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

Gotemba Japan • December 7-9, 2001

Friday, December 7, 2001

18:30-19:00 Cocktail Reception in the Main Lobby

19:00 Dinner in Room A

Greetings:

Kenichi Ito, President, The Japan Forum on International Relations, 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 Addresses:

Hakuo Yanagisawa, Cabinet Minister for Financial Services
Kenneth Dam, Deputy Secretary, United States Treasury

Saturday, December 8, 2001

7:00-8:30 Breakfast at Restaurant Fuji View
7:00-8:30 Breakfast Meeting of Facilitators and Reporters at Restaurant Fuji View

8:30-8:40 **Welcome & Opening Remarks** in Room A
Hiroshi Ota, Executive Vice President, The Japan Forum on International Relations, Inc.
Hal Scott, Nomura Professor & Director, Program on International Financial Systems, Harvard Law School

8:40-9:00 **Session 1: Financial Restructuring (Government, Banks, Debtors)** in Room A
Japanese Panelist: Mikio Wakatsuki, Chairman of the Board of Counselors, The Japan Research Institute, Ltd.
Japanese Panelist: Yuji Tsushima, Member of the House of Representatives
U.S. Panelist: William Seidman, Chief Commentator, CNBC

9:05-10:25 Small Group Sessions 1-5

Group	*Room*	*Facilitators*	*Reporter*
1	B	Yoshio Okubo & Donald Kanak	Hal Scott
2	C	Akihiro Wani & Robert Fallon	Robin Radin
3	D	Mitsuaki Yahagi & Curtis Milhaupt	Peter McKillop
4	E	Takayoshi Hatayama & Kent Calder	William Grimes
5	Main Lobby	Yukinori Ito & Hugh Patrick	Chris Wells

10:25-10:40 Refreshment Break

10:40-11:10 **Session 2: The Regulation of Capital Markets** in Room A
Japanese Panelist: Yasuhisa Shiozaki, Member of the House of Representatives
Japanese Panelist: Mineko Sasaki-Smith, Chief Strategist, PriceWaterhouseCoopers Consultants Co., Ltd.
U.S. Panelist: Arthur Mitchell, Partner, Coudert Brothers LLP

11:10-12:20 Small Group Sessions 1-5

Group	Room	Facilitators	Reporter
1	B	Akitoshi Takatsuki & David Asher	Hal Scott
2	C	Minoru Nakazato & Robert Feldman	Robin Radin
3	D	Masatsugu Nagato & Thomas Cargill	Peter McKillop
4	E	Hiroshi Ota & Laurence Bates	William Grimes
5	Main Lobby	Mitsuhiro Fukao & David Sneider	Chris Wells

12:30-13:30 Lunch at Restaurant Fuji View (upstairs)
Keynote Address:
R. Glenn Hubbard, Chairman, Council of Economic Advisers

13:30-14:30 **Session 3: Stock Exchange Competition** in Room A
Japanese Panelist: Atsuo Nishihara, Managing Director, Tokyo Stock Exchange
Japanese Panelist: Hiroyuki Yamamoto, General Manager, Nomura Securities Co., Ltd.
U.S. Panelist: Rich Bartolotta, Chief Financial Officer, NASDAQ Japan
U.S. Panelist: James Shapiro, Senior Managing Director, Asia Pacific, New York Stock Exchange

14:30-18:30 Free

14:30-17:00 Reporters (from Small Group Sessions) meeting in Room C

18:30-19:00 Cocktail Reception in the Main Lobby

19:00 Dinner in Room A
Keynote Address:
Haruhiko Kuroda, Vice Minister of Finance for International Affairs, Ministry of Finance

Sunday, December 9, 2001

7:00-9:00 Breakfast at Restaurant Fuji View
8:00-9:00 Breakfast Meeting of Discussion Chairmen and Steering Committee at Restaurant Fuji View

9:00-10:15 **Presentation & Discussion** in Room A
Financial Restructuring (Government, Bank, Debtors)
Japanese Chairman: Akinari Horii, Advisor to the Governor, Bank of Japan
U.S. Chairman: Robert Dugger, Managing Director, Tudor Investment Corporation
Reporter: Hal Scott, Nomura Professor & Director, Program on International Financial Systems, Harvard Law School

10:15-10:30 Refreshment Break

10:30-11:45 **Presentation & Discussion** in Room A
The Regulation of Capital Markets and Stock Exchange Competition
Japanese Chairman: Takeshi Ohta, Chairman of Advisory Council, The Daiwa Research Institute, Inc.
U.S. Chairman: Thierry Porté, President, Morgan Stanley Japan Ltd.
Reporter: Christopher Wells, Partner, White & Case LLP, Tokyo

11:45-13:30 Closing Lunch at Restaurant Fuji View

REPORT: 2001 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan & the United States, Gotemba, December 7-9, 2001

The fourth Symposium took place in Gotemba, Japan at what appeared to be a critical time for the Japanese financial system. Stagnant economic growth, declining stock prices, increasing non-performing loans (NPLs), and high levels of bankruptcies in the real economy made for serious concerns among participants. Uncertainty about the government's intentions regarding NPL disposal, the impending ¥10 million limit on deposit insurance payouts (the "payoff" issue), and willingness to shut down insolvent financial institutions also remained a problem. Finally, the slowdown of the U.S. economy, particularly in the aftermath of the September 11 attacks, created some fears both for the health of the U.S. financial sector and for the negative effects on the economies of Japan and its Asian neighbors. Indeed, it was pointed out that this was the first time since the late 1970s that North America, Japan, and Europe were all experiencing slowdowns simultaneously, making for an unusually precarious time for the world economy.

I. Financial Restructuring

Discussion of financial restructuring focused for the most part on the Japanese banking system. Japanese banks were seen to face several major problems – preeminently the high levels of non-performing or potentially non-performing loans, but also excessive scale, problematic management practices, and the timing of "payoff" limits.

Meanwhile, further reform was generally seen as difficult. The resulting political stalemate was described by many participants as the key hurdle to be surmounted.

Dealing With NPLs

One of the major challenges facing financial institutions and regulators in Japan is that of NPL disposal. Despite apparently aggressive write-offs of NPLs since 1998, the stock of bad loans has actually increased. One of the major points of discussion in both plenary and small-group sessions had to do with how banks can be persuaded or forced to carry out NPL disposal and how the government should support such efforts.

Opinions on how to deal with the problem varied, based on each participant's analysis of the cause of the current NPL problem. Analyses of the causes varied:

- Irresponsible lending and rollover lending by banks.
- Lack of effective supervision by regulatory authorities. (Despite the BOJ's role in prudential regulation, virtually all participants focused on the actions of the FSA and its predecessors in the Banking Bureau of the Ministry of Finance.)
- The problems of the real economy, as seen in macroeconomic malaise, a depressed stock market, low corporate profitability, and high rates of corporate bankruptcy.
- Lack of political leadership.

Problems of Bank Management

Among participants who were concerned with the management of Japanese banks, one of the main criticisms was that bank managers have no incentive either to officially recognize the extent of bad loans or to cut off suspect borrowers. In many cases, revealing the actual extent of bad loans would make depositors and financial markets nervous or even panicked. More importantly, many banks simply do not have

enough capital to absorb loan write-offs – were they to do so, their capital-asset ratios would fall below the mandated levels of 8% for internationally active banks and 4% for domestic banks. In such a situation, it was suggested, the rational course of action for managers is to conceal the problem and hope that the condition of borrowers improves. Looking at it from the point of view of individual bank managers, many participants agreed that current management has a strong incentive to delay serious problems until future managers are available to take the blame.

Another broad range of issues concerned the lack of competitiveness of most Japanese banks, as seen in overreliance on the traditional retail banking business, excessive personnel and branches, and lack of sophistication in management of information and IT systems. The lack of competitiveness was seen to stem from the traditions of the old "convoy system," which inhibited innovation and rewarded size. Japan's mega-banks, formed by mergers of existing major banks, were seen to perpetuate the same problems rather than solve them.

A final theme that pervaded many of the presentations and discussions was that Japanese banks have never learned how to analyze value and risk. During Japan's period of rapid growth, focus on collateral and long-term relations were effective ways of judging risk, especially when the financial regulators and monetary authorities stood behind the stability of banks. However, such means are fundamentally dangerous in a world of falling asset values.

Restructuring Corporate Debtors

Many participants agreed that one of the central problems of NPLs was the misallocation of capital. Continual rolling over of NPLs ensures that the weakest and least efficient firms get a disproportionate share of credit, instead of those firms with serious prospects for growth and profits.

More generally, a common theme during the Symposium was that many of the problems that are often described as issues of the financial sector actually stem from weakness of the corporate sector. Several participants pointed out that many of the firms that had gone bankrupt in recent years had been classified as relatively healthy until just before their failures. While this was partly attributed to poor credit analysis by banks, it also appeared to reflect broader weaknesses in the Japanese economy.

Thus, a major issue was how weak borrowers could be restructured in order to make them more able to regain profitability and to pay back at least a portion of their debts. Most participants agreed that substantial attention should be focused on borrowers, and not just lenders. A number of problems with the current legal framework were identified. One of these was the difficulty of using bankruptcy procedures as a means of restructuring failing borrowers. Many participants who had had experience in the U.S. financial sector felt that for creditors to push through informal workouts on weak debtors was a far more constructive way of carrying out restructuring than going through time-consuming and expensive bankruptcy procedures. One legal obstacle noted was the existing disincentives to converting debt to equity.

Role of Government in NPL Disposal

The Japanese government was generally seen as having played a crucial role both in the establishment of the current situation and – at least by many participants – as an impediment to beneficial change. While virtually all participants felt that the government faced a series of difficult or perhaps even unresolvable dilemmas, many expressed an impatience with what they saw as excessive caution in taking decisive action. With regard to NPL disposal, the central issues were macroeconomic policies (discussed below) and the supervisory efforts of the FSA.

The general cynicism about the accuracy of loan risk classification by individual banks extended to bank inspections by the FSA. The FSA's declared totals of non-performing loans and of "marked-to-market" capital were widely questioned as unrealistically low, although some participants defended FSA's work. Those who were most critical of the FSA numbers tended to put forward a political explanation: they felt that the FSA has been soft on banks in order to forestall anger by politicians whose constituencies would be hurt by bank failures or loan cutbacks. Another explanation was that there is as yet no political consensus as to how to deal with large numbers of failing banks, and therefore FSA was (perhaps correctly and perhaps excessively) concerned about the impact on the nation's financial system of forcing large numbers of banks out of business.

While much of the unhappiness focused on anti-reform elements within the Liberal Democratic Party, Prime Minister Koizumi and his team also came in for some important criticism. Leaving the macroeconomic dimension aside for the moment, it was pointed out that Koizumi's game plan for reform has been focused on first restricting

fiscal deficits and cutting back government-owned corporations and financial institutions (such as the Japan Highway Corporation, the Japan Housing Loan Corporation, etc.). In order to keep those items at the top of the agenda, the cabinet had been arguing since the spring that no major capital infusions would be needed to shore up banks with excessive NPLs; thus, admitting to the actual scale of the problem would force it to backtrack on its pledges.

On a more optimistic note, a number of participants who said that they had been very skeptical of FSA inspections over the last couple of years felt that there were important changes afoot. Citing recent inspections that had been much more thorough and strict, as well as statements by top regulators, these participants expressed some hope that the government was finally willing to face up to the full magnitude of the NPL problem.

Another major criticism of the FSA, for which critics also saw a political explanation, had to do with its pressures on banks to avoid a credit crunch. In practical terms, some argued, this has meant pressure to lend to weak firms. Several cited recent press reports that Shinsei Bank had been pressured to increase its lending to small and medium-sized firms (SMEs), as well as anecdotal reports of pressures on various banks to keep lending to politically connected firms such as construction companies. If these reports are true, they make for an impossible situation for banks, which are expected both to lend more responsibly and to continue lending to troubled firms.

Resolution and Collection Corporation

In addition to the concerns about bank supervision, several participants suggested that uncertainty about the intentions of the government also inhibited NPL disposal. Since banks are not sure whether there will be a subsidized buy-out of NPLs by the government, it is rational for them to hold off on selling their current holdings at market value.

The problem is compounded by problems with the way the Resolution and Collection Corporation (RCC) has handled the purchase and sale of NPLs. The basic problem, ironically, has been the RCC's mandate not to lose money on purchases and sales of bad debt. For banks that have not been declared insolvent, this means that the prices that the RCC will pay for assets are extraordinarily low, averaging under 10% of face value; in many cases, this is well below the estimated value of the loan or asset. The result is that there has been very little willingness on the part of banks to sell their loans to the RCC. (One participant described rumors that many of the loans that banks have been willing to sell to the RCC have been "pachipon" loans, or loans to organized crime affiliates.)

Perhaps as serious as the RCC's purchasing practices is the way it handles sales of the assets it has taken on. Based again on the principle of not losing money on assets, the RCC has been unable to sell loans below cost. One result has been the non-emergence of a market in secondary debt. Based on U.S. experiences in resolving the S&L crisis, several speakers and participants argued that large amounts of distressed assets must be sold off quickly at auction. While early prices will be low, they argued, soon the market

will find a reasonable equilibrium at which it will be attractive for banks and the RCC to dispose of NPLs and for other financial institutions to purchase them.

In addition to the issues of pricing and procedure, the issue of resources was seen as constraining the RCC. Current plans of the Japanese government have suggested the RCC as the major institutional means of disposing of NPLs of solvent institutions as well as those of failed ones. However, public funds for purchase would be clearly insufficient if the rules were shifted to allow for greater risk-taking in purchases and sales. Some participants expressed skepticism that the RCC would be able to maintain its independence from political pressures to purchase NPLs from favored banks at inflated prices if the profit principle were waived.

Finally, the speed of NPL disposal was also a major issue. The government's current timetable struck many participants as far too slow; they argued that policies must be used to force auctioning off of NPLs as soon as possible, and that there was no justification for delay. Until banks dispose of NPLs, the argument went, they would not be able to lend to healthy firms and to make profits and contribute to the efficient allocation of capital. Others raised the objection that accelerated NPL sales would likely lead to more bank failures, and thus would be a dangerous plan.

Expertise

There was some debate over where the expertise to deal with NPLs and bank disposal would be found. Some participants expressed skepticism that there are enough accounting and legal professionals in Japan with sufficient expertise in such matters. (It was pointed out that this has been one of the factors that has constrained the FSA to date.)

Some even suggested that the only way to get around the problem would be to rely on foreigners. However, other participants expressed confidence that if there were profits to be made, the expertise would develop – they argued that just such a phenomenon had occurred in the United States during the savings and loan crisis, and that the same thing could happen in Japan. On the brighter side, most participants seemed to agree that there was a satisfactory legal framework in place for work-outs of failed institutions.

Macroeconomic Issues

One of the key debates over the course of the weekend was over the reciprocal effects of bank weakness and macroeconomic stagnation. The key question was whether macroeconomic stagnation was the main determinant of the banks' problems, or whether the fragility of the banks made macroeconomic growth impossible. This debate has important implications for policy: should Japan opt first for macroeconomic stimulus or for bank restructuring?

The macroeconomic situation was seen to have severe negative effects for banks in at least three ways. First, lack of demand growth in the economy has made for much greater weakness in the corporate sector, which has been reflected in high rates of bankruptcy and needs for loan rollovers. Thus, it contributes directly to the emergence of new NPLs. Second, lack of growth is also reflected in asset prices. Since banks' capital adequacy is highly conditioned on the value of the stocks and real estate they hold, the continual decline of asset prices presents a serious problem. Third, deflation and the zero interest rate policy mean that banks' margins between deposit and loan rates are dangerously low, probably even negative once administrative costs are factored in. This

is one reason why so many banks seem to prefer to leave their money in accounts at the BOJ or to invest in Japanese government bonds (JGBs) rather than lend it out.

The effects of poor macroeconomic performance on banks are thus low or negative profits and increasing stocks of NPLs. These effects are made worse by the fact that the declining value of banks' capital bases make them less able to absorb those losses. In other words, banks will be stuck in a losing game as long as macroeconomic stagnation and deflation persist. The flip side is that firms that rely on domestic banks for finance will inevitably be constrained in their ability to obtain new or continuing funding.

While this was a strong argument, a number of participants argued that macroeconomic stimulus is beside the point. They felt that the macroeconomic situation is the *result* more than just the cause of weakness in the banking system. Part of this position was based on the idea that there is a credit crunch that inhibits financing of new companies. A more long-term view was that strong macroeconomic growth will be unsustainable even if fiscal and monetary stimuli are used aggressively because the problem of the Japanese economy is one of misallocation of capital. In other words, these participants argued that the key to revitalizing the Japanese economy is for banks to shift their lending away from rollover loans to unprofitable firms toward new lending to healthy firms. This means eliminating NPLs and holding banks accountable for their lending decisions rather than just bailing out the economy with demand stimulus.

While most participants appeared to agree with the logic of both sides, the way in which they weighted the two perspectives led to radically different policy sequencing.

First, the short-term deflationary consequences of cutting off lending to weak companies and ruthlessly closing banks that are unable to remain solvent in the face of

aggressive NPL disposal were clear to everyone. At issue was whether this would create a severe deflationary spiral (as the "macro" camp feared) or would dissipate relatively quickly as firms and financial institutions adjusted to the new world in an atmosphere of decreased uncertainty.

The argument for a deflationary spiral is simple: that cutting off funding to unhealthy firms will have negative effects on the owners, workers, and business partners of those firms, and that given the large number of essentially insolvent firms and the precarious state of the economy, a deflationary crisis would inevitably ensue. The counter-argument depends on the assumption that many economic actors in Japan are not taking decisive actions due to great uncertainty concerning regulation, the state of the financial system, and other factors. Proponents of the counter-argument felt that reducing such uncertainty will allow firms and individuals to again invest based on rational calculation. By doing so, both confidence and efficient allocation of resources can be restored.

Many of the proponents of the latter view suggested that macroeconomic stimulus has become like a drug to which the Japanese economy is addicted. To carry on the metaphor, they suggest that the economy has become increasingly desensitized to the stimulative effects of macroeconomic loosening. Thus, "withdrawal symptoms" are unavoidable but will lay the groundwork for a healthier future. In other words, they are far less concerned about a crisis than the "macro" camp.

A political version of the anti-stimulus position was also common. Many of the proponents of this position acknowledged the logic on both sides, and felt that strong structural policies should ideally be combined with fiscal and/or monetary support to

alleviate their deflationary aspects. However, they doubted that it was possible to force the political system to impose painful structural reforms as long as a cushion was being provided by macroeconomic easing. In this calculation, they appeared to parallel the Koizumi administration's position. Some suggested that an economic or political crisis would be necessary to force painful reforms, prompting discussions of what an "optimal crisis" might look like. (The concept of an "optimal crisis" led to some vigorous debate, with some participants arguing strongly that crises by their very nature are unpredictable and often uncontrollable, so that the very idea of an "optimal" one was potentially dangerous.)

Policies

A wide variety of potential policy responses were discussed, reflecting the multifaceted nature of the problems facing the banking system as well as disagreements about the fundamental causes of those problems. There was also considerable disagreement about the ways in which various policies would interact with each other.

Fiscal Policy

The general debate for or against macroeconomic stimulus has already been described, but the specifics of how fiscal and monetary policy might be used to deal with the current situation were also vigorously discussed. The debates regarding fiscal policy could be categorized into micro issues and long-term macro issues.

To begin with micro issues, many participants felt strongly that Japanese tax and spending policies have created serious inefficiencies and distortions in the economy. In

particular, the heavy emphasis on public works and the geographical focus of spending on rural areas was seen to have propped up large segments of the private sector, but with little return in terms of long-term economic benefits. Most participants agreed that such spending had proceeded well past the point of diminishing returns. Even those who supported continued macroeconomic stimulus agreed that the targets of spending should be changed.

A common suggestion for how funds should be redeployed was to support redeployment of laid-off or otherwise displaced workers. Specific recommendations included extended unemployment benefits, active job placement services, and expanded worker retraining programs. Most participants felt that such measures were essential to structural adjustment, particularly given the rigid structure of the Japanese labor market. However, some cautioned that the track record of worker retraining and placement programs in Japan and other countries suggested that a healthy skepticism was in order about how much of a difference such expenditures would make.

One unresolved issue for many was the regional dimension. Fiscal austerity will likely have its worst effects on regional economies; to make matters worse, regional bank failures could have severe repercussions in their areas. (One example given was that Asahi Bank alone accounts for 83% of all bank loans in Saitama prefecture.)

The other side of fiscal policy is taxes, and here there were a variety of opinions expressed. At the broadest level, many if not most participants appeared to feel that tax cuts would have a more positive effect on the economy than spending increases. Indeed, several cited recent research that suggests that the multiplier effect for tax cuts in Japan is higher than for spending – precisely the opposite of previous assumptions. If that is

correct, then it would be possible to carry out fiscal stimulus without propping up "addicted" construction firms and rural communities. A number of specific taxation issues were also discussed, but these will be addressed in the context of Session Two below.

Monetary Policy

Virtually all participants agreed that Japanese banks – however well or poorly managed – have little hope of profitability as long as their margins on retail deposits and lending remain negative. Leaving aside choices that banks can make on their own (such as charging higher fees for depositors or lowering their overhead costs through reducing payroll), the most obvious way to deal with this issue is to raise lending rates. However, real interest rates are already relatively high given the economy-wide deflation, and to raise them would surely choke off many troubled firms.

The only way to solve this dilemma from a monetary standpoint would be by manufacturing inflation. "Inflation targeting" was a popular topic of discussion, with a particular focus on the means by which it could be achieved. Since short-term interest rates have been effectively at zero for over two years, further monetary easing requires a broader definition of which instruments can legitimately be targeted, including long-term government bonds, corporate bonds, real assets (stocks and real estate), and foreign currencies.

While some participants expressed pessimism that even these measures could produce beneficial levels of inflation, most of the discussion focused on the pros and cons of specific instruments. A few participants argued that all instruments should be

legitimate targets for purchase by the BOJ, but many felt that there was serious potential danger to be found in the BOJ getting involved in trying to prop up specific companies or asset markets. Thus, most of the focus was on increased BOJ funding of fiscal deficits and on aggressive unsterilized intervention in currency markets. Some participants felt that the former might set a dangerous precedent that would weaken the long-term fiscal discipline of the government. One novel suggestion was that the BOJ could purchase securitized NPLs sold by the RCC, thus simultaneously subsidizing NPL disposal and monetizing government debt in a non-precedent-setting way.

With regard to unsterilized foreign exchange intervention, the crux of the argument was over the international impact. One concern was the reaction of the United States, which many perceived as not wanting to see a major depreciation of the yen unless serious banking and structural reforms are underway. However, other participants felt that the U.S. government was prepared for a significant yen devaluation, and would not object too strongly.

The other focus was on other Asian economies, many of which compete with Japanese products on world markets. If the yen were to depreciate relative to their currencies, they would lose competitiveness, which in some cases might threaten still-fragile recoveries. Evidence was presented that most of the East and Southeast Asian currencies are moving more in tandem with the yen than previously, however, which suggested that they would follow suit in the case of a yen depreciation against the dollar and euro. The exceptions would be any economies whose currencies are pegged to the dollar, of whom the two largest are China and Hong Kong. Thus, there was some concern that Japan-China relations might be adversely affected by a conscious strategy of

devaluation. There was no consensus on just what the trigger points for U.S. and Chinese anger might be.

"Payoff"

A more specific policy issue addressed throughout the weekend was whether the Japanese government should postpone the date by which deposit insurance limits will be put into effect (currently scheduled for April 1, 2002 for time deposits). The imposition of ¥10 million as the limit for insurance "payoffs" when a bank goes bankrupt, already delayed for one year, was seen by many participants as having potentially profound effects for the Japanese banking system. Whether those effects would be positive or negative was a hotly debated point.

Most participants agreed that the effect of limiting the insurance payoff would be to cause many depositors to pull their deposits from banks seen as weak, thus accelerating the flight from such marginal institutions. It was pointed out that a record number of *shinkumi* and *shinkin* had already closed their doors in 2001, which most observers have attributed to the advance effects of the payoff limits. Participants were apparently unanimous in the opinion that without postponement there would be a considerable number of additional collapses as April approached, with the effects extending to larger institutions as well.

The main debate centered around whether this was a positive or a negative effect. Those who felt uneasy about imposing the limit as scheduled pointed to the possibility of panicked runs on banks and contagion even to relatively healthy institutions. They argued that the danger that large parts of the credit system would collapse was far worse

than any moral hazard that might arise from not imposing insurance limits. In short, they felt that the payoff limit was likely to spark a banking crisis that might not be controllable, with the likelihood of not only devastating the Japanese economy, but also creating negative effects on other countries at a time of global economic weakness.

Among the advocates of payoff limits, some suggested that a crisis might be necessary to force Japanese policy makers and business people to make drastic decisions, and that a crisis that also had the effect of clearing out the problems of the banking sector might well be the "optimal crisis." Others argued that the effects would not be nearly as bad as the most pessimistic projections. Central to the more guardedly optimistic position was the judgment that the Japanese government's financial crisis management framework is advanced enough to be able to close or nationalize large numbers of institutions without throwing the real economy into turmoil. Advocates of this point of view suggested that maintaining the current schedule for payoff limits would allow for a relatively orderly exit of large numbers of marginal institutions that have been involved in inefficient practices such as rollover lending to functionally bankrupt firms. (Ironically, the emergency framework allows government to trigger Article 102 of the deposit insurance law, which temporarily eliminates limits in a banking emergency. However, the declared imposition of payoff limits was expected to precipitate failures because ordinary savers will not be sure that they will be insured beyond ¥10 million.)

There was also an important political justification put forward even by some of those who believed that imposition of the new limits was dangerous. Prime Minister Koizumi and his economic team have repeatedly stated their intention to impose the limits, and would be seen as backing down if they again delayed. This was seen as likely

to slow the pace of other necessary reforms as well, as Koizumi would lose credibility. (Japanese government representatives at the conference strongly reiterated their commitment to the current plan.) Additionally, many participants felt that the politicians who have publicly clashed with the Cabinet on the payoff question are among the most anti-reform politicians in the LDP and Diet; postponing payoff limits would constitute a victory for them and for their overall agenda. In any event, postponement of the limits would require Diet approval, which makes a delay all the more unlikely.

Postal savings

Related to the payoff issue specifically as well as to the general role of the government in distorting the banking system was postal savings. As depositors flee from weak institutions to protect their savings, participants agreed that one of the major havens would be the postal savings system, which is not subject to limits on deposit insurance. With over a third of all deposits already, the postal savings system is poised to grow substantially.

The growth of postal savings raised three serious questions. One concerns government finances. Deposits in the postal savings system are guaranteed by the central government rather than through deposit insurance *per se*. The concept of redeeming non-performing loans with private capital as banks do is also absent from postal savings. Thus, only the quality of the system's loan portfolio stands between its depositors and a taxpayer-financed bailout. While a substantial share of postal savings system assets are in the form of central government bonds, participants had serious concerns about the

quality of other assets, including bonds of local governments and loans to government-owned corporations and financial institutions.

In addition to the financial risk of some of the postal savings system's assets, the heavy use of postal savings to fund government-owned corporations has been a key pillar of support for those corporations. Many participants agreed with the Koizumi administration's judgment that many of the government-owned corporations have been a drag on the Japanese economy, engaging in inefficient activities for the benefit of powerful political constituencies. (For many years, postal savings had been automatically transferred to such uses through the Fiscal Investment and Loan Program, or FILP. While that system has technically been changed so that government corporations are funded by "FILP bonds," it has had little impact so far on changing the relationship between postal savings and the quasi-public sector.)

Finally, postal savings has been a major competitor for private banks. Many participants expressed the opinion that the privileged status of postal savings would make it hard for private institutions to compete for deposits after deposit insurance limits take effect. Moreover, plans to privatize postal savings were seen by some as being even worse than the current situation, since that would allow the system to compete with private institutions in lending and capital market activities – all with government subsidies and guarantees.

Recapitalization, Nationalization, and Workouts

The severe situation facing virtually all Japanese banks as a result of high NPLs and weak asset prices has again raised the issue of whether the government should

engage in another round of recapitalization. While some participants felt that recapitalization would be inevitable, many argued vigorously that it would be a bad idea. They pointed out that recapitalization in 1998 had not solved the banks' financial problems, and had moreover not improved bank management. Thus, opponents of recapitalization felt that moral hazard would be unavoidable in the event of new government intervention. (While some felt that recapitalization could be a positive move if strict performance conditions were attached, most felt that it would be politically impossible to actually enforce such conditions.)

A major alternative would be nationalization of failing banks. Participants seemed to share a broad consensus that the legal framework for nationalization was well established and works well. However, the prospect of nationalizing significant portions of the banking system worried many. One concern raised was that this would vastly increase the role of the state in the banking system and could invite political interventions in credit allocation. Moreover, the administrative tasks of managing and selling off nationalized banks would be immense, and probably beyond the abilities of the RCC and FSA.

Despite these evident challenges, several participants felt that large-scale nationalization would be a positive tool for broad-reaching and necessary changes, including radical reduction of NPL rollovers, replacement of current management, and possibly reduction of capacity in the banking sector. Without drastic action, they argued, the banking system would just limp along from crisis to crisis. A major advantage seen by some advocates of this point of view was that it would vastly increase foreign ownership, as there would not likely be sufficient domestic demand (or capital) to take on

the responsibilities of reprivatizing nationalized institutions. These participants felt that more foreign competition would force Japanese banks to adopt more efficient practices and risk management. There was some debate over whether such widespread foreign ownership of the domestic banking sector would be politically and socially acceptable, however.

A third group expressed serious concerns that the only way to force such changes under the current system is through nationalization or establishment of bridge banks in the event of an actual bank failure. They argued that there was a need for measures at a more intermediate level – in other words, improved ability to carry out "workouts" for banks that were not yet failing but that are in weak condition. (This general discussion clearly relates to the specific issue of how the RCC should act in the financial system.)

Politics

Underlying much of the discussion on the woes of the Japanese banking sector was the perception that politics drives everything. While a number of participants voiced dissatisfaction with the policy priorities of the Koizumi administration – particularly in terms of the sequence of fiscal reform, administrative reform, and banking sector reform, as well as with the actual proposals for NPL disposal and purchasing of bank capital – most appeared to be more concerned with the anti-reform forces within the LDP and bureaucracy. Thus, there was a general concern that Koizumi's administration should be supported (if perhaps gently nudged to shift its priorities), since the alternative would be much worse.

A key issue had to do with leadership, which many participants felt had been lacking in the Japanese political system over the last decade or more. They argued that without a clear and credible direction from the government, there would be no incentive for private actors to change their behavior significantly – this perception was prominent in discussions of NPL disposal, fiscal and monetary policy, and the "payoff" issue. Some of these participants felt that Koizumi might be the last chance for assertive, pro-reform leadership, but others seemed more pessimistic about how resolute he really is, let alone whether he can maintain support within his party.

The issue of leadership and clear direction extended to the bureaucracy, especially the FSA. A number of participants expressed disappointment with the current leadership of the FSA, which they saw as being far more concerned with maintaining political capital than with carrying out its responsibilities as a watchdog over the financial system.

A different sort of leadership issue was expressed regarding the Bank of Japan. While most agreed that the BOJ has seen rather assertive leadership in the last several years, many felt that the BOJ's leaders had been far too concentrated on fighting a two-front war against the apparently undetectable specter of resurgent inflation and the very detectable specter of political interference. In the process of fighting turf battles, the argument went, the BOJ had overstepped its responsibilities and was contributing to economic stagnation and a potential deflationary crisis.

Issues for the United States

While most of the weekend's discussion involved Japan's fragile banking system, some participants did raise red flags about the U.S. system as well. One of these was the

stock of “sub-prime” loans that had accumulated during the boom years of the late 1990s. With slower economic growth and a decline in asset prices, many of these could be in danger of default. There was some concern whether U.S. banking prudential regulation was up to the task, and whether the United States may be seeing some major bank failures of its own.

II. The Regulation of Capital Markets and Stock Exchange Competition

While the condition of the Japanese banking sector dominated much of the weekend’s debate, capital markets in Japan (and, to a lesser extent, the United States) were also a serious cause for concern among many participants. In particular, concerns were raised over the low levels of interest among Japanese investors and the lack of a “market for corporate control.” In theory, capital markets are a key means of pooling and allocating funds in an economy, but participants felt that Japanese capital markets have not tended to work that way.

The continued reliance on bank lending for new corporate funding led some participants to argue that the Japanese economy generally is “undercapitalized” and “overleveraged” – a potentially dangerous situation. Thus, they were concerned with how to accelerate the ongoing shift from bank-based finance to capital markets-based finance. But it was also pointed out that making that shift during a period of asset-price deflation was largely unprecedented and potentially dangerous.

On a more optimistic note, participants generally agreed that the introduction of stock market competition in recent years has significantly improved services and functioning of stock exchanges. Also, the Big Bang was seen as having fundamentally

improved the legal framework of capital market activity, although many participants felt that there were additional systemic changes that should be made.

Japanese Capital Market Torpor

The overall focus of discussion was on the problem of low levels of activity in capital markets. Until investors regain confidence in the capital markets, stock prices were expected to remain stagnant and – perhaps worse – the markets would not be an effective mechanism for allocating capital. Key causal factors identified included the poor state of the economy, lack of trust in the system, still-inadequate regulation, and the absence of a market for corporate control. Some participants also pointed to corporate practices and Japanese culture as explanations.

Weak Economy

A major disincentive for potential investors in Japanese capital markets has been the weak state of the economy. Very few firms have been consistently profitable, which inevitably has meant low dividends and declining stock prices. In other words, buying stock has become almost by definition a losing proposition – thus, it is quite rational for Japanese households to keep their savings in bank or postal deposits, or even in cash. This rationality at the individual level has helped to guarantee low or negative returns, however.

Bond markets contain their own problems. Some participants argued that the general negative effects of the weak economy on capital markets have been compounded by a problem of adverse selection in bond markets. They argued that strong companies

are no longer seeking to raise funds on the domestic capital markets; indeed, many are reducing bond debt with their profits. This leaves only weaker companies seeking new funds in capital markets, which makes the markets even more unsafe. As investors stay away from the capital markets in droves, the result has been that weak companies cannot borrow, while strong companies choose not to do so.

Lack of Trust

In addition to the poor current prospects of many publicly traded Japanese firms, a number of participants believed that Japanese households and individuals simply do not trust capital markets as a destination for their savings. The lack of trust was said to extend throughout the system to include brokerage firms, exchanges, firms themselves, the quality of market information, and politicians and financial regulators. Foreign financial firms were seen to be equally distrusted.

Fundamentally, advocates of this view argued, Japanese people believe that the deck is stacked against small players in the market. Much of this sentiment was seen as going back to brokerages' practices during the bubble and early post-bubble years, when small investors had been victimized by such practices as very high commissions, churning of their accounts, intermingling of client and house accounts, and capital-loss compensation for preferred clients. Given the expectations of abuse by brokers, it would be clearly irrational to invest in market that is not actively booming, let alone a declining one.

In addition to beliefs about unfair treatment, participants pointed to inadequate disclosure as an important disincentive to investing in the Japanese capital markets by

anyone, but particularly by small investors. Some specifics regarding disclosure are discussed below, but many participants felt that the problem went beyond accounting rules and administration. Among the Japanese public, they felt, the crux of the problem was that people no longer trust that regulators and politicians are on their side. Thus, the evaporation of trust in government over the last decade has apparently had direct effects on capital markets as well.

Lack of Market for Corporate Control

A number of participants argued that one of the key microeconomic factors in the moribund state of the Japanese stock market has been the lack of a market for corporate control. In other words, even large shares of ownership in a firm often add up to very little ability to make major shifts in corporate behavior. The most dramatic evidence of this has been the virtual impossibility of carrying out a hostile takeover of a publicly traded company.

If ownership does not equal control, it was argued, then there is no incentive for an investor to take a large equity position in a failing firm. In Japan new owners cannot easily change the management team, sell off unproductive divisions, eliminate redundant workers, or make other strategic shifts they see as necessary to revive the profitability of the firm. One specific lament by some participants was the inability to carry out "cash force-out mergers," which were the backbone of the U.S. M&A boom in the 1980s. Much of this is due to rules that have been put in place to protect minority shareholders, but many participants felt that they had become simply an impediment to meaningful takeovers.

Many U.S. participants argued that the threat of takeovers was an essential force in disciplining managers to focus on profitability, regardless of how many actual takeovers occur; the absence of such a threat in Japan was thus seen to have contributed to self-serving behavior by corporate managers. This tendency was reinforced by corporate practices such as the tendency of boards to be dominated by insiders. In other words, governance has been almost completely ceded to managers, who were seen to be unlikely to make decisions that would lead to their own elimination or the elimination of their sources of power.

Another issue raised with respect to corporate practices was the difficulty of reducing employees even when management is cooperative with the new owners. Customary practices of lifetime employment within larger Japanese firms (in some cases reinforced by employment case law) were seen to make downsizing nearly impossible. When downsizing does occur, participants pointed out, it has tended to be through attrition and restriction of new hires – with the paradoxical effect that the most easily reemployable and lowest paid employees are the first to go, leaving an overpaid, less efficient workforce.

In order to make M&A a useful tool for revitalizing firms, then, many participants felt that social barriers to hostile takeovers would need to disappear, and that legal barriers to tender offers and to functional control of acquired firms would need to be eliminated.

While a firm majority appeared to agree with these views, a minority called for caution in trying to impose U.S.-style corporate practices on Japan. This was particularly true in the case of lifetime employment, which a number of participants argued was key

to the success of Japan's most efficient manufacturing firms. One example given was Nissan, where as one participant pointed out, the company had shifted abruptly toward profitability with only a small infusion of foreign managers and without large-scale layoffs.

Issues of Regulation

While participants generally praised the successful implementation of the 1998-2001 Big Bang, many felt that more reforms would be necessary to make the Japanese capital markets fully "free, fair, and global." These focused particularly on disclosure, treatment of mutual funds, tax policy, and the general attitude of the government toward capital markets.

Disclosure

One of the main complaints about the current framework was that it did not assure proper disclosure. Despite the many improvements in accounting standards, many felt that they did not yet approximate global standards. An example was that consolidated reporting rules still leave important loopholes that allow firms to conceal losses. Several participants expressed hopes that making the accounting standards body fully autonomous from the government (accomplished in July 2001) would make a major difference in the quality of accounting.

Others suggested that the problem was less one of setting stricter standards, and more of making auditing less subject to the interests of management. They pointed to the fact that most corporate auditors are essentially management insiders, and that outside

audits are also chosen by either management or management-dominated boards of directors. Unless corporate auditors could be forced to take on more responsibility for the accuracy and legality of their reports, these participants argued, there would be little hope for effective information disclosure.

Mutual Funds

Many participants agreed that another regulatory issue that made capital markets less attractive was rules regarding mutual funds and defined-contribution pension plans ("401(k)-style plans"). They pointed out that mutual funds are the most practical way for individuals and households to invest in the stock market, as well as to diversify their holdings. Defined-contribution pension plans were seen as particularly useful, based on experience in the United States. Not only were they seen to vastly increase the amount of funds held by households – as well as to increase business for foreign mutual fund companies – but they could also help with the problem of inflexible labor markets. Since most Japanese corporate (defined-benefit) pension plans have long vesting periods that have been based on the assumption of lifetime employment, employees are often unwilling to leave their employers and layoffs too are often difficult. By increasing the portability of retirement savings, defined-contribution plans could reduce some of that inflexibility, it was argued.

Taxation

In discussing the role of taxation in reinvigorating Japanese capital markets, three main issues were raised. Most directly, a number of participants argued that Japanese

capital gains taxation made it unattractive to sell stock. While some called generally for a reduction or elimination of the capital gains tax, others focused on the recent elimination of a rule that had allowed sellers of stock to pay a low rate on gross sales rather than the higher rate on actual gains. However, there was also some skepticism that capital gains tax was a major impediment to stock market activity, since stock values had fallen to low early-1980s levels.

There were also calls for tax policies that would encourage disintermediation. While the capital gains tax was an important issue in this regard, it was also pointed out that current tax policies tend to subsidize bank deposits at the expense of stockholders.

More indirectly, many participants were unhappy with the postponement of consolidated taxation. Unconsolidated corporate taxation makes acquisition of money-losing firms much less attractive to profitable ones, and they argued that it has artificially depressed the M&A market. A common interpretation for the delay in implementation of consolidated taxation was that the Ministry of Finance feared a reduction of tax revenue, and had deliberately stalled.

Government vs. Market

A common criticism of reforms to date was that the overall system of regulation was not yet sufficiently "market oriented." This broad judgment was used to explain a variety of perceived problems, including the delays in accounting standards, tax reform, and mutual fund regulation as already discussed.

Critics of the current regulatory system also felt that market principles were not yet sufficiently ingrained into the attitudes of regulators. For example, they suggested

that in many cases FSA bank examiners were more concerned with concealing problems of banks or with maintaining bank lending to politically connected firms than with ensuring accurate disclosure of NPLs. Similarly, they felt that cases of collusion and concealment throughout the financial sector and the economy more generally were not pursued with great vigor. Unless greater respect for markets and fairness were established, they argued, political expediency would often trump professionalism.

Among those who were unhappy with the current regulatory system, another line of thinking suggested that the problem could be attributed to inadequate institutional safeguards against political intervention. The logic was that regulators are subject to pressures from politicians who can help or hinder their careers; alternatively, they were seen as being subject to temptation from regulated firms. Either way, insulation from such pressures was presented as an important part of the solution – following the example of the RTC in the United States, some even suggested a rule that all contacts between politicians and FSA or RCC officials should be made public. In related discussions, there was some debate over whether Japan would be best served by having a single unified financial regulatory structure (the "UK model") or by maintaining some degree of overlap among FSA, BOJ, SESC, and RCC.

Culture and Corporate Practices

In describing a perceived anti-market bias in Japanese financial regulation, some participants went beyond an analysis based on politics or governmental structure to suggest that patterns in Japanese society and culture might be the core cause.

One such argument was that Japan's postwar tradition of equality had led to a suspicion of entrepreneurial success. In direct contrast to what some have called the "cult of the entrepreneur" in the United States, these participants felt that Japanese society punishes those people who take big chances and achieve great success. The flip side of that view was that Japan does not sufficiently respect failure – unlike Silicon Valley firms that will often consider a business failure or two on a job candidate's résumé as a positive factor, those who have failed in business in Japan were not seen as having access to second and third chances. The result, these participants argued, was that Japanese people are less willing to take entrepreneurial risks than Americans, and are even perhaps not "greedy" enough for a no-holds-barred capitalism to work.

A different but related version of the cultural argument was that Japanese society is based on stable social hierarchies. Thus, the argument goes that odds are stacked in favor or insiders, and the only way to achieve prominence and respect is through established channels of advancement. Other participants countered these claims by pointing to some of the great postwar entrepreneurial success stories like Matsushita, Honda, Sony, Nintendo, and Softbank.

Finally, some participants suggested that transparency was particularly difficult to achieve in Japan. This was seen as partly due to the issue of hierarchies, but also to what some called a "shame" based culture. Thus, to air a person's (or firm's) mistakes might be particularly difficult to accomplish in Japanese culture. There was disagreement here as well, as some participants pointed out that few Americans or Europeans are enthusiastic about advertising their mistakes or crimes either.

Corporate Practices

A less encompassing version of the cultural argument had to do with corporate practices. It was argued by many that several of the corporate practices that had been closely identified with Japan's postwar economic successes now stand in the way of necessary shifts toward more market-based interactions. Most central was the web of long-term relations that have bound companies to their employees (and vice versa), creditors to debtors, and suppliers to customers.

Cross-shareholding and the lingering effects of the main bank system were seen as particularly important aspects of that phenomenon, with negative results for efficient capital markets and markets for corporate control. Unless such relationship-based financing dissipates, capital markets will have only a peripheral role in capital allocation in Japan.

Generally speaking, participants felt that the legal infrastructure had evolved much more quickly than actual corporate practice. In particular, the slow move to outside directors and the limited use of stock options as performance incentives stood out. Since most of the legal obstacles to such practices have been eliminated, it appeared that much of the impetus for further change would have to come from corporations themselves. Several participants, arguing that corporate managers are acting rationally given the incentives they currently face, expressed pessimism that such changes would happen quickly.

Stock Exchange Competition

Discussion of stock exchange competition may have been the most optimistic of the conference. Panelists and other participants seemed to agree that competition among exchanges had improved services for investors and listed companies throughout the world. In the United States, the vigorous technology-based NASDAQ of the 1990s was seen as having introduced important technological innovations and reduced spreads not only in its own trading system, but also in the New York Stock Exchange and other exchanges that were forced to compete.

In Japan, similarly, NASDAQ-Japan was seen as having prodded the Tokyo Stock Exchange and the JASDAQ network to loosen listing requirements for new firms as well as to tighten disclosure rules. It also introduced dealer-based market structures. The increase in IPOs that resulted, it was suggested, could help to support entrepreneurship in the Japanese economy as a whole. Similarly, the Osaka exchange's Nikkei-225 index was introduced to compete with Singapore, and had helped to revitalize what had formerly been only a regional exchange.

Ironically, stock exchange competition has also led to amalgamation. Regional exchanges in both Japan and the United States have felt pressure and in some cases have disappeared. Some participants pointed to Europe as a market where amalgamation was occurring particularly quickly. There was no consensus on what the optimum number of exchanges would be for Japan, but participants did acknowledge that it was at least possible that the very exchanges that had injected competition and innovation into each country's capital markets might well disappear themselves.

Despite the apparent globalization of world stock markets, however, some were skeptical of whether Tokyo could actually be seen as a global capital market. Even though foreign investors have become a major source of funds, it was noted that the number of foreign firms listing in Japanese stock markets had declined dramatically over the course of the last decade. Similarly, few Japanese firms are listed on foreign exchanges. Nonetheless, Japanese exchanges are seeking to compete on the same basis as other exchanges throughout the world – liquidity, diversity of products, credibility of information, and quality of market regulation.

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