SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR JAPAN AND THE UNITED STATES
PORTSMOUTH, NEW HAMPSHIRE • OCTOBER 22 – 24, 2004

FRIDAY, OCTOBER 22

6:15-7:00 p.m.	COCKTAIL RECEPTION
7:00 p.m.	DINNER GREETINGS HAL SCOTT Nomura Professor & Director, Program on International Financial Systems (PIFS), Harvard Law School ROBIN RADIN Associate Director, PIFS, Harvard Law School TASUKU TAKAGAKI Chairman, Board of Trustees, The International House of Japan, Inc. KEYNOTE ADDRESS HIROSHI WATANABE Vice Minister of Finance for International Affairs, Ministry of Finance RANDAL QUARLES Assistant Secretary for International Affairs, U.S. Department of Treasury
9:00-12:00 a.m.	AFTER-DINNER COCKTAILS

SATURDAY, OCTOBER 23

7:00-8:30 a.m.	BREAKFAST
8:30-8:40 a.m.	WELCOME & OPENING REMARKS TASUKU TAKAGAKI, The International House of Japan, Inc. HAL SCOTT, PIFS, Harvard Law School
8:40-9:00 a.m.	SESSION 1 The Future Competitiveness of Japan in International Capital Markets PANELISTS: Toru Shikibu, Financial Services Agency Robert Feldman, Morgan Stanley Japan, Ltd.
9:00-10:25 a.m.	SMALL GROUP SESSIONS
10:25-10:40 a.m.	REFRESHMENT BREAK
10:40-11:10 a.m.	SESSION 2 The Future Competitiveness of the U.S. in International Capital Markets PANELISTS: Masatsugu Nagato, Mizuho Corporate Bank, Ltd. Kenneth Dam, University of Chicago Law School
11:10-12:20	SMALL GROUP SESSIONS
12:20-2:00 p.m.	LUNCH

KEYNOTE ADDRESS
TIMOTHY GEITHNER
President, Federal Reserve Bank of New York

2:00-3:00 p.m. SESSION 3
The Significance of China for U.S. and Japanese Financial Markets
PANELISTS: Akinari Horii, Bank of Japan
Lyric Hughes-Hale, China Online & Hughes International
Alicia Ogawa, Lehman Brothers

3:00-6:15 p.m. FREE TIME
3:15-5:45 p.m. Portsmouth Historic Treaty Tour by Boat

6:15-7:00 p.m. COCKTAIL RECEPTION

7:00 p.m. DINNER
KEYNOTE ADDRESS
RONALD LOGUE
Chairman and CEO, State Street Bank

9:00-12:00 a.m. AFTER-DINNER COCKTAILS

SUNDAY, OCTOBER 24

7:00-8:30 a.m. BREAKFAST

8:30-9:35 a.m. **PRESENTATION & DISCUSSION**
The Future Competitiveness of Japan in International Capital Markets
CHAIRS: Ryusaburo Harasawa, The Bank of Tokyo-Mitsubishi, Ltd.
Hugh Patrick, Columbia Business School

9:40-10:20 a.m. **PRESENTATION & DISCUSSION**
The Future Competitiveness of the U.S. in International Capital Markets
CHAIRS: Yoshio Okubo, The World Bank
Richard Medley, Medley Global Advisors

10:20-10:30 a.m. REFRESHMENT BREAK

10:30-11:20 a.m. **PRESENTATION & DISCUSSION**
The Significance of China for U.S. and Japanese Financial Markets
CHAIRS: Mikio Wakatsuki, AXA Japan Holding Co., Ltd.
Arthur Mitchell, Asian Development Bank

11:20-1:30 p.m. CLOSING LUNCH

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

Portsmouth, New Hampshire October 22-24, 2004

The seventh Symposium was held at Wentworth-by-the-Sea in Portsmouth, NH, the site of the treaty negotiations that concluded the Russo-Japanese War in 1905. Sessions considered the competitiveness of Japanese financial institutions and markets, the competitiveness of U.S. financial institutions and markets, and the potential impact of China on both. More than in any previous Symposium, economic and financial developments in Japan had been generally positive over the previous year, and participants were able to adopt more forward-looking discussions. A key focus for the future is the reform of the Japanese postal savings system. While concerns were raised about U.S. competitiveness based on threats to macroeconomic growth and U.S. consumer debt. Only one substantial threat was identified, over-regulation from Sarbanes-Oxley and settlement agreements engineered by Elliott Spitzer, the Attorney General of New York.

Session 1

The Future Competitiveness of Japan in International Capital Markets

Discussion of Japan's financial competitiveness concentrated on several topics. These included evaluation of progress to date in improving regulation and financial conditions within Japan, how to transform Japanese savers into investors, the role of financial institutions in promoting sound corporate governance, effects of the continuation of zero interest rates, postal savings reform, and possible excessive concentration in the banking system. Participants questioned the extent to which capital markets were fulfilling their basic duties to allocate capital efficiently and to impose discipline on corporations, and discussed ways to improve the fulfillment of these functions in the future. While the general consensus was more upbeat than in previous years, much of the discussion focused on issues that remained problematic or unresolved. That focus is reflected in this summary as well.

A "Report Card" on Japanese Finance

Participants agreed that substantial progress had been made to date in improving the safety and soundness of the Japanese financial system. This was evidenced by the improving financial condition of major banks, improved quality of regulation, increasing quality and professionalism of FSA inspectors and inspections, reduced deflation, and improved infrastructure. In particular, the major banks' success at meeting the 2002 Takenaka Plan targets for NPLs was a reassuring sign. The publication of an inspection manual and of inspection results had also considerably improved transparency.

There remained, however, disagreement about whether improvements were sufficiently rapid to prevent another crisis or to adequately service the needs of the Japanese economy. For example, NPL rates remained higher than desirable, albeit at manageable levels. Financial institutions were seen as becoming "less weak," but there were still no Japanese financial institutions that could be considered leaders in global markets. On inspections, the relatively low numbers of inspectors created concerns that many banks, especially regional ones, were not being adequately inspected. And while reduced, deflation remained a problem both for economic activity generally and more specifically for the ability of banks to make profits on lending. Further strengthening of the SESC was also seen to be important.

With regard to Tokyo's development as an international financial center, the picture was mixed. While legal infrastructure was seen by many participants to be approaching global standards and foreign investor participation accounted for about a third of activity, the number of foreign firms listed on the Tokyo Stock Exchange had dropped precipitously to less than one quarter of its 1991 peak. The recent listing by a Chinese company provided only limited grounds for optimism.

Other concerns were also raised. One common point was the disparity among financial firms in the Japanese market. With regard to banks, while participants noted with approval the reductions in NPLs and improvement of capital and profitability of the major banks, concerns remained as to the health of second-tier institutions. One participant even characterized their activities as "19th century asset allocation." It was agreed that these banks had not been as closely scrutinized by regulatory authorities. Moreover, their reliance on lending and their unsophisticated risk assessment practices created the likelihood of continuing troubles both for them and for their clients. This was seen as particularly a problem for SMEs, which are still heavily reliant on bank loans.

The SME reliance on bank loans highlighted for many participants an important defect of Japanese capital markets – the lack of deep and liquid markets for SME commercial paper, junk bonds, and the like. It was argued that without such means of better linking entrepreneurs with investors with an appetite for risk – what one participant dubbed the "Millken revolution" – job creation and innovation by SMEs would remain below their potential.

As in previous years, participants also noted that the lack of depth, breadth, and liquidity of markets in financial products such as asset-backed securities and corporate and junk bonds, limited the risk management abilities of financial institutions in the Japanese markets. While participants saw improvements in these regards, there was some frustration with the perceived reluctance of Japanese financial institutions and firms to make effective use of these products. On the bright side, increases in syndicated loans and real estate-backed securities were seen as positive developments in the movement toward market efficiency and transparency.

CONSOLIDATION AND CONCENTRATION

One trend that many participants perceived as a mixed blessing in both Japan and the United States was the trend toward consolidation and market concentration in the banking sector. The development of "megabanks" in Japan had improved balance sheets and led to some cost-cutting that boded well for their profitability. Moreover, the establishment of multi-functional financial conglomerates created some attractive opportunities for synergy and cross-marketing of products. For example, several of the banks have become major sellers of insurance products and investment trusts. Thus, to many, the consolidation trend had been an important element in the movement of Japanese banking out of crisis.

At the same time, serious concerns were also raised about the trend. One was that the megabanks lacked clear business models to justify their establishment. Despite some cost-cutting in terms of branch networks and IT, many participants argued that important redundancies and inefficiencies remained. Moreover, the sheer size of the resulting institutions was seen by many to threaten flexibility and innovation. A second major concern was that Japanese banks were becoming too big to fail, and that this might be an implicit business objective of some of the merger activity. One widely raised example for both criticisms was the efforts by SMFG and MTFG to take over UFJ and create a "gigabank." Finally, overconcentration might put further pressure on second-tier banking institutions, and create opportunities for unfair pricing power for the city banks in the longer run.

For these reasons, some participants cautioned that the consolidation trend might lead over time to increased systemic risk even as it improved the fortunes of individual institutions.

POSTAL SAVINGS

While concentration among private financial institutions was seen as having some positive consequences in addition to negative ones, participants appeared unanimous in their concerns about the excessive size and distortionary effects of the postal savings and insurance system. These concerns had also been expressed in previous Symposiums, but there was considerably more discussion of them in Portsmouth, apparently for two reasons: the improved situation of the private sector and the announcement in September of a government plan to change the system.

The fundamental concerns about postal savings were ones that have been widely expressed over the years: its excessive size, politicized operations, unlimited government deposit guarantees, lack of effective regulatory oversight, and tax-free character. Postal savings thus was seen to create a variety of serious risks and distortions in the Japanese financial system as well as a potentially serious drain on government finances. In a nutshell, the world's largest deposit-taking institution was seen as both an unfair competitor and a source of systemic risk.

The Koizumi administration's September announcement of its framework for reorganization of Japan Post and eventual privatization of its financial functions offered a new basis for discussions about its effects. The Koizumi plan, while lacking details, had three main points. First, it called for the establishment in 2007 of four postal corporations under a holding company, divided by function. Second, with regard to the two financial corporations – savings and life insurance – it called for privatization over a 10-year period. Third, it called for the postal financial institutions to be regulated in the same way as private financial institutions – including limited deposit guarantees, taxation of profits, and supervision by the Financial Services Agency.

While the principles of equal treatment were seen as a positive development, it appeared to be the unanimous view of participants that the proposed reforms would not go far enough to eliminate the problems of financial system distortions and systemic risk. Central to these concerns was the sheer scale of the postal financial system, which accounts for over a third of deposits and approximately 40% of life insurance policies in Japan. In comparison with the proposed merger of UFJ with another "megabank" to form a "gigabank," the postal savings system would still be more than twice as large – a search for new superlatives yielded "super gigabank" and "terabank." A financial institution of the magnitude of postal savings and insurance would have the ability to compete unfairly, especially once the current restrictions on its activities were lifted. Participants felt that either a break-up or even abolition of the system would be required, and were disappointed that the Koizumi plan did not address the scale issue at all.

A second concern raised about the Koizumi plan was that, despite formal limits on deposit guarantees called for in the plan, an implicit unlimited guarantee would remain. (It was also assumed that older existing deposits would retain their unlimited guarantees.) Participants believed that if the system were to find itself with insufficient funds to pay back depositors, the government would have no choice but to step in to subsidize a full pay-out. Knowing this, depositors would have no incentive to limit their exposure. Moreover, the failure of such a "super gigabank" would overwhelm the resources of the Deposit Insurance Corporation, so any bail-out of depositors would have to come out of the national budget.

Third, participants expressed skepticism about the likelihood of the postal financial system adhering to prudential regulation and behaving as a responsible financial institution. They believed that the power of the LDP's "postal tribe" and the political popularity of postal savings would ensure that strict supervision would be impossible – in any battle between the postal institutions and FSA inspectors, they argued, the latter were sure to lose. Management would understand this, which would reduce its incentive to follow the rules. Moreover, the very reason for the popularity of postal savings within the LDP was seen to be the issuing of economically irrational albeit politically attractive loans, which would reinforce incentives toward irresponsible lending. Additionally, the postal financial system has not been professionally managed to deal with increasingly sophisticated financial markets and risk assessment requirements, and a number of participants expressed skepticism that it could be rapidly transformed into a highly professional and responsible financial institution. While outsourcing for some of the portfolio management was seen as likely, there were also concerns about the procedures for choosing and overseeing outside managers.

More generally, there was deep concern as to where the postal financial institutions would invest and lend their vast funds. At one level, there was concern about irresponsibility leading to system-threatening losses. Almost as worrying to many participants was the prospect of an efficient postal financial institution exercising monopoly power to take away private institutions' market share or alternatively bidding prices for financial services down to a level where only the tax-advantaged and partly government-owned postal institutions could make any sort of margin. (While the Koizumi plan called for postal savings to receive the same tax treatment as other institutions, there was considerable skepticism that this would actually happen, and on what timetable.)

As a final point, participants agreed that the ultimate effects of the postal system changes would depend greatly on the details of the final law and its implementation. They agreed that the reform would bear watching in coming years.

TURNING JAPANESE SAVERS INTO INVESTORS

Building on the discussion of the activities of banks and the postal savings systems, participants discussed the continuing preference of Japanese households for keeping their financial assets in government-guaranteed savings deposits and in insurance policies. Many participants felt that this was a fundamental failing of the Japanese economy. If the fundamental purpose of a financial system is the allocation of capital to its most profitable uses – what one speaker characterized as "matching money to ideas" – then the unwillingness of Japanese households to take on risks for higher rewards was seen as a key limiting factor in the development of dynamic capital markets.

A number of participants argued that there needed to be a fundamental shift in saver psychology to realize that risk and reward are closely related, and thus to create a "risk-taking mentality." Several suggestions were made for how that might occur. At one level, the problem was seen as a lack of investor education, and several participants argued that financial institutions needed to become much more assertive in providing such education to their customers.

A counter-argument was that investor caution toward financial products was not the result of irrationality, but rather of rationality. The risk-return relationship, they argued, has not properly existed in Japan. Equities have been extremely volatile and have also had poor or negative returns over extended periods; bank or postal deposits, on the other hand, have been extremely safe and have had reasonably good real returns in the face of deflation. Some participants added that investors have been deeply suspicious of securities firms as institutions, due to their reputations for manipulating markets and disadvantaging small investors. One securities executive even argued that the shift to allowing banks to sell securities was a good thing for the securities industry as a whole, as it would begin to bring households who were suspicious of securities firms back into investing.

A separate perspective on the relationship between risk and return emphasized the enduring factors in the Japanese financial system that discourage risk-weighting. One example was the preferential treatment mandated for SMEs, either through explicit government loan guarantees or guidance to banks not to reduce SME lending. Loan guarantees in particular were seen by a number of participants to discourage banks from improving their risk assessments of firms and then adjusting their interest rates and willingness to lend to reflect differential risk. A second, more macro-level factor pointed out by many participants was the extremely low interest rate environment. With the present and future values of loan payments nearly equal, there was less incentive to differentiate among borrowers, these participants argued. Third, unlimited deposit guarantees were seen to de-incentivize investment by large savers such as wealthy individuals and firms; even though limits are set to be reimposed in April 2005, the continuing exemption of "settlement accounts" was seen potentially to skew investment choices. Finally, some participants expressed concern about the lack of a sense of fiduciary responsibility among portfolio managers and pension fund managers, which might be related to the way in which they are compensated.

On a more technical note, tax issues were seen to reduce some of the incentives for investing. While interest income is no longer privileged over dividend income, capital gains are still privileged over dividends. Moreover, the tax system is not symmetric for capital gains and losses. Finally, it was noted that withholding taxation on JGBs remains unwieldy.

A continuing sort of "Catch-22" was also noted. The lack of investment alternatives (such as domestically issued corporate bonds, among other instruments in which markets have been rather shallow and illiquid) has made more widespread financial investment less attractive. At the same time, the lack of interest in investing contributes to shallower and less liquid markets than might otherwise be the case.

Finally, it was noted that certain classes of investors have been slow to develop in Japan. These include vulture funds, activist funds, and private equity investors in addition to the venture capital and angel funds on which financial media have often focused. Some participants felt that increasing numbers of such institutional investors would be a key factor in improving the attractiveness of Japanese financial markets. Similarly, improvement of the environment for defined contribution pension plans, such as more favorable tax treatment, was offered as one important way to increase the investor population.

CORPORATE SECTOR REFORM: REMAINING ISSUES

Taking a broader view of the financial system, there was considerable discussion about the ultimate users of funds in the corporate sector. Here, the focus was much more on capital markets than on deposit-taking institutions. While most participants were appreciative of the many improvements toward efficiency and transparency, they were also impatient to see more complete changes. As in previous Symposiums, the key issues boiled down to transparency, corporate governance, takeover markets, and disincentives to all three. Without reform in the corporate sector, it was argued, capital market improvement would face inherent limits.

While participants lauded improvements in corporate disclosure and audits, including consolidated accounting, stricter standards, and more assertive enforcement efforts by authorities, most felt that some aspects of the system were not working as they should. Participants did point out some positive signs, such as the example set by the IRCJ in terms of mark-to-market and impairment accounting, but the consensus was that these practices were not as widespread as they ought to be. There were particular concerns about auditing, where it was pointed out that truly independent auditing was being done at only a minority of firms. Moreover, despite the avowed interest of regulatory authorities in ensuring proper accounting and disclosure, the lack of available inspectors was seen to render the enforcement threat weaker than it should be.

The lack of independent auditing was seen by many participants as a reflection of continued deficits in proper corporate governance. While some pointed to progress on the establishment of independent corporate boards, it was agreed that this was still relatively uncommon in Japan. In the absence of independent boards and auditors, participants worried that managers at many firms were free to run their companies for their own benefit.

A closely related issue was disclosure. Examples were offered of lack of disclosure of crucial information that led to severe mispricing of shares, in general disadvantaging small shareholders relative to major ones, and shareholders in general to management – as one participant put it, managers in some firms have engaged in “gross abuse of minor shareholders.” (There was some disagreement regarding whether the actions of the various actors in the UFJ takeover bids provided evidence of this sort of selective disclosure.) To address the issue of selective disclosure, some participants felt that better regulations, such as the FD rule in the United States, were necessary. Others emphasized the role of markets in punishing firms that misrepresented their activities or that did not establish adequate controls in terms of information disclosure.

The role of markets in disciplining firms was again seen to be an area in which capital markets have not been very effective in Japan, despite improvements over previous years. In particular, a number of participants expressed concern that there was not yet a market for corporate control. Some saw the UFJ merger contest as a potential test case for the power of managers relative to shareholders, but there was not universal agreement on what the proper outcome would be for UFJ. It was also noted that financing for attempted takeovers remained difficult to obtain.

Advocates of more extensive markets for takeovers also expressed concern over certain legal aspects of acquisitions. Regarding hostile takeovers, they were dismayed that poison pills and similar defenses have been allowed (some believed even encouraged). Such defenses were seen as being of benefit only to managers, and not to shareholders. Concern was also raised over the *de facto* impossibility of doing cross-border stock-for-stock acquisitions. The requirement that unrealized capital gains be recognized in order to do stock-for-stock swaps was seen as prejudicial against foreign firms seeking to takeover Japanese firms, and an important impediment to improving the market for corporate control.

HOW WILL JAPAN TRANSITION FROM ZERO INTEREST RATES?

A final question that was addressed in many discussion, albeit mostly indirectly, was that of how Japanese financial institutions and corporations would handle the eventual transition away from zero interest rates. The ultra-low interest rate environment was seen to have a number of deleterious effects on the functioning of capital and banking markets, whose behavior would need to change as a normal yield curve and the possibility of risk-weighting reemerged. (This was a different question than what Japanese monetary policy should be, which was not a major topic for discussion.)

One issue has already been noted above – i.e. the lack of incentive for careful risk assessment and risk-based loan pricing. On the bright side, rising rates would make it possible for banks to improve their margins on lending; given the continued reliance of banks on lending rather than fee-based services, this could be a positive development for them. On the other hand, they would face the fact that the default risk-free assets in which they have been heavily invested (such as JGBs) carry substantial price risks. Other capital market participants would also have to adjust their portfolios to deal with the change. Some concern was expressed regarding the quality of planning to deal with that eventuality.

On the corporate side, there was concern that the ultra-low interest rates might be concealing considerable weaknesses. Thus, some participants feared that NPLs might start to increase again; while this was seen as less of a problem for the major banks, with their relatively healthy capital and NPL positions, it fed into the concerns noted above regarding the second-tier institutions.

Session 2

The Competitiveness of the United States in International Capital Markets

Participants generally agreed that U.S. capital markets and financial institutions remain the most competitive and attractive in the world. The markets were seen to be unparalleled in terms of depth, breadth, and liquidity, as well as legal and technological infrastructure. The extraordinary profitability and technological sophistication of the financial sector in the United States were seen as evidence that they remained the standard for the world. In terms of bank income, for example, U.S. banks were in a stronger situation than Japanese banks not only because of bigger spreads, but also due to their much greater reliance on fee-based services. Nonetheless, many participants raised warnings about what they saw as emerging overregulation and misregulation, rising costs, overconcentration, and the potential dangers of macroeconomic shocks.

OVERREGULATION? THE SARBANES-OXLEY EFFECT

Much of the concern over regulation of U.S. capital markets centered on the Sarbanes-Oxley Act and related regulatory changes. While a number of participants argued that Sarbanes-Oxley had had some important beneficial effects in terms of stabilizing and improving transparency in the markets, an apparent majority felt that it imposed excessive costs on both financial corporations and firms, and expressed a preference for at least a partial rollback.

Concerns about Sarbanes-Oxley and related rules fell into three general categories: excessive costs, adverse incentives for executives, and reduced attractiveness of U.S. capital markets. Many participants felt that the reporting requirements under Sarbanes-Oxley were too expensive, although it was also pointed out that there was no clear way of measuring whether the costs were too high relative to the benefits in terms of information quality. One speaker stated that the reporting requirements cost his firm 5 cents per share. Some participants related anecdotes about firms that were choosing not to list because of the costs of compliance. A related complaint was that CEOs were spending too much time on compliance issues and not enough on managing their firms' strategies and operations.

Sarbanes-Oxley was also held up as an obstacle to foreign firms' listing on U.S. stock exchanges, given that there had been no new such listings since its passage. Some participants expressed concern that foreign firms would increasingly bypass U.S. capital markets in favor of European or perhaps Asian ones that had less onerous regulations. (This point was not confined to the Sarbanes-Oxley Act itself, but to what they considered to be more extensive overregulation.)

While Sarbanes-Oxley was the focus of discussions of overregulation, other concerns about overregulation were also put forward. One participant, for example, argued strongly that rules on analysts had made their reports much less useful, and actually contributed to a deterioration in the information available to the markets.

These concerns were not universal. There was a substantial group that felt that Sarbanes-Oxley had done much more good than harm, and that it would become a *de facto* global standard of regulation. Many participants also saw the legal restrictions on analysts to have been a necessary action to protect retail investors and ensure the integrity of analysis. Finally, participants were apparently unanimous in their approval of fair disclosure (FD).

MISREGULATION? THE SPITZER EFFECT

While many participants expressed concern about possible overregulation, others emphasized the problem of misregulation. Of particular interest was the so-called "Spitzer Effect." Most participants appeared to be unhappy about the effects of criminal investigations and prosecutions in the financial industry by New York Attorney General Eliot Spitzer.

These concerns fell into three categories. Some participants felt that the aggressiveness of the attorney general's office constituted a sort of "populist regulation," in which the financial sector was being attacked because of popular resentment against financially successful individuals and firms. Many of these participants also objected to specific targets of Mr. Spitzer's campaigns as being unfairly and inappropriately accused of wrongdoing. It was argued that populist regulation had the tendency to overregulate and criminalize legitimate business choices.

Other participants felt that these campaigns were creating a new kind of "regulation by settlement agreement." Such regulation was seen to bypass the usual legislative or administrative processes, and constitute an inappropriate incursion by the state officials and courts into federal regulatory functions. Since settlement agreements are focused on dealing with specific criminal violations, they may not create an optimal balance between market efficiency and enforcing compliance. Moreover, settlement agreements were seen by these participants to be an inflexible means of managing a highly dynamic industry.

Third, many participants were worried about the possibility of similar actions by attorneys general of other states. They feared that this would increase costs severely. This was of particular concern in the insurance industry, where regulation is already deeply fragmented.

Many participants who worried about the "Spitzer Effect" also felt that the means by which the attorney general's office went about its work were unfair. In particular, they were concerned about the office's tactic trying cases through the media and adopting remedies without getting all the facts and weighing alternative approaches to problems.

While most participants seemed to have negative assessments of the "Spitzer Effect," some argued that the attorney general's actions had for the most part been positive. They pointed out, for example, that there had been real violations of law and principle in the cases to date. Moreover, they felt that it was the inadequacy of the response by the SEC and other regulators that had forced the attorney general's office to step into the breach. While no one expressed satisfaction at "regulation by settlement agreement" *per se*, these participants felt that other means had simply not worked. Finally, some participants expressed the hope that the "Spitzer Effect" would pressure regulators to create more effective regulations and enforcement regimes.

GIGABANKS AND OVERCONCENTRATION

In addition to concerns about trends in U.S. financial market regulation, a considerable amount of discussion focused on increasing concentration in the United States, particularly in the banking center. As in Japan, it was considered that there was a clear trend toward concentration in the banking sector, as seen in the growing dominance of "megabanks" or even "gigabanks." Overconcentration was presented as the negative flip side of the consolidation that has improved efficiency through economies of scale in IT and economies of scope through diversification. While consolidation has led to higher profits, three main dangers were identified.

First, as in Japan, the possibility was raised that part of the motivation for consolidation was for banks to become too big to fail. This would increase both moral hazard in megabank activities and increased systemic risk. While there appeared to be no appetite for stricter antitrust enforcement in the financial sector, many participants were uneasy about those implications.

A second concern was the problem of lack of competition. It was pointed out that most major cities now have fewer than five major banks competing, and that this offered opportunities for market power and oligopolistic pricing. Opinion appeared divided regarding the actual market power of megabanks, however. For many retail services, such as mortgages, credit cards, and money management, the existence of Internet and other options increased the power of retail customers. It was suggested, however, that for many retail customers and SMEs, there were few viable choices regarding basic services and lending.

A third, related, concern was about innovation. While U.S. financial institutions have become the most efficient and dynamic in the world as a result of IT investment and innovation, it was suggested that reduced competition could reduce those incentives. Although consolidation may have contributed to the ability of financial institutions to invest aggressively, it could at some point remove their incentive to do so.

Leaving aside the question of the private gigabanks, some participants expressed concerns about GSEs. Recent reports about the governance and regulation of these financial institutions were seen to raise the question of whether the U.S. financial markets might be more exposed to serious risks than is generally perceived. While this was not presented as an urgent issue, preventive regulation and oversight was seen as important.

MACRO ISSUES

Several macro issues were also raised by participants. These included the low U.S. savings rate, high consumer debt burdens, and the effects of future interest rate hikes. While most participants felt the U.S. economy and financial system to be highly resilient in the face of likely shocks, others were concerned that there were also some important vulnerabilities that would make it less so.

One concern raised was the low U.S. savings rate, especially when considered in conjunction with extremely high fiscal deficits. A few participants argued that it was a handicap of the U.S. financial markets that they depended on the inflow of savings from other parts of the world, and expressed concern that these flows might dry up as financial markets improved in savers' home countries. This appeared to be a minority view, however, with many participants arguing instead that as long as U.S. financial firms and markets were efficient and innovative, the source of funds would be irrelevant.

A different angle on the same problem was whether U.S. deficits would be sustainable, and what would be the effects if Asian central banks were to withdraw their reserves from the United States. Although this question was raised several times, however, there appeared to be little concern that there would be an abrupt shift. But some participants did express concern that high deficits would create a longer-term drag on the U.S. economy more generally.

The highly-leveraged situation of U.S. households also created some concern, particularly among Japanese participants. The major worry was not about financial institutions' exposure to consumer borrowing, since it was generally agreed that they are adequately hedged. Rather, there was a fear that weakness in the economy could make that debt unsustainable for many individuals, and contribute to a significant slowdown in demand. (A few participants also pointed to the dangers of a U.S. property bubble, but this issue was not examined at any length.)

A final concern from the macro point of view was how the economy would handle shifts in interest rates. With rates on an upward trend, some participants worried that there may be many investments or firms whose health depended on unnaturally low interest rates – essentially mirroring the discussion about the prospects for ending zero interest rates in Japan. Moreover, the Fed's focus on creating a stable and predictable environment was seen by at least one participant as lulling U.S. financial institutions into taking on too much risk.

EXECUTIVE COMPENSATION

A final topic of discussion among some of the small groups was executive compensation in U.S. financial institutions. Two questions were raised: Are U.S. executives paid too much? And, does the form of executive pay create appropriate incentives?

Most of the discussion in this regard focused on alignment of individual incentives with company interests. Participants generally agreed that it was impossible to state *a priori* that a given individual was being paid too much. Rather, the concern was to balance compensation with performance. This concern seemed to focus particularly on managers of hedge funds, where financial rewards have been especially high, and where some participants felt that average returns were being too richly rewarded. But in the end, most participants agreed that responsibility for deciding whether such managers are overpaid must lie with their own firms and with the financial institutions that choose to provide funds to them.

Session 3

The Significance of China for U.S. and Japanese Financial Markets

In Portsmouth, the Symposium directly addressed the issue of China for the first time. Generally speaking, participants viewed China as an opportunity for U.S. and Japanese financial institutions, but several cautionary voices were also raised. In particular, there were concerns over the Japanese economy's macroeconomic dependence on China in recent years, the course and effects of shifting the Renminbi to a float, the poor environment for financial services in China, and the effects of foreign policy issues on financial cooperation between China and both Japan and the United States.

FINANCIAL OPPORTUNITIES

Participants expressed interest in the potential for U.S. and Japanese financial firms to profit from doing business with China, although their optimism was tempered by concerns about existing and potential problems.

The potential of China was seen to be obvious. The foreign role has been considerable in this regard. This has been particularly true with regard to FDI, which has accounted for considerable capital formation and technology transfer, but the underdeveloped nature of Chinese financial services also was seen to provide considerable opportunities for foreign investors and financial services providers. As China opens its financial markets to meet its obligations of WTO entry, foreign firms will be able to compete in more and more aspects of domestic finance. The opening up of class-A shares to foreign ownership is one step in that direction. Even in traditional financial activities such as servicing foreign firms and lending to corporations and financial institutions, considerable growth prospects were seen – for example, Japanese banks had been increasing their lending to China considerable in recent years, offering profit-making opportunities when domestic opportunities were slim.

Nonetheless, participants agreed that significant dangers remained to doing business in China. A number of economic challenges were noted, including geographic and class inequalities, lack of energy efficiency, and unemployment issues related to capital accumulation and regional migration. The crude nature of monetary policy implementation was also pointed out as a cause of economic volatility.

As for specific challenges for financial markets, one major concern had to do with property rights and the commercial code – participants worried that the rule of law was not sufficiently established to guarantee their rights in case of disagreements with authorities or local counterparts. A second worry was over the parlous state of the big four Chinese banks, in which some participants claimed that over 50% of loans were non-performing. This raised the potential for a very severe financial crash that could involve foreign financial institutions and severely injure the economy as a whole. Both of these concerns pointed to a more general point as well – that Chinese financial markets are still fundamentally not free and the rule of law is poorly established. The substantial direct involvement of the Chinese state and the potentially arbitrary nature of its actions led participants to be even more cautious.

Ironically, the poor development of financial markets also was seen to present an important opportunity. The vast shift of household savings from the formal banking system to the curb markets could make for a huge potential opportunity to intermediate the huge funds currently being withheld from the banks. Moreover, it was argued that the poor return on locally held funds was already creating excellent business opportunities for foreign financial institutions. One participant described the current situation as a "total equity return swap" in which Chinese savers preferred to earn 4% on U.S. treasury bonds while U.S. firms in turn invested in China, earning 10-15% – essentially, the argument went, Chinese household have been lending money cheaply for foreigners to reinvest in China for excellent returns. Others pointed to the fact that these "round-trip" investors in China provided a lot of value in the form of management expertise and technology transfer.

JAPAN'S "DEPENDENCE" ON CHINA

One clear theme that appeared in discussions about China was its growing importance to Japan's economy. It was noted that much of Japan's GDP growth in recent years had resulted from exports to China. Moreover, Japan's burgeoning trade with and investment into China was seen to be a key factor in restructuring and improving the efficiency of Japanese manufacturing. Finally, Japanese bank lending to China has also been on the increase, offering the possibility of improved revenues for the banks.

This interdependence was generally seen as a win-win situation. However, some participants expressed concern that Japan had become too dependent on the Chinese economy, and raised the possibility that this may create a dangerous vulnerability. Part of the concern was purely economic. In this view, Japan's growth in the current upswing has again been export-led, with a particular reliance on China. If the Chinese economy were to slow down, the Japanese economy might lose critical support and again find itself in stagnation. Another concern was that if a serious financial implosion were to occur in China, Japanese financial institutions might find themselves heavily exposed. As noted above, financial crisis was seen to be a very real possibility for China. The likelihood of government miscalculation in dealing with economic overheating or financial system problems suggested to many that dependence on the Chinese economy would be even more dangerous than dependence on export-led growth.

Foreign Policy Risks

While China's domestic economic policies and conditions were seen to be unpredictable and potentially very dangerous for both Japan and the United States, foreign policy considerations were also of concern to participants. Given the difficulties of relations with China for both countries, there was some fear that politics might be an even greater obstacle to maximizing mutual gains than economic volatility. The possibility of unexpected flare-ups injuring the economic interests of Japanese and U.S. firms and financial institutions was never far from the surface of discussions.

On the U.S. side, the most likely political flashpoints were seen to be Taiwan and North Korea. While participants acknowledged the relatively positive relationship forged with China in the face of global terrorism, they noted that these unresolved questions remained at the heart of both U.S. and Chinese interests in the region. Renewed concerns about human rights or U.S. troop deployments in Asia also offered the possibility of frictions. However, the Taiwan and North Korea issues in particular were seen to hold the danger of major showdowns that risked a chilling effect on economic relations.

The same issues were in play in Sino-Japanese relations as well. An additional concern in this regard, however, was the extraordinary intensity of Chinese resentment towards Japan due to its wartime actions and the perception of the Chinese population that Japan has not apologized properly or shown sufficient contrition. While many Japanese observers have argued that anti-Japanese sentiments have been politically manipulated by the Chinese government, several Symposium participants cautioned that the government has in many cases actually sought to tamp down popular feelings. The sway of anti-Japanese feelings and the undeveloped nature of the rule of law in China suggested to many participants that official or unofficial harassment of Japanese firms and financial institutions might constitute an ongoing problem. Thus, Japanese firms may incur greater political risk by investing in China than firms based in other countries.

One additional risk that was suggested in the context of Sino-Japanese relations was the possibility of resource competition between the two countries, as China's growth has demanded ever greater imports of commodities, especially oil. Participants agreed that such competition would likely be peaceful, but the possibility of political tensions stemming from competition for oil pipelines in Russia, for example, could not be completely discounted. On a related issue, the high levels of Chinese environmental degradation and cross-border air pollution were seen to be yet another challenge for Japanese authorities and firms in dealing with China.

FLOATING THE RENMINBI?

A final cluster of issues regarding China centered on the Renminbi. Three key questions were raised: How would China handle the eventual transition to a float? Would China allow significant Renminbi appreciation in the meantime? And what were the implications of China's large foreign exchange reserve holdings?

Participants agreed that China would eventually need to increase the flexibility of its currency regime. Most argued that a float would be unavoidable, although the Japanese government has discussed the attractiveness of a managed float based on a currency basket that includes the yen and other currencies in addition to the dollar. Regardless of how free the float eventually would be, participants were very interested in the process by which it would occur. They expressed particular concern about the condition of Chinese financial markets, and the opinion was expressed that financial regulatory reform might be a necessary precondition of full capital account opening. In the meantime, it was suggested that gradual opening of the current account should continue, and more areas of the financial system should be made available to foreign financial institutions.

Most participants felt that revaluation of the Renminbi would be an essential step on the way to a float. Several pointed out that China was currently in the enviable position of having a strong Renminbi rather than a currency that was subject to attack. They argued that this offered an opportunity for China to move to a float relatively rapidly without serious negative effects on growth or access to funds. An alternative intermediate step suggested was the shift to pegging to a currency basket, which would allow for greater flexibility, particularly if there was a large shift in the value of the dollar relative to other major currencies.

Finally, related to the issue of revaluation, China's large currency reserves were seen both as an effect of undervaluation of the Renminbi and as a potential source of instability in the international economy. The efforts to maintain the value of the Renminbi versus the dollar have meant accumulation of significant reserves held in U.S. treasuries, which has fed into the "total equity return swap" (see above) between China and the United States. It has also made participants nervous about the ability of China to maintain its peg against the dollar. While some observers have expressed concern that China could create chaos by withdrawing its reserves from the U.S. markets, however, most participants seemed to agree that any such withdrawal would be gradual, and thus manageable. But those reserves were seen as contributing to a global overhang of dollars that could have long-term negative influences on the U.S. economy, particularly if payments imbalances were to persist.

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