upset relationships with suppliers, customers, and main banks prevented them from implementing business models appropriate to changing market circumstances. Moreover, they felt that management tended to reward itself at the expense of shareholders, while offering little clear accountability – the large size and insider nature of Japanese corporate boards was a major example in this regard. Directors were understood as still seeing their roles as members of management rather than as representatives of owners. Only by reducing board size, separating director functions from management functions, and bringing in outsiders to represent shareholders could management's conflict of interest be reduced.

In contrast, a number of participants cautioned that such solutions were bound to clash with the logic of Japanese-style management, and actually create worse outcomes. This argument centered on the importance of firm-specific skills and of reciprocal trust within the corporation. With regard to workers, the centrality of firm-specific skills to production of value meant that much of the value of a Japanese firm lies within its employees; moreover, expectations of lifetime employment were seen to create the mutual trust on which development of firm-specific skills and worker responsibility were based. Thus, aggressive corporate downsizing was seen to risk impairing firm value. With regard to oversight of management, it was argued that firm-specific knowledge is essential to understanding the operations of Japanese firms, and thus poorly-informed outside board members would be at a disadvantage in directing the firm, rather than injecting greater discipline. While these participants called for greater accountability and openness, they were concerned about the implications of convergence to a U.S. model.

Regardless, there was a general sense that Japan was moving to some extent in the direction of U.S.-style corporate governance, in several ways. First, capital markets were becoming of increasing importance to firms' access to financing. While an effective market for corporate control had yet to emerge, price fluctuations were seen to put increasing pressure on management. This was at least partly due to a substantial unwinding of cross-shareholding and other stable shareholding, which means that creditors, borrowers, customers, and suppliers have become less tightly tied to each other, and thus less willing to extend extraordinary assistance. The reduction of banks' shareholding was particularly significant in this regard. Other factors, such as shareholder suits, also reinforced increased management attention to the interests of shareholders. Overall, despite the perception that problems in accounting standards and regulatory enforcement in Japan persisted, it was felt that many of the rules are in place for substantial change in corporate governance in Japan. The relative slowness of actual behavioral change, however, suggested to some participants the need for a focus on changing "mindsets" rather than rules.

Best Practices in Corporate Governance

While considerable differences of opinions remained concerning the appropriate model for corporate governance for each country, there was a greater degree of consensus concerning what might be called corporate governance "best practices."

With regard to corporate boards, two prescriptions were prevalent in discussion. First, many participants called for clearer separation of board and management in Japan. Debate persisted on whether this functionally required the presence of a significant number of outsiders on boards – for example, there was disagreement as to whether directors from related firms could ever be independent. In addition, there was a call for smaller boards with purely oversight functions.

A second important point in this regard had to do with improving the information available to directors. This point was made particularly strongly in reference to Japanese firms, but some participants also suggested its relevance to U.S. firms. In Japan, two particular problems were seen to hamper the effective flow of high-quality information to directors. First was the informal nature of information systems within Japanese firms – since firm-specific knowledge has been valued, and informal networks have been a key conduit for information within firms, only well-connected insiders were seen to have a chance to get an accurate picture of firm activities. Outside directors would be particularly excluded from access to timely and accurate information. Second, audit committees have traditionally been seen as lower in the corporate hierarchy than top management, and have thus been unable to demand information or act as an effective check on management actions. In the United States, participants saw the problem as less significant, but some cautioned that directors were able to spend relatively little time monitoring firm activity, and that their access to information is generally contingent on cooperation on the part of management.

Appropriate (but restrained) supervision by regulators was also seen as important. While there was some disagreement as to specifics – and especially as to the appropriateness of specific laws, such as Sarbanes-Oxley – there was a general consensus that government enforcement of disclosure rules is essential. Also, several participants emphasized the need for some means of regulating conflicts of interest, whether by regulatory agencies or through the court system.

In the end, however, many participants argued that good corporate governance and ethical behavior are dependent on the integrity of the CEO and those around him or her. As one executive argued, if a CEO's main purpose is to manipulate the stock price in the short term, he or she will tend to try to cut corners in accounting and compliance, and shareholders will be injured. Given the CEO's ability to shape board composition and the information that is passed to directors even in the United States, a great deal of responsibility must lie in his or her hands. Following this reasoning, some participants argued that rethinking of corporate compensation packages would be essential. Some focused on composition of pay (i.e. stock, options, bonuses), but others focused on size. However, there was no consensus on whether CEO compensation should be lower or higher.

Role of Capital Markets

Participants saw effective capital markets as an indispensable means to enforce market discipline on management. Despite acknowledgements of the volatility and imperfections of capital markets, they were seen to fulfill two essential functions: to ensure proper allocation of capital to reward well-managed firms and to punish poorly-managed ones, and to provide a market for corporate control. Japanese capital markets came under criticism in both respects.

The first function of capital markets is to monitor firms' performance and to allocate capital accordingly. Due to the importance of bank financing and the prevalence of stable shareholding, Japanese capital markets were seen to have had virtually no role in disciplining or rewarding firms during much of the postwar period. Only over the last twenty years have they begun to gradually take on that role. Instead, firms relied on their long-term relationships with main banks to provide them with finance, and in turn the main banks were expected to monitor their performance. While there was disagreement on how well the system had worked in the past, there appeared to be unanimity among participants that main banks do not now fulfill those functions. Meanwhile, capital markets have been slow to take on that role, although significant changes have been seen.

The second essential function of capital markets – acting as a market for corporate control – was seen by many participants, especially those from the United States, as being key to effective corporate governance. They described takeover bids as being the ultimate check on managers, since takeovers assume that the new owners will be able to provide better direction than would existing managers. Takeovers might be particularly threatening to Japanese managers, since they are often followed by replacement of top management, significant downsizing of the labor force, and elimination or sale of poorly-performing units. Pointing to U.S. experience since the 1980s, these participants saw the fear of "hostile" takeovers (some objected to the term "hostile"; it is used here as shorthand) as being an extremely effective motivator to make managers heed shareholders' interests.

In both cases, the role of outsiders as agents of change was seen by most participants as being key to corporate reorganization and revitalization. Whether those outsiders were to come in the form of independent directors who could push their agendas on management or as an entirely new management team was seen as less important than that new knowledge and methods be applied within failing corporations. To date, foreigners have been particularly important as agents of change in several firms, and Nissan under Carlos Ghosn was cited by many. The Nissan case was seen as particularly instructive, because it took the installation of an outsider as CEO to carry out bold reorganization plans that had largely been prepared inside the corporation. Over time, it was expected that more Japanese firms and individuals would be in a position to play that role in troubled Japanese firms.

It was unanimously agreed, however, that Japan does not yet have an effective market for corporate control; thus, many participants felt that capital markets are not yet doing their job with regard to corporate governance. The fact that there has yet to be a successful tender offer or proxy fight was seen as demonstrating the lack of credibility of capital markets in enforcing effective corporate governance. While there were some legal issues raised, such as the impossibility of going private without the individual assent of all minority shareholders, for the most part participants agreed that the absence of successful takeover bids stemmed not from the insufficiency of laws, but rather from investor timidity and the vested power of managers and stable shareholders.

Despite the negative assessment of Japan's market for corporate control, a number of participants saw reasons for optimism. In particular, market participants observed an increase in interest among firms and financial institutions both in planning for takeovers and in defending against takeovers. Several offered the opinion that it would take a foreign company or other non-traditional Japanese firm, in concert with a foreign financial institution, to carry out the first hostile takeover. Only after the creation of a precedent – and a successful example of making money out of it – would Japanese firms and lenders be likely to enter the market. The reason given was that Japanese firms would suffer reputational damage by attacking one of the tenets of proper corporate behavior, and thus would only be willing to do so if there were sufficient money to be made to make the reputational cost worthwhile. Over time, they suggested, the stigma of takeovers would fade, as it has in the United States, and an effective market for corporate control might emerge.

The Meaning of Resona: Corporate Governance of Financial Institutions

Corporate governance of Japanese financial institutions has been of particular interest in past Symposia, and the 2003 Gotemba Symposium was no exception. In this regard, the case of Resona Bank, which was subjected to a *de facto* nationalization in May 2003, was seen as being of great symbolic and practical importance. However, there was considerable disagreement as to whether Resona was a positive move or a step backward from enforcement of effective bank management.

Some participants echoed initial assessments of the Resona takeover as being an essential step toward enforcing better management on banks. They argued that the action sent a clear signal to the rest of the banking community that excessive use of deferred tax assets to pad capital-asset ratios would no longer be acceptable. Moreover, the wholesale dismissal of upper management, and its replacement by a new management team, was a striking move to force greater managerial accountability. Finally, they pointed to significant dilution of existing shareholders as likely to improve investor monitoring of corporations – and thus corporate governance.

An apparently much larger group of participants disagreed with that assessment, however. They argued that several aspects of the Resona action would lead to continued irresponsibility on the part of management at other banks. The main objections were as follows: First, although common shareholders suffered dilution of their holdings, that dilution was limited. Thus, the operation was a partial bail-out to shareholders, which would in fact undermine investors' incentives to monitor and control management. Second, there were criticisms of the haste with which the government made decisions about the price of the operation and the dilution of existing shareholders – in other words, the FSA did not carry out proper due diligence. This was seen to be both an irresponsible use of public funds and a poor example of how to do business. Finally, many participants criticized the takeover for failing to reduce inefficiencies or to introduce a new business model; to make matters worse, they pointed to the continuation of socially mandated lending to struggling firms (especially SMEs).

The two interpretations allowed for relatively few points of agreement. Even the boomlet in bank stocks since the summer could be interpreted in contrasting ways: either it represented prospects for improved management and profits or it reflected moral hazard, as investors flocked to enjoy the upside of current improvements in profits without worrying about the downside of losing their investment. As for the effects on Resona's profitability, eyes were necessarily toward the future, but there was a strong sentiment of pessimism.

Session 3

Industrial Revitalization in Japan: Mechanisms & Obstacles

Revitalization?

In the end, much of the discussion about both sustainability of growth and quality of corporate governance hinged on whether and how Japanese corporations could return to profitability. While some participants offered evidence that significant strides had been made in corporate restructuring, others dismissed the improved performance as being the result of a cyclical upturn and unsustainable cost-cutting. Opinion was similarly split between (generally cautious) optimism and pessimism regarding prospects for major improvements in the short term.

There was consensus on a few basic points, however. Creditors were seen to be key to the process of restructuring and revitalization. Simply writing off NPLs or selling them to be warehoused at the Resolution and Collection Corporation was seen as not addressing the core of the problem, even though it is what many banks have done in the past. Second, participants agreed that firms would need to emphasize shareholder value in order to make their recoveries sustainable. Third, cost-cutting measures alone would not be sustainable in the long run, especially if they were to focus on downsizing of labor and reduction of capacity. Rather, productivity improvements through innovation as well as cost-cutting were seen to be essential

The key questions concerned how to achieve these goals. While one plenary session concentrated on the role of the newly-established Industrial Revitalization Council of Japan, many participants argued that the solution would lie ultimately with private sector efforts.

IRCJ

The IRCJ was established in May with a capitalization of ¥10 trillion and a mission to take on the revitalization of failing firms. Banks would surrender a portion of their debtholdings, and the IRCJ would take on a controlling share of the company, carry out a wholesale restructuring to turn it around, and then sell off its shares at a profit within three years. It would focus on the middle of the distressed loan market, leaving the healthiest of those firms to work out matters independently with their creditors and the weakest of the firms to go into bankruptcy.

Despite the attention achieved through its establishment, however, as of September 2003, the IRCJ had taken on only six relatively minor firms, and was having a hard time persuading banks to make large-scale use of its services. Two major reasons were given by participants for banks' reluctance in this regard. First, some stated that banks preferred to set up their own restructuring groups, in order to recoup a greater percentage of their loans. Second, participants pointed out that the IRCJ's valuations on loans were much lower than those of the FSA.

The issue of valuation appeared to be a key one, which raised a number of questions for participants. First, why was there such a large discrepancy between IRCJ and FSA valuations? In theory, both use discounted cash flow analysis, but it appeared that IRCJ had applied such analysis to arrive at much lower valuations than did the FSA, especially with regard to land. The incentive for banks to cooperate with the IRCJ would be reduced if its valuations were systematically lower than FSA's, since the transfer of the loan would result in further write-offs and further capital losses. This would be particularly true in a zero-interest rate environment, where there is no penalty for holding onto non-performing assets. Second, has the FSA been doing its job correctly if its valuations are consistently and significantly higher than the IRCJ's? There was significant suspicion that FSA was in fact overvaluing loans as a means of keeping banks solvent.

It was generally agreed that there is little likelihood that the IRCJ will be able to allocate all of its investment funds during its short planned lifetime of five years. And although there was some discussion of whether banks should be required to offer some quantity of NPLs to the IRCJ, most agreed that this would be neither feasible nor desirable. Thus, many participants argued that the IRCJ would be a sideshow at best in the restructuring and revitalization of Japanese firms, and expressed skepticism that this was a "new beginning."

In response, supporters of the IRCJ argued that it in fact can fulfill several important roles in Japan's corporate revitalization. For one thing, it may be a role model for serious restructuring. Carrying out serious due diligence and coming up with reasonable valuations of firms may demonstrate to other potential work-out firms and vulture funds that it is possible to accurately value a distressed firm, which is essential to making a profit on restructuring. Similarly, it is forcing firms to create new and innovative business plans, rather than just downsizing labor and reducing capacity. This too may be a good example to firms, banks, and investors.

Moreover, the IRCJ may be able to fill certain niches in the overall restructuring market. For example, government-owned financial institutions have not been in a position to write off loans to surviving companies. Selling their loans to the IRCJ offers them a solution that avoids both continued rolling over of loans to weak borrowers on the one hand and forcing bankruptcies on the other. Second, the IRCJ may be instrumental in addressing the collective action problem of bank coordination in writing down loans. Main banks have traditionally taken on the largest burden in writing down loans to borrowers, but in many cases are no longer willing to do so. If they insist on a *pro rata* write-down, however, other lenders may balk. Turning to the IRCJ may help solve this collective action problem. Third, although the IRCJ was originally envisaged as fixing major firms, it was pointed out that banks would be much more willing to write off loans from small firms, which would have less of an impact on their balance sheets.

Even in these niche markets, however, the IRCJ's total impact will be small as long as its clientele is small. Few participants saw serious likelihood that there would be a large influx of new clients. Thus, IRCJ's effects are most likely to be symbolic or as a role model. (Cynics pointed out, however, that the symbolism of being ignored by financial institutions might be at least as important as the symbolism of a few successful work-outs.)

Private Sector Efforts

Given both the sheer magnitude of Japan's NPL problem and the expectation of most participants that the IRCJ's portfolio would remain relatively small, it is inevitable that most restructuring/revitalization efforts will be up to private sector institutions. Indeed, all the major banks have established restructuring units that will seek to fix problematic borrowers, and in the process make some money. In theory, at least, most participants agreed that this is a job for the private sector. However, despite the obvious profit motive, many expressed skepticism that the banks are up to the job.

Two basic problems were cited in this regard. First, given FSA rules and the zero-interest rate environment, banks have little incentive to force rapid restructuring on distressed firms. Instead, they have a bias toward "restructuring" the loans by stretching payments out over a longer period. Second, many participants doubted the competence of banks to design and implement effective restructuring plans that would lead to sustainable corporate growth. Thus, the preference of banks for keeping restructuring essentially in-house did not inspire universal confidence on the part of Symposium participants.

Other participants cited the potential importance of other institutions, such as vulture funds or consultants and investment bankers with expertise in restructuring. Here, as in the capital markets discussion described above, many participants saw a key role for foreign participants. Foreigners were again seen as having both experience with successful restructurings, and fewer compunctions about breaking cultural norms. Over time, it was argued, successful restructurings by foreign actors would increase the willingness of Japanese firms to enter the fray. Also, cooperation between Japanese and foreign firms would provide useful experience and expertise to Japanese firms and individuals, who would then be expected to have a wider impact over time.

There were few suggestions beyond this as to how to create a rapid increase in private sector-led restructurings. However, as seen in the first session, some participants were optimistic that firms themselves had become more proactive in their own restructuring efforts, which could perhaps be a major step toward the recovery of some portion of the "non-performing borrowers."

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GOTEMBA, JAPAN • OCTOBER 3-5, 2003

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