SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY
AN AGENDA FOR JAPAN & THE UNITED STATES
PORTSMOUTH, NEW HAMPSHIRE • OCTOBER 20-22, 2006

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FRIDAY, OCTOBER 20

6:00-7:00 Cocktail Reception

7:00 **GREETINGS**
Hal S. Scott, Nomura Professor and Director, PIFS, Harvard Law School
Robin Radin, Associate Director, PIFS, Harvard Law School
Tasuku Takagaki, Chairman, The International House of Japan

Yasuhisa Shiozaki, Chief Cabinet Secretary (*pre-recorded speech*)

Dinner

KEYNOTE ADDRESS
Hiroshi Watanabe, Vice Minister of Finance for International Affairs, Ministry of Finance
Robert Dohner, Deputy Assistant Secretary, U.S. Department of Treasury, International Affairs

9:30-12:00 After-Dinner Cocktails

SATURDAY, OCTOBER 21

7:15-8:15 Breakfast

8:15-8:25 **WELCOME & OPENING REMARKS**
Hal Scott, Nomura Professor and Director, PIFS, Harvard Law School
Tasuku Takagaki, Chairman, The International House of Japan

8:25-8:45 **PANEL SESSION**
Topic 1: How can Tokyo and New York ensure their competitive positions in the future as global financial market centers?
Japan Panelist: Tadashi Nakamae, President, Nakamae International Economic Research (NIER)
U.S. Panelist: Douglas L. Peterson, Chief Executive Officer, Citigroup Japan; Chief Executive Officer and Chairman, Citibank Japan

8:45-10:15 **SMALL GROUP SESSIONS**

10:15-10:25 Refreshment Break

10:25-10:45 **PANEL SESSION**
Topic 2: What is the impact of Japan's economic resurgence on the U.S. - Japan financial relationship?
Japan Panelist: Ryusaburo Harasawa, Managing Director - Chief Executive, Operations and Systems Unit, The Bank of Tokyo Mitsubishi UFJ Ltd.
U.S. Panelist: Matthew Goodman, Managing Director, Stonebridge International LLC

10:45-12:15 **SMALL GROUP SESSIONS**

12:15-1:30 Lunch
KEYNOTE ADDRESS
Yo Takeuchi, Senior Executive Director, Development Bank of Japan

1:30-3:00 **PANEL SESSION – PLENARY DISCUSSION ONLY** – Grand Ballroom
Topic 3: Monetary policy after Greenspan and quantitative easing
Japan Panelist: Akinari Horii, Assistant Governor, Bank of Japan
Japan Panelist: Teizo Taya, Special Counselor, Daiwa Institute of Research Ltd.
U.S. Panelist: David Hale, President, Hale Advisors LLC
U.S. Panelist: John Makin, Principal, Caxton Associates, LLC

3:00-5:45 Free Time

6:00-7:00 Cocktail Reception

7:00-9:30 Dinner
KEYNOTE ADDRESS
Hideyuki Takahashi, President & CEO, Nomura Holding America Inc.
Joseph L. Rice, Chairman, Clayton, Dubilier & Rice

9:45-12:00 After-Dinner Cocktails

SUNDAY, OCTOBER 22

7:15-8:15 Breakfast

8:15-9:30 **PRESENTATION & DISCUSSION**
Topic 1: How can Tokyo and New York ensure their competitive positions in the future as global financial market centers?
Japan Chair: Hiroyuki Kamano, Partner, Kamano Sogo Law Offices
U.S. Chair: Jonathan D. Schuman, Regional Vice President, AIG Global Investment Group

9:30-10:20 **PRESENTATION & DISCUSSION**

Topic 2: What is the impact of Japan's economic resurgence on the U.S. - Japan financial relationship?

Japan Chair: Mikio Wakatsuki, Chairman, AXA Life Insurance Company Ltd.

U.S. Chair: Laurence W. Bates, General Counsel, Japan, General Electric Japan

10:20-10:30 Refreshment Break

10:30-11:30 **PRESENTATION & DISCUSSION**

Topic 3: Monetary policy after Greenspan and quantitative easing

Japan Chair: Masaru Yoshitomi, President & Chief Research Officer, Research Institute of Economy, Trade and Industry (RIETI)

U.S. Chair: Robert Alan Feldman, Chief Economist, Morgan Stanley Japan Ltd.

11:30-1:30 Closing Brunch

Japan Participants

Tomoaki Ando	Director, Managing Executive Officer, The Sumitomo Trust & Banking Co.
Akira Ariyoshi	Director, Regional Office for Asia and the Pacific, International Monetary Fund
Jeffrey R. Bohn	General Manager, Head of Financial Strategies Division, Shinsei Bank
Nobuyoshi Ehara	Partner, Unison Capital Inc.
Atsushi Fukui	Partner, CPA, KPMG AZSA & Co.
Takeshi Fukutani	Chief Executive Officer, Tokio Marine Financial Solutions Ltd.
Takashiro Furuhata	Executive Director, The International House of Japan Inc.
Yasuhiro Harada	President & CEO, Rating and Investment Information Inc.
Ryusaburo Harasawa	Managing Director - Chief Executive, Operations and Systems Unit, The Bank of Tokyo-Mitsubishi UFJ Ltd.
Takayoshi Hatayama	Advisor, ABeam Consulting Ltd.
Akinari Horii	Assistant Governor, Bank of Japan
Masato Hotta	Chief Correspondent, Nihon Keizai Shimbun
Hiroyuki Kamano	Partner, Kamano Sogo Law Offices
Yasuo Kanzaki	Special Advisor, Nikko Citigroup Ltd.
Mikio Kato	Senior Fellow, The International House of Japan Inc.
Etsuko Katsu	Professor, Meiji University
Shigeki Kimura	Director, Development Institutions Division, Ministry of Finance
Susumu Kohsaka	Deputy Head, Compliance Headquarters, Japan Securities Dealers Assoc.
Kozo Koide	Chief Economist, DL-IBJ Asset Management Ltd.
Shizuharu Kubono	Senior Managing Director, Member of the Board, The Norinchukin Bank
Kazutoshi Kuwahara	General Manager, Japan Branch, Genworth Mortgage Insurance Corp.
Junichi Maruyama	Deputy Commissioner for International Affairs, Financial Services Agency
Naoko Nakamae	Tokyo Correspondent, The Economist
Tadashi Nakamae	President, Nakamae International Economic Research (NIER)
Kazuki Nakamoto	Managing Director, Daido Life Insurance Co.
Takehiko Nakao	Minister (Finance), Embassy of Japan
Tomoo Nishikawa	Managing Partner, Sidley Austin/Nishikawa & Partners
Masahiko Oshima	General Manager, Planning Dept., Sumitomo Mitsui Banking Corp.
Hiroshi Ota	Advisor, Mitsubishi Heavy Industries Ltd.
Atsushi Saito	President & CEO, Industrial Revitalization Corporation of Japan
Setsuya Sato	Senior Director, Supporting Office, Industrial Revitalization Corporation of Japan (IRCJ)
Joseph R. Schmuckler	President & COO, Nomura Securities International Inc.
Rieko Shimojo	General Manager, International Business Development, RS Asset Management Japan Co. Ltd
Hitoshi Shimura	Chief Representative, Ministry of Finance Government of Japan
Yoichi Suzuki	Consul General, Consulate General of Japan - Boston
Tasuku Takagaki	Chairman, The International House of Japan Inc.; Senior Advisor, The Bank of Tokyo-Mitsubishi UFJ Ltd.
Hideyuki Takahashi	President & CEO, Nomura Holding America Inc.

Yoshikazu Takeda	Managing Director, General Manager for the Americas and Europe, Nippon Life Insurance Co.
Yo Takeuchi	Senior Executive Director, Development Bank of Japan
Rintaro Tamaki	Senior Deputy Director - General, International Bureau, Ministry of Finance
Teizo Taya	Special Counselor, Daiwa Institute of Research Ltd.
Ryoichi Ueda	President & CEO, Mitsubishi International Corp.
Tomoyoshi Uranishi	Executive Officer, Tokyo Stock Exchange Inc.
Mikio Wakatsuki	Chairman, AXA Life Insurance Company Ltd.
Akihiro Wani	Partner, Linklaters
Hiroshi Watanabe	Vice Minister of Finance for International Affairs, Ministry of Finance
Bill Wilder	President & CIO, Nikko Asset Management Co. Ltd.
Ken Yagi	President & CEO, RS Asset Management Japan Co. Ltd
Shuji Yanase	Of Counsel, Nagashima Ohno & Tsunematsu
Yukio Yasuda	General Manager, Americas Division, Mizuho Corporate Bank Ltd.
Masamichi Yokoi	Chairman & Chief Executive Officer, Daiwa America Corp.
Yoichiro Yokoyama	Director General, Treasury Department, Development Bank of Japan
Naoyuki Yoshino	Professor, Department of Economics, Keio University
Masaru Yoshitomi	President & Chief Research Officer, Research Institute of Economy, Trade and Industry (RIETI)

U.S. Participants

David L. Asher	Managing Director, Anshin Capital Advisors
Susumu Awanohara	Director, Medley Global Advisors LLC
Megumi Azuma	Legal Counsel, Public Policy, General Electric Japan
Laurence W. Bates	General Counsel, General Electric Japan
Kent E. Calder	Director & Edwin O. Reischauer Professor-S.A.I.S., Edwin O. Reischauer Center for East Asian Studies, Johns Hopkins University
Thomas F. Cargill	Professor of Economics, University of Nevada, Reno
Andrew J. Conrad	Senior Vice President & Counsel, Director of Governmental and Legal Affairs, Aflac International Inc.
Robert Dohner	Deputy Assistant Secretary, U.S. Department of Treasury, International Affairs
Robert Alan Feldman	Managing Director, Morgan Stanley Japan
Matthew Goodman	Managing Director, Stonebridge International LLC
William W. Grimes	Associate Professor of International Relations, Boston University
Robert F. Grondine	Partner, White & Case LLP
David Hale	President, Hale Advisors LLC
Steven Hess	Vice President/Senior Credit Officer, Moody's Investors Service
Takeo Hoshi	Professor of International Relations and Pacific Studies, University of California at San Diego
Lyric Hughes Hale	Founding Publisher, China Online Inc.
William F. Jarvis	Managing Director, Commonfund Institute
Donald P. Kanak	Senior Fellow, Program on International Financial Systems, Harvard Law School
Masaaki Kanno	Managing Director & Chief Economist, JPMorgan Securities Asia Co.
Richard Katz	Editor, The Oriental Economist Report

Kazutoshi Kuwahara	General Manager, Japan Branch, Genworth Mortgage Insurance Corporation
Donald P. MacLeod	President & CEO, Capital Partners Securities LLC
John Makin	Principal, Caxton Associates LLC
Jonathan S. Malamud	International Counsel (Japan), Prudential Financial
Mark Mason	Managing Director, TransPacific Capital Group LLC; Senior Advisor, Program on Alternative Investments, Columbia Business School
Geoffrey Matsunaga	General Counsel, Japan Branch, Genworth Mortgage Insurance Corp.
Peter McKillop	Senior Vice President, Global Consumer and Small Business Bank, Bank of America
Richard Medley	Chairman, Medley Capital Management
Victoria Melendez	Managing Director, Rockefeller & Co.
Barry Metzger	Partner & Attorney at Law, Baker & McKenzie LLP
Anthony M. Miller	Managing Director, Ramius Capital Group LLC
Arthur M. Mitchell	General Counsel, Asian Development Bank
Julius Moschitz	Macroanalyst, Wellington Management Company LLP
Hiroshi Murakami	Senior Managing Director, Cerberus Japan K.K.
Allan O'Bryant	President and CEO, Yunzei Capital LLC
Alicia Ogawa	Director, The Program on Alternative Investments, Center on Japanese Economy and Business
Hugh T. Patrick	R.D. Calkins Professor of International Business Emeritus and Director, Center on Japanese Economy and Business, Columbia Business School
Douglas L. Peterson	Chief Executive Officer, Citigroup Japan; Chief Executive Officer & Chairman, Citibank Japan
Jeremy Pitts	Partner, Baker & McKenzie Tokyo
Robin Radin	Associate Director, Program on International Financial Systems, Harvard Law School
Joseph L. Rice	Chairman, Clayton, Dubilier & Rice
Andres Rubio	Managing Director, Cerberus Japan K.K.
Joseph Sanberg	Director, Japan Investments, Tiger Global Management
Jathon Sapsford	Executive Director, Morgan Stanley Japan Securities Co., Ltd.
Charles D. Saunders	Principal & Senior Portfolio Manager, NorthRoad Capital Management LLC
Jonathan D. Schuman	Regional Vice President, AIG Global Investment Group
Hal S. Scott	Nomura Professor and Director, Program on International Financial Systems, Harvard Law School
Henny Sender	Senior Special Writer, The Wall Street Journal
Clifford Shaw	Chairman, Chamberlain Holdings Ltd.
Allan D. Smith	Regional Vice President & General Counsel, Japan and Korea, AIG
Paul Speltz	President, Kissinger Associates Inc.
Elizabeth Varet	Chairman, American Securities LP
J Weinstein	Deputy Director, Program on International Financial Systems, Harvard Law School
Ayako Weissman	Chief Investment Officer, AS Hirota Capital Management
Christopher P. Wells	Partner, White & Case LLP
Michael J. Wilson	President, State Street Global Advisors (SSgA) Ventures Group
Jeffrey Young	Head of Currency Research, Citigroup

SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:

AN AGENDA FOR JAPAN & THE UNITED STATES

OCTOBER 20-22, 2006
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BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR JAPAN & THE UNITED STATES

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The ninth 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 ability of Tokyo and New York to maintain their competitiveness as global financial market centers, the impact of Japan's economic resurgence on US-Japan financial relations, and challenges for monetary policy in the post-quantitative easing/post-Greenspan era. Participants were mostly upbeat about Japan's economic prospects, but highlighted some potential concerns for both Japan and the United States. With regard to financial markets, many expressed concern about aspects of both the New York and Tokyo markets, pointing to London as the emerging global financial market leader.

Session 1
How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

Participants noted that there has been a significant move toward concentration among financial markets, with most agreeing that there were likely to be no more than 2-3 truly global ones in coming years. While New York, London, and (trailing further behind) Tokyo were seen as the obvious current global leaders, many participants expressed concerns about the long-term competitiveness of Tokyo and New York as centers for global financial markets. Some argued that UK financial regulation and supervision was the new world standard and even that London had effectively supplanted New York as the preeminent global market. Discussion of this topic focused on perceived infrastructural, regulatory, and other legal impediments and weaknesses in the two markets. The main complaints about US exchanges had to do with excessive regulatory burden. As for Japan, while all agreed that Tokyo had improved considerably since the Big Bang, most saw considerable room for continued improvement. Moreover, some worried that introduction of U.S.-inspired rules might actually increase regulatory burden in Japan rather than improving the functioning of the market.

Importance of Being a Global Center

Some participants questioned whether it was actually important for Tokyo or New York to be global financial market centers. Two concerns were raised in this regard. There was some concern over whether financial markets drew too many economic and human resources from other sectors of the economy. Other participants suggested that global competitiveness was less important than effectively allocating capital domestically and that, given the size of the US and Japanese economies, New York and Tokyo could continue to thrive as financial market centers even without being truly “global.”

Most participants disagreed with both of those positions. Instead, they strongly supported the idea that promotion of global financial market centers was an appropriate – and indeed important – national goal for both Japan and the United States. They offered several general reasons. Most fundamentally, they argued that effective capital allocation within an economy depended on the quality and liquidity of financial markets. To enjoy sufficient liquidity in a world of financial globalization, markets would need to be attractive to footloose investors. Related to this point, a second reason was that domestic investors and households deserved access to innovative financial products and services, in order to make better use of their

savings. A third reason given was that such markets would be a useful base for the global advance of domestic financial institutions – this point was made particularly in the case of Japan, whose financial institutions were seen to be reentering global competition following years of weakness and retrenchment. In this regard, it was suggested that Tokyo markets should acquire a financial position in Asia analogous to that of London's position in Europe. Finally, it was argued that in post-industrial, service-oriented economies such as Japan and the United States, global financial markets created attractive employment and opportunities for profit. Some participants worried that this might contribute to greater income inequality, but there was no agreement on whether that was actually the case or whether anything could or should be done about it.

Some participants raised a more general question about the relevance of location of exchanges in an increasingly "virtual" financial market. It was noted that traders can be located anywhere in the world and that an increasing proportion of trading was being done through electronic exchanges. Indeed, for some markets, such as currencies, the irrelevance of physical exchanges is an established fact. But other participants cautioned that it may not be possible to extrapolate such experiences to equity and bond markets. Especially in equity markets, even if much of the trading is done outside of the exchange, they argued that listing rules and the roles of lawyers and accountants made a single physical location a necessity. Moreover, the need was seen to remain for a controlling legal authority in many financial product areas in order to facilitate dispute resolution.

Elements of Financial Market Competitiveness

Participants agreed on several elements of financial market competitiveness, which were used in discussions to compare London, New York, Tokyo, and other potential competitors. These included variables related to law and regulation – such as transparency of rules, fairness and stringency of enforcement, regulatory burden, and government responsiveness – as well as ones that could broadly be considered infrastructural, such as technology and access to top-quality human resources. The existence of significant domestic markets was also noted, helping to keep New York and Tokyo as significant global market centers. London's *de facto* position as the financial center for the European Union was seen to give it a considerable base as well.

Most participants agreed that London could be considered a leader in virtually all of these areas. The one note of caution had to do with the potential for the EU to issue potentially burdensome directives, such as a recent one meant to protect retail investors. New York generally ranked highly, but there were concerns about regulatory burden, strictness of enforcement, and government responsiveness. Tokyo was seen as having more significant deficits, including exchange and settlement technology, insufficient access to human resources, and continuing issues related to regulation and supervision. Among the big three markets, it was noted that over the previous eighteen months, London had gained 152 new foreign listings, New York only 54, and Tokyo actually had a net loss of four. This seemed to suggest that a New York listing was no longer a *sine qua non* for global corporate "credibility." Beyond those markets, it was noted that several smaller markets, including Hong Kong and Singapore, offered impressive infrastructure and low regulatory burden. It was suggested that such markets might attract some listings and transactions away from other centers, particularly Tokyo.

For New York (and for US markets in general), the primary concern was regulatory burden. Participants pointed to Sarbanes-Oxley especially as a source of excessive costs for listing in New York. Complaints about Sarbanes-Oxley echoed those expressed in previous Symposiums, especially the amount of time and energy that managers needed to fulfill their various accounting requirements and a perceived increase in corporate risk aversion. The existence of multiple and overlapping regulators was seen as another problem – in particular, the enforcement style of the New York attorney general's office in recent years was put forward by some participants as a disincentive to listing in New York. Other reporting requirements such as "know your client" were also seen to add to compliance expenses. Finally, the heightened stringency of visa requirements in the post-9/11 environment was seen by some participants both to restrict access to valuable human resources and in some cases even to exclude some short-term visits, for example for road shows.

Tokyo's problems were seen by participants as being even more fundamental than those of New York. Several recent computer failures at the Tokyo Stock Exchange were the most obvious, but participants also pointed to deficits in settlement of financial transactions, other than government debt transactions carried out under the Bank of Japan's book-entry system. Many participants also perceived a lack of qualified professionals available in Tokyo. The greatest attention, however, was paid to concerns over the regulatory environment.

Regulatory Burden

The concept of regulatory burden was an important one in discussions at the Symposium. Regulatory burden was seen as the total costs of complying with market regulations and dealing with court cases related to those regulations.

A number of participants expressed the view that regulatory burden had proved to be one of the greatest determinants of exchange market competitiveness, and that this explained New York's perceived loss of competitiveness versus London. They were particularly dismayed that US regulatory burden had increased since 2002, while UK regulatory burden had decreased, and argued that these opposite trends were a bad omen for New York's future competitiveness. It was even stated that the only reason there had not been a large-scale exodus of public company listings from New York to London was the existence of a rule (yet more evidence of regulatory burden) that effectively prevents US-incorporated firms from escaping from the reporting and other requirements of the US 1934 Securities and Exchange Act (including the Sarbanes-Oxley provisions), if they have more than 500 investors.

By far the biggest concern of participants with regard to US regulatory burden was the Sarbanes-Oxley Act. Participants described as onerous several provisions of the law, particularly Section 404, which imposes personal responsibility on CEOs and CFOs for internal controls, auditing, and financial statements. Some Japanese participants stated that their firms had decided not to list their ADRs in New York because they did not want to incur the additional expense and legal scrutiny created by Sarbanes-Oxley. While many of the problems that Sarbanes-Oxley sought to address were seen as legitimate ones, it was argued that the law had been put together too hastily and had gone too far – indeed, some participants argued that any practices that were actually abusive had been illegal even prior to Sarbanes-Oxley, and pointed out that none of the major criminal cases for securities law abuses had been prosecuted under its provisions. (Other concerns about US regulation are addressed in the next section, on regulatory style.) As a general principle, some participants advocated explicit use of cost-benefit analysis when creating new regulations.

As for Japan, participants agreed that improvement of regulation had been substantial, though there remained some persistent and serious problem areas. Some participants felt that regulators still imposed excessive restrictions on certain types of financial products in Japan, as compared to the lack of restrictions in the UK and US markets. Private equity and hedge funds

were seen to experience some issues with regard to acquiring and exiting positions. One of the biggest concerns, as in the previous Symposium, was over the tax and commercial law treatment of triangular mergers involving foreign firms, which effectively prevented their use in Japan's M & A market. The Ministry of Justice was scheduled to issue new commercial code regulations and the Ministry of Finance new tax rules to facilitate such mergers as of early 2007. Participants expressed hope that these guidelines would eliminate the impediments, but some were withholding judgment until they could see the actual guidelines.

In addition to these longer-standing concerns, there was a debate about the implications of Japanese adoption of their own versions of several US laws and practices, particularly reporting requirements following the Sarbanes-Oxley model ("J-SOX"). Some participants believed that these measures would be a significant step in the wrong direction, imposing excessive costs on financial market participants at exactly the time that US markets were losing competitiveness to London, as a result of those very legal provisions. Others defended the adoption of those measures, on several grounds. One rationale was the need for Japan to improve the international credibility of its financial markets. Critics disagreed, arguing that Japan could achieve both credibility and lower costs by following UK practices instead of those of the United States. In response, proponents offered a second justification: that deficiencies in Japanese corporate governance and traditional supervision called for these measures. Finally, several participants argued that differences between the Japanese and US rules and legal systems would mean imposition of lower costs than the critics predicted. In particular, it was pointed out that class-action suits would be relatively restricted in reach, ease of filing, and in the potential for large judgments.

Styles of Regulation

Going beyond specific issues of regulation, participants discussed the impact of different styles of regulation – the basis of regulation, the responsiveness of policy makers and regulators to changing circumstances, and the means of enforcement. Many spoke approvingly of UK regulation, which they depicted as principles-based, responsive to the needs of industry, and evenly enforced. They suggested that Japan and the United States had much to learn from the UK experience.

Some participants criticized the US system for being excessively legalistic and less responsive to industry concerns. Concerns about excessive legalism embraced both the rules

themselves and the means of enforcement. With regard to the rules, the criticism was that they focused excessively on prescribing and proscribing specific actions, making them inflexible and costly to comply with. With regard to enforcement, there were few criticisms of the SEC and other regulatory bodies themselves, but many participants pointed out that the US court system had taken on a function of enforcement of rules both through prosecutions such as those by the New York attorney-general's office and through the mechanism of class action suits. While some participants defended civil suits as an important means of recourse for investors, most appeared to agree that the system added excessive cost and uncertainty to doing business in the US markets. Finally, the process of policy making – particularly with regard to legislation, such as Sarbanes-Oxley and the Patriot Act – was seen as unwieldy and unresponsive to the legitimate concerns of industry.

Japanese styles of regulation came under different criticisms, although participants cited favorably improvements in rule of law and a culture of compliance. One concern had to do with regulatory transparency – as one example, it was stated that the FSA still had not issued clear guidelines on insider trading. Although the FSA's intention was described as trying to prevent the exploitation of loopholes, some participants argued that the absence of "safe harbor" rules or clear guidelines introduced excessive uncertainty and risk into doing business, thus making financial actors excessively risk-averse. In this case, the FSA was said to be working on a statement of best practices, but that was not seen as enough to satisfy the critics. More generally, several participants argued that the ambiguous nature and reach of much of Japanese financial regulation was having the effect of reviving administrative guidance as a major pillar of supervision.

The biggest concerns about Japanese regulatory style had to do with the behavior of the FSA. Some participants argued that FSA supervisors were excessively heavy-handed, both in their means of dealing with financial institutions and in the punishments levied. In terms of interactions with regulated firms, some participants stated that inspectors used threats and non-disclosure orders to intimidate individuals and financial institutions. (This claim was disputed by a number of participants, both Japanese and American.) In terms of punishment, many participants expressed dismay at the prevalence of business suspension orders, even for what they considered to be relatively minor infractions.

Another concern that was raised about FSA enforcement was that it might be biased against foreign financial institutions. The general consensus appeared to be that this was not in

fact the case, despite public perceptions. One perspective was that Japanese financial institutions were being treated equally harshly, but did not complain as openly as foreigners. Others observed that foreign financial institutions were more likely to be involved in technically complex transactions whose legal status was inherently less legally tested. Thus, it would not be surprising if they were more closely monitored than financial institutions involved in simpler or more clear-cut transactions, such as traditional bank lending. This observation linked with a final concern regarding Japanese enforcement, which was that the FSA, SESC, and prosecutors' offices lacked the requisite technical skill to effectively judge the impact of complex financial transactions.

Human Resources and Technical Skills

Participants discussed at length the importance of human resources throughout the financial markets, including financial professionals, lawyers, accountants, regulators, exchange managers, and IT professionals. Access to highly qualified professionals was seen as a key aspect of efficient and competitive financial markets. While some concerns were expressed about the impact of US visa and travel restrictions on the ability to recruit, most discussion centered on Japan.

Participants expressed the opinion that the scarcity of these specialized human resources in Tokyo was a major limiting factor for the financial markets. In particular, the lack of legal and accounting professionals was seen as an obstacle, given the significantly strengthened rules on disclosure and auditing and the growth in complex financial transactions. It was observed that, despite increases in training programs (as seen, for example, in the growth of graduate schools of law in Japan), it takes years of practical experience for graduates of such programs to become seasoned professionals.

Three other issues specific to Japan were highlighted. First, a number of participants argued that Japanese nationals with requisite training and technical skills to work with complex financial products and transactions were unwilling to work for Japanese financial institutions, preferring to work for foreign firms, where they would be less bound by hierarchy and could receive better compensation. (This claim was disputed by several participants, some of whom stated that they had recently seen a return of such personnel to Japanese financial institutions.) Second, a number of participants argued that Japanese financial institutions further restricted their access to valuable skills by not hiring or advancing non-Japanese employees. In this

regard, it was observed that few foreigners with desirable skill sets have been able to master Japanese well enough to work within a predominantly Japanese-language environment.

Finally, it was widely agreed that Japan lacks a well-educated retail investor class. Participants talked about efforts to educate young people about investing, as well as the need to educate senior citizens who might be moving their savings out of bank accounts and insurance policies into more risky assets for the first time in their lives. Without better investor education, some warned, liquidity would remain low despite the increasing availability of useful and attractive financial products.

Session 2
What Is the Impact of Japan's Economic Resurgence on the US-Japan Financial Relationship?

Acknowledging a trend of positive economic news and data coming out of Japan, participants turned their attention in the second session to the impacts of an improved Japanese economy on US-Japan financial relations. Discussions covered a broad range of topics, reflecting considerable diversity of opinions. Major topics of discussion included the nature and sustainability of Japan's economic recovery, the international aspirations of Japanese financial institutions, investment opportunities within the Japanese economy, regional economic initiatives, and opportunities for regulatory harmonization among Japan, the United States, and Europe.

The Nature of Japan's Recovery

Symposium participants were cheered by the positive economic news emerging from Japan, including continued positive growth, healthy corporate profits, and evidence that deflation in consumer prices and real estate may finally be over. Evidence of a move out of a deflationary environment was a matter of particular relief. It was also noted that the economic improvements were private-sector-led, with net government spending continuing to decrease. And the exit of the IRCJ (ahead of schedule) was seen as a very positive indicator.

Despite the positive news, however, some participants expressed skepticism about the pace and durability of the current recovery. A number of them argued that "resurgence" was too strong a word to describe what they saw as essentially a moderate recovery. They pointed out that, given several years worth of underemployment and hidden unemployment (in the form of discouraged workers), a real economic resurgence would require more than a return to trend growth. They also pointed to several weaknesses in the Japanese economy that might tend to slow it down. Leaving aside monetary policy and the equivocal data on prices (which are addressed in Session 3 below), four major concerns loomed large for these participants.

First, they argued that the Japanese economy was still overly dependent on external demand growth; in particular, they saw the corporate sector as oversaving. While household saving rates had dropped considerably, corporate savings remained high, contributing to underconsumption and probably slower growth. The concern was that corporations were not investing retained earnings in profit-maximizing ways. Several participants argued that

corporations could improve their own return on equity and help to improve the purchasing power of the household sector by significantly increasing dividends. While some participants suggested that such changes might already be on the way, others felt that the lack of a market for corporate control was perpetuating managers' incentive to build up cash positions.

A second major concern was the stagnation of household income, despite the length of the current recovery. This was seen to be the result of persistent slackness in the labor market, and a number of participants also worried that without healthy consumption growth the recovery would not be sustainable. Third, a number of participants worried about how the government would handle fiscal adjustment, in terms of both timing and method. Fourth, participants expressed concern at the lack of domestic risk capital.

In addition to these macro concerns, several participants pointed to smaller but still significant trouble spots. One was weakness in several sectors, such as pharmaceuticals and some services. More broadly, some were concerned that structural reforms might stall as economic conditions became more comfortable, reducing the incentive for restructuring of problematic sectors and firms. It was also pointed out that the recovery has been uneven, with many sectors and geographical areas not sharing in growing prosperity. Some suggested that recovery was restricted to Tokyo and a few other major cities, which was seen as a potentially serious problem, given that fiscal redistribution to the countryside is being restricted.

Most participants were more optimistic, however, if in many cases cautiously so. There appeared to be a general sense that the recovery was sustainable. Whereas skeptics pointed to the household income numbers as evidence of the weakness of the recovery, optimists argued that labor market slack would allow for non-inflationary growth, as unemployed, discouraged, and part-time workers were drawn back into employment. Even if wage rates remained stagnant, it was pointed out, reasonable growth in household spending could continue as long as employment continued to increase. Another positive sign for the sustainability of growth was the draw-down in inventory combined with continued healthy capital investment. Optimists also pointed to the improved health of the financial sector, especially banking, which they saw as important for corporate growth, particularly among SMEs.

On a different note, many participants were troubled by the Japanese government's moves to lower the interest rate ceiling on consumer finance. They argued that the lack of a sub-prime lending market would distort the Japanese financial system, and also that making

interest rate restrictions stricter (at a time when interest rates across the board were expected to be on an upswing) would restrict consumer spending and contribute to the problem of underconsumption. While most participants agreed that the proposal would be dangerous for the economy, others argued that it was meant not to penalize lenders or appeal to populist sentiment, but rather to restrict access to credit for borrowers who would not be in a position to pay back additional borrowing. In the absence of consumer credit reporting agencies (and indeed of full-file credit reports more generally), they argued, it was essential to impose restraint upon lenders.

Macro Consequences on Bilateral Financial Relations

Participants felt that sustained Japanese economic recovery would have several effects on Japan-US economic and financial relations at the macro level. One of these would be increased reliance on domestic demand to fuel Japanese growth, which would reduce Japan's global trade and current account surpluses. Although this would not necessarily mean a reduction in bilateral surpluses with the United States, participants felt that would be highly likely. That was seen as politically beneficial, although some participants felt that US protectionist sentiment was aimed mainly at China, with Japan much less of a target.

A reduced global current account surplus would also reduce the amount of capital exports from Japan to the rest of the world, including the United States. Ideally, participants felt, this would fit into multilateral efforts to reduce global imbalances. Increased domestic demand in Japan could help to pick up slack created by a slowdown in growth (and improvement of the current account) of the US economy. However, Japan would only be one piece of a puzzle that would also involve China, Europe, and the major oil exporters. Moreover, few participants seemed to believe that a fundamental, rather than just cyclical, change was underway in Japan's long-established pattern of underconsumption.

Japanese economic recovery was also seen to improve prospects for Japanese firms generally, and thus a continuation of foreign investors' interest in Japanese assets and companies of all sorts. In particular, participants expected foreign purchases of equities to remain healthy. Most were less optimistic, however, about prospects for US firms and financial institutions to engage in large-scale M&A in Japan, due to continued aversion to takeover bids

and corporate cultural issues that arise when Japanese firms are taken over, whether by private equity, vulture funds, or sectoral competitors.

One major question for some groups of participants was what the effects would be on the yen. Several conjectures were made, but in the end most agreed that it would be impossible to predict even direction, much less magnitude, of shifts, given the uncertainties surrounding capital flows. There was also uncertainty about how the Ministry of Finance would handle serious changes in the level of the yen, which could have an important impact not only on the yen-dollar rate but also on official reserves. Given the sensitivity of the US public to the issue of "manipulating currency," the official reserves figures would bear watching.

Investment Opportunities in Japan

Many participants argued that the Japanese economic situation presented many attractive opportunities for investment. In addition to the stock market and increasing foreign management of investment trusts and pension funds, they pointed to four key issues.

First, participants agreed that there remained many poorly managed firms in Japan that could be attractive targets for corporate turn-arounds. With prospects of healthy economic growth offering an improved general sales outlook, many felt that there were profits to be had in acquiring such firms. A number of participants argued that practical and cultural barriers to M&A activity (see below) would be a stumbling block to entry and that IPOs were still difficult in Japan, making exit harder as well. While optimists generally conceded the difficulty of acquiring large public companies, they suggested that this was less of an issue with SMEs, especially in cases of essentially bankrupt firms with viable business models or in family firms in the midst of generational transitions.

Second, participants agreed that a number of sectors continued to exist in which economic restructuring had lagged other parts of the economy. In areas such as pharmaceuticals that had traditionally been sheltered by a variety of government policies and restrictive business practices, many participants argued that the imperative to restructure would become apparent. Strikingly, real estate was put forward as a viable investment, with the increasing popularity of REITs noted. Another sector in which number of participants expressed interest was in consumer finance. This was an area that had been achieving healthy returns, but many mainstream financial institutions had been ambivalent about entering it, due to the unsavory reputation of *sarakin*. While recent years had seen renewed interest among both

foreign and Japanese financial institutions, at the time of the Symposium the Japanese government was ironically moving forward on legislation that would administratively restrict interest rates. This could make takeovers and establishment of new ventures in the sector much less attractive.

Third, the end of the zero interest-rate policy raised the prospect of a reemergence of a normal yield curve and risk-weighting of interest rates in the near future. Such a differentiation based on maturity and risk was seen as likely to contribute to more vibrant debt and debt-derivative markets. The "reintroduction" of interest rates would also have a positive effect on the viability of banks, which would finally be able to profit on lending. Finally, it was agreed that SMEs have remained heavily dependent on bank finance. This was seen as a shortcoming of Japanese financial markets.

Despite general agreement about the existence of attractive investment opportunities, there was some skepticism about takeover prospects. Most participants agreed that a market for corporate control had yet to take hold in Japan, pointing out that there still had not been any successful TOBs, despite the summer's Oji-Hokuetsu drama. Others felt that Oji's bid for Hokuetsu had been an important inflection point in the willingness of Japanese investors and mainstream companies to accept unsolicited takeover bids. This was seen as likely to be an even bigger barrier for foreign firms seeking to restructure weak firms, since such restructuring was likely to disadvantage multiple stakeholders. Some participants even described a partial reemergence of cross-shareholding. An additional concern for private equity firms was regulations that make it difficult to take a public firm private. Finally, a number of participants expressed the opinion that Japanese corporate culture (i.e. prioritizing the interests of stakeholders such as labor, management, and related firms) made any merger or acquisition in the Japanese context a difficult matter, even after the merger was made. This would tend to raise the costs and lower the benefits for both sides of the bargain.

The Reemergence of Japanese Financial Institutions on the International Stage

With the resurgence, or at least recovery, of the Japanese economy, the prospect of the reintroduction of interest rates, the strong performance of the TSE, the improvement in bank balance sheets, and major new recruitment efforts, Japanese banks and other financial institutions were finally looking to expand internationally again. Proponents of international expansion pointed out that major Japanese banks derived far less of their total revenues and

profits from international activities than did banks based in the United States, United Kingdom, or continental Europe. This was seen to be a problem from the perspectives of both diversification and attractiveness to top clients that demanded global services. Also, profit margins for lending services have been poor in Japan's zero interest rate environment, adding another impetus to overseas expansion.

While the rationale for a more international business strategy among the major banks was clear, and participants agreed that their balance sheets were healthy enough to expand their focus from fixing their domestic problems, a number of participants expressed skepticism about the ability of even the Japanese mega-banks to be competitive internationally. While some of the criticism was based on Japanese financial institutions' poor records in the 1980s, others pointed to perceived current flaws, including excessive reliance on lending, lack of credit culture, and inadequately developed risk assessment and risk management. Overall, they felt that Japanese banks and other financial institutions had lagged behind premier global institutions in terms of modernizing their business models and practices.

A number of participants argued that Japanese financial institutions should focus their international expansion strategies on Asia as a means of working around some of these deficits. They argued that Japanese financial institutions' main comparative advantage at the international level was their working relationships with Japanese firms, particularly where those firms marked strong alternative means of financing their activities. East Asia was seen as an area in which local markets were not well developed, local financial institutions were not serious competitors, and Japanese firms were well-established and major customers for relatively complex (and lucrative) transactions. By using their natural advantages within the East Asian region, it was argued, Japanese financial institutions could build their international operations. The economic dynamism of the region was seen to make this an attractive area from which to build. An Asia-centered strategy was not universally seen as the wisest course of action, however, due to remaining legal and customary restrictions on various forms of financial products, transactions, and international transfers within many Asian economies. Moreover, deficits in information and enforcement were seen to increase the risk of concentrating international efforts in Asia.

Market Integration and Harmonization

A final topic of discussion in Session 2 was opportunities for market integration and harmonization. Participants addressed these issues both in terms of improving market efficiency and expanding business and growth opportunities.

Harmonization of financial regulations across major markets was seen by most participants as highly desirable. (Some raised concerns that global harmonization attempts could lead to excessive regulatory rigidity, and a few expressed fears that it would put too much power in the hands of regulators. These were minority positions, however.) Proponents of harmonization felt that transnational inconsistency of rules made compliance much more difficult and costly. Meanwhile, inconsistency of reporting standards reduced comparability of data from different markets, introducing market imperfections and uncertainty. They pointed to some successes, like IASB's IFRS efforts and nascent discussions among Japanese, US, and European regulators over how to coordinate policies or at least recognize home-country reporting standards for foreign companies listing on their stock exchanges. But they urged US and Japanese regulators both on a bilateral basis and in cooperation with their European counterparts to make these efforts more aggressively and on an ongoing basis.

While regional integration was somewhat removed from the topic of financial market impacts of Japanese economic recovery, participants linked the themes more indirectly. The main argument was that Japan's continued economic growth depends crucially on the regional production networks that have developed in East Asia. In order to support those networks, it was argued, Japan would need to be proactive in setting up institutions to reduce transaction costs. Moreover, with the global tide of preferential or free trading agreements (PTAs or FTAs), they saw it as important that Japan not be at a disadvantage in participating in regional trade and rapid economic growth in East Asia. In Japan's PTAs (which the government prefers to call Economic Partnership Agreements, in recognition of their coverage of a variety of non-trade issues), there has typically been a financial component, aimed at ensuring access for Japanese financial institutions and often including technical assistance to improve financial regulation and supervision. Some participants further suggested that the United States and Japan should cooperate in trying to create financial standards for East Asia.

Session 3
Monetary Policy after Greenspan and Quantitative Easing

The year 2006 saw the end of both the Bank of Japan's unprecedented five-year-long policy of quantitative easing and the end of Alan Greenspan's nineteen-year tenure as chairman of the Federal Reserve Board. Participants took the opportunity of the Symposium to reflect on the effects (and side effects) of these eras, and to look at the challenges and likely responses of the two central banks moving forward. They agreed that both the Fed and the BOJ faced questions about credibility and communication in addition to their specific macroeconomic challenges. And in both cases, the big question was whether the central bank would be able to manage the economic transition facing it – avoidance of a hard landing by the Fed and avoidance of a relapse into deflation for the BOJ.

While the main macroeconomic challenge differed between the two economies, several common themes connected the discussion. One of these was the relationship between goals and side effects of monetary policy. For Japan, several serious side effects to quantitative easing were put forward, including negative effects on the financial sector (especially banking). For the United States, side effects of monetary policy in the Greenspan years were seen to include both the stock market bubble of the late 1990s and the housing bubble that appeared to be just ending. A second theme was the impact of global easy money, which was seen as having important, albeit not identical, effects in both economies. A third theme was the problem of establishing credibility; in this respect, there was a particular focus on inflation targeting.

The BOJ after Quantitative Easing

The most significant disagreements over monetary policy concerned how the Bank of Japan should navigate the transition from quantitative easing into "normal" monetary policy. Participants were generally cautiously optimistic about the deflation picture in Japan, but there was also skepticism as to whether deflation had really come to any end. In terms of policy prescriptions, there was a sharp break between those whose main concern was not choking off growth and those who felt that the quantitative easing and zero-interest rate policy had discouraged adequate risk assessment among lenders and discipline among borrowers.

Analytically, there was considerable debate over how inflation and deflation should be measured. Most participants explicitly or implicitly accepted the validity of focusing on consumer prices, but many were skeptical that the current situation actually constituted a post-

deflationary environment. With inflation officially registering in the tenths of a percent, participants pointed out that any upward bias in the index or even random measurement error could have enough of an effect on the rate to make a slightly deflationary situation look like a stable or even slightly inflationary environment. (Indeed, the rebasing of the index year from 2000 to 2005 by itself had had such an effect.) Despite the official position of the BOJ, most participants appeared to share the view that the current methods of measuring consumer price shifts still contained a meaningful upward bias, despite the Bank's efforts to account for improvements in quality.

A related concern was whether the BOJ was pursuing an appropriate measure of "price stability." While the BOJ is not officially an inflation targeter, participants agreed that it maintains a "soft" inflation target. Its monetary policy announcements since 2001 have contained provisions tying the end of quantitative easing to the end of deflation, defined by a record of annual increases in the CPI, and subsequent interest rate hikes to a sustained resumption of inflation. The result has been a de facto inflation target of 0-2%, with a central tendency of 1%. Some participants defended this target range, but most were concerned that it was too low. One reason given was the measurement problem already noted: that the CPI likely had an upward bias, and that relatively minor measurement errors or one-off events could make an actual deflationary environment look stable or even slightly inflationary. Thus, the current target range was seen as not leaving enough margin for error. A second concern was that, because nominal interest rates have a lower bound of zero, inflation targets should be comfortably above zero in order to maintain the ability to lower interest rates in the event of deflationary pressure. A third argument was that a minimal level of inflation is necessary to help employment to adjust, given that wages tend to be sticky downwards. This point was not discussed in detail, and there appeared to be some disagreement as to whether it applied to Japan in the same way as to Western economies.

The ultimate question underlying all these debates was whether BOJ policy would support Japan's continued economic recovery or stall it. There appeared to be a general consensus that the BOJ leadership had a preference for starting to raise interest rates again early in the new year. Several participants agreed with the BOJ position concerning its soft inflation target, and argued that the Bank would introduce interest rate hikes at a measured pace that would not cut off the recovery. Many others were skeptical, expressing concern that the BOJ leadership appeared intent on establishing a "normal" monetary policy (i.e. positive nominal interest rates, with room for both cuts and hikes) as quickly as possible. They feared

that in the Bank's haste to raise rates, it could cause a credit contraction or crisis of confidence that could lead to the reemergence of deflation.

Part of the basis for the debate was differing understandings of how self-sustaining the recovery was. But another element had to do with perceptions of how severe the side effects of the zero-interest rate policy might be. Those who sided with the BOJ on the question of interest rates argued that quantitative easing and zero interest rates had had pernicious effects throughout the economy, even though they had been necessary to deal with a crisis situation. Those effects included disincentives for proper risk assessment by both lenders and borrowers, lack of differentiation between healthy and unhealthy companies, and problems of moral hazard. For supporters of the BOJ policy, those problems had become more serious than the risk of renewed deflation, which they saw as relatively unlikely. Most participants, however, appeared to be more concerned with deflation than with the side effects of an extremely low interest rate environment.

A final point related to Japanese monetary policy after quantitative easing had to do with the credibility of the Bank of Japan. Participants agreed that the 2001 pledge to maintain quantitative easing until deflation subsided had been an important step in helping markets to feel confidence that monetary policy would not choke off economic recovery until some point in the future. But now that that future point had arrived, there were new questions about how markets formed their expectations of monetary policy. Some participants pointed to the soft inflation target range of 0-2% as having effectively communicated to market participants how monetary policy would be carried out, arguing that this gave a great deal of credibility to the Bank's announced intention of maintaining price stability. Others were more skeptical. They pointed out that, unlike the quantitative easing regime, which had clearly stated standards for change, the current situation allowed for considerably more discretion in interest rate policy. Thus, until some time had elapsed during which markets could observe a stable monetary policy, they would feel uncertain about how the BOJ would respond to economic changes. In addition, a number of participants were suspicious of the BOJ's real intentions, predicting that the Bank would be willing to sacrifice the health of aggregate demand in order to further its microeconomic goals of creating a culture and promoting restructuring. They feared that this could lead to a relapse into deflation.

Fed Policy after Greenspan

The post-Greenspan Fed was also seen to be facing several difficult challenges. The most severe of these was how to stave off stagflation as high energy prices coincided with the end of the housing boom. It was argued that, having completed the measured series of rate hikes begun under Greenspan, Chairman Bernanke now faced the challenge of whether to respond to consumer prices, housing prices, or economic growth and employment. These indicators appeared increasingly to call for divergent monetary policy responses. Indeed, it was observed that the Fed had allowed consumer prices to exceed the preferred upper boundary, presumably in order to allow for an orderly adjustment in the face of stagnating or declining housing prices.

An additional challenge for Fed policy makers was noted by some participants: the sustainability of US current account deficits. A number of participants argued that the Fed's job would be complicated by the need to maintain higher than ideal interest rates in order to keep attracting foreign capital into the United States to fund that deficit. They speculated that fear of capital flight might thus lead to a hard landing, as monetary policy became incapable of responding to the housing market and consumer spending. Other participants disputed this story, pointing out that there was no clear consensus on what sustainability means or when market participants might decide that a given situation is no longer sustainable. They felt that the inherent strengths of the US economy, a favorable interest rate spread, and the general attractiveness of dollar assets made a hard landing scenario unlikely.

In practical terms, participants seemed to agree that the Fed would hold interest rates steady until mid-2007, at which point it might start to lower them in response to weakening domestic demand. Most appeared to agree that this was likely to support a relatively smooth adjustment. However, it was also pointed out that economic shocks, an unexpected change in consumer confidence, or a miscalculation by monetary policy makers could easily lead to a hard landing. There was a range of opinions on how likely a hard landing was, but most seemed relatively optimistic that, even though a slowdown was probably inevitable, it could be effectively managed so as to produce minimal adjustment costs.

One thing that did not concern most participants was the credibility of Fed policy under Bernanke. Despite a slightly rocky start in terms of communication, it was generally agreed that both the Fed and Bernanke himself enjoyed considerable credibility in financial markets, as a result of their consistent commitment to price stability and Bernanke's own reputation as an

advocate of inflation targeting. (Inflation targeting itself, however, was not seen by all participants as ideal.)

Common Problems for Japan and the United States

While much of the discussion was framed in terms of the issues facing either Japan or the United States, several common or joint issues were also addressed. These included the effects of global easy money, multilateral payments imbalances, and fiscal-monetary policy coordination.

Participants generally agreed that the world had been awash in liquidity since at least since the beginning of the decade. Long-term real interest rates had been at historically low levels in the major currencies, and economies such as China had huge pools of excess savings. The result was seen to be global easy money. There was considerable debate about both the causes and implications of that situation, however. Regarding causes, participants split as to whether it was due to emerging economies' excess savings, low inflationary expectations, excessively easy monetary policy by central banks, hedge fund strategies or some combination. Expectations about implications also varied, based on analysis of the phenomenon's roots. Those who believed that the situation was caused by low inflationary expectations or high Chinese savings were not particularly worried about the implications. For those who understood it to be primarily policy-induced, the implications were more worrisome. Their reasoning was that US monetary policy under Greenspan and Japanese quantitative easing had effectively eliminated large financial institutions' fears of systemic risk, thus leading them to be much more accepting of risk than ever before – in other words, monetary policy had created an environment of moral hazard. Such a situation would call for adjusting financial players' expectations of a bail-out downwards before a crisis hits. This was seen to be no easy task, especially in an era of mega-banks and huge financial conglomerates.

Global payments imbalances too were seen to be a joint problem, in which Japan had consistently been on the surplus side and the United States consistently on the deficit side. For those concerned with sustainability, it was clear that multilateral efforts including China, Europe, and major oil producers would be essential. In terms of the bilateral Japan-US relationship, it was agreed that recovery in Japan and slowdown in the United States would contribute somewhat to reducing imbalances. However, it was also recognized that the imbalances would not be rectified just by cyclical shifts. Thus, the problem remained unresolved (although, as

noted above, some participants denied that sustainability was a problem that required official management at all).

Finally, fiscal policy coordination emerged as a common problem, albeit not a joint one. Both Japan and the United States were seen to require a reduction of massive fiscal deficits. But it was not clear how monetary policy could or should support long-term fiscal consolidation. Participants noted the existence in Japan of a general roadmap for fiscal consolidation, but much less of a clear expectation of how US fiscal deficits might be reduced. In both cases, however, monetary policy makers were seen to have legitimate concerns about how much they should take fiscal policies as given or try to shape them.

PRESENTATION OF FINAL PLENARY SESSIONS

Building the Financial System of the 21st Century:

An Agenda for
Japan and the U.S.

Session I

How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

Terms of Competition: Public Equity Markets

	U.S.	Japan	UK	HK
Professional Skills	High	Medium	High	Medium
Transparent Rules	High	Medium	High	Low
Enforcement Fairness	Highest	Medium	High	Low
Enforcement Stringency	Highest	High	Medium	Low
Regulatory Burden	High	High	Low	Low
Transaction Prohibitions	Low	Medium	Low	Low
Government Responsiveness	Medium	Low	High	High
Domestic Focus	Medium	High	Low	Low
Liquidity	Highest	Medium	High	Medium
Technology	High	Low	High	High
Importance of Financial Sector to Economy	High	Medium	Highest	High

Japanese Problem: Professional Skills

- Deficit versus U.S./Europe
- Most skilled in past went to foreign firms—is there a shift to domestic firms?
- Negative impact of too few English speakers
- Japanese firms do not hire/advance non-Japanese

Japanese and U.S. Regulatory Burdens

Item	U.S.	Japan
Class actions	Yes	No (Coming?)
Intimidation	Yes (Spitzer) No (SEC, OCC)	Yes
Criminal Actions Against Corporations	Yes (can bankrupt)	Yes
SOX 404	Yes	Pending
Business Suspensions	Very Exceptional	Yes

Domestic Focus

- Can Japan or the U.S. maintain internationally uncompetitive domestic markets in a global world?
- China has both domestic (Shanghai) and international (Hong Kong) markets

Importance of Equity Markets

- Financial Sector as a percent of GDP: U.S. 8.1%, Japan 3%, UK 15%
- Will competition between markets be irrelevant in a “virtual” world?
- Is too much finance “non-productive” leading to national decline (Tobin Tax)?
- Is finance accelerating income inequality?

Session II

What Is the Impact of Japan's Economic Resurgence on the U.S.-Japan Financial Relationship?

Recovery

- Reform fatigue/complacency/absence of necessity
- Uneven (regional/sectoral/household versus industry)
- Sustainability?

Macro Consequences

- Increased Japanese trade surplus would increase friction, but surplus is declining
- Increased global flows between Japan and U.S.
- Expansion of Japanese banks overseas: U.S. *vs.* Asia
- ¥/$ Exchange Rate: indeterminate effects

Next Steps in Recovery Policy

- Market Integration
  - Japanese - U.S./Europe regulatory dialogues
  - Japanese FTAs in Asia
  - Convergence initiatives, e.g., IFRS
- Expansion of Consumer Financial Services

Japanese Mergers and Acquisitions

- Will Japanese firms overpay for and/or be able to manage acquisitions?
- Will Japan be open to U.S. private equity—taking public companies private?
- Will shareholders of U.S. firms accept shares of Japanese companies (as opposed to cash)?
- Hostile takeovers
  - Will Japan accept them?
  - Can they actually be done in the U.S. (poison pills)?

Session III

Monetary Policy After Greenspan and Quantitative Easing

Questions for Discussion

- Will BOJ kill the recovery?
- What are the effects of global easy money?
- Can the Fed avoid a recession?
- Has Fed policy removed risk for large investors (moral hazard)?
- How does Japan measure inflation?

APPENDIX I

KEYNOTE ADDRESSES

HIDEYUKI TAKAHASHI

NOMURA

Saturday, October 21st, 2006

Symposium on Building the Financial System of the 21st Century

Hideyuki Takahashi
Chief Executive Officer - Nomura Holding America, Inc.

Contents

NOMURA

Japanese Economy

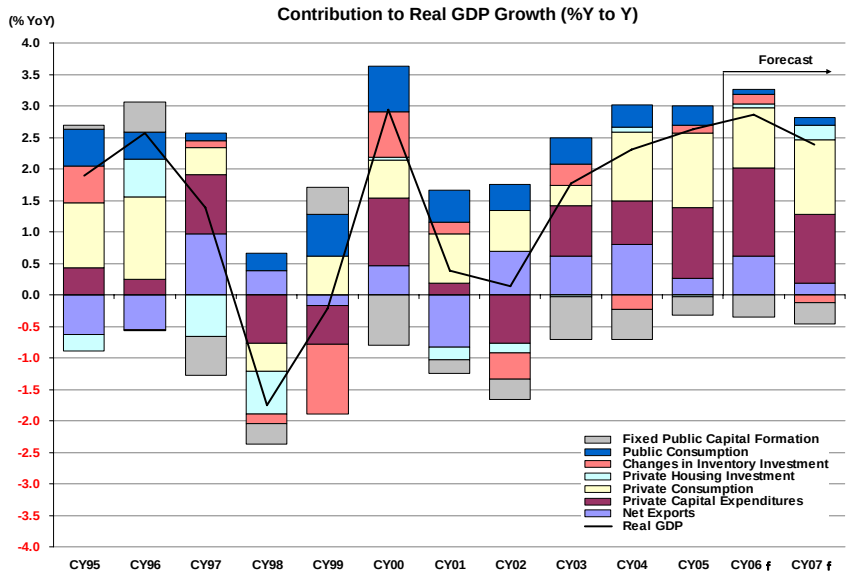
■ Business Cycle Expansion and Contractions

	Trough	Peak	Trough	Expansion (Months)	Contraction
1ST Cycle		June 1951	October 1951	Special procurement boom	
2nd Cycle	October 1951	January 1954	November 1954	Investment boom (27 mon.)	
3rd Cycle	November 1954	June 1957	June 1958	Jinmu boom (31 mon.)	Deep recession
4th Cycle	June 1958	December 1961	October 1962	Iwato boom (42 mon.)	
5th Cycle	October 1962	October 1964	October 1965	Olympic boom (24 mon.)	Securities slump
6th Cycle	October 1965	July 1970	December 1971	Izanagi boom (57 mon.)	
7th Cycle	December 1971	November 1973	March 1975	Japanese archipelago remodelling boom (23 mon.)	
8th Cycle	March 1975	January 1977	October 1977	(22 mon.)	
9th Cycle	October 1977	February 1980	February 1983	(28 mon.)	World recession
10th Cycle	February 1983	June 1985	November 1986	(28 mon.)	High-yen recession
11th Cycle	November 1986	February 1991	October 1993	Bubble boom (51 mon.)	Heisei slump
12th Cycle	October 1993	May 1997	January 1999	(43 mon.)	
13th Cycle	January 1999	November 2000	January 2002	(22 mon.)	
14th Cycle	January 2002	Month? 200?		**Over 57 months (longest period)**	

NOMURA

Japanese Economy

■ ...portending another year of above-trend growth...



Source: ESRI, METI, MIAC, Nomura

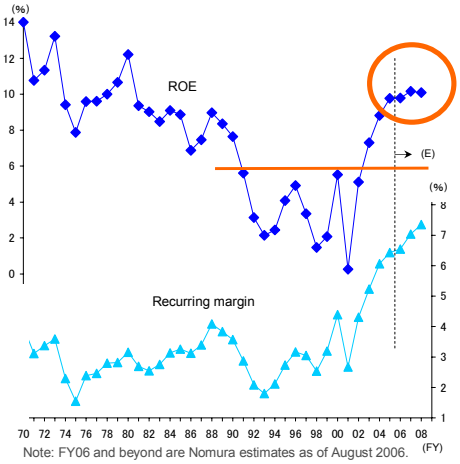
NOMURA

Japanese Economy

■ Structural Improvement in Corporate Earnings

- Material improvement in corporate earnings is supported by non-cyclical factors, such as restructuring and economic expansion in Asian countries

ROE and Recurring Margin



Note: FY06 and beyond are Nomura estimates as of August 2006.
Source: Nomura

Outlook for Recurring Profits (as of Aug 31st 2006)

(% change, year-on-year)

	Recurring profits				
	FY04	FY05	FY06E	FY07E	FY08E
NOMURA 400	19.9	20.5	7.3	11.8	7.8
NOMURA 400 (ex financials)	22.2	11.3	7.4	11.6	7.2
Manufacturing	20.7	14.5	9.3	11.6	7.3
Basic materials	79.1	21.6	4.4	5.6	1.8
Processing	10.2	14.1	13.3	14.6	9.4
Non-manufacturing	18.9	28.3	5.0	12.2	8.3
Non-manufacturing (ex financials)	24.8	5.7	3.6	11.7	6.9
Materials	79.1	21.6	4.4	5.6	1.8
Machinery & automobiles	12.0	16.8	8.2	10.9	8.7
Electronics	7.5	9.4	22.6	20.4	10.4
Wholesale, retail and distribution	18.3	18.8	9.1	9.5	7.5
Information	13.9	-14.2	-1.5	11.4	8.6
Utilities & infrastructure	27.2	3.4	-1.4	14.3	5.5
Financials	6.3	83.5	6.9	12.7	10.2

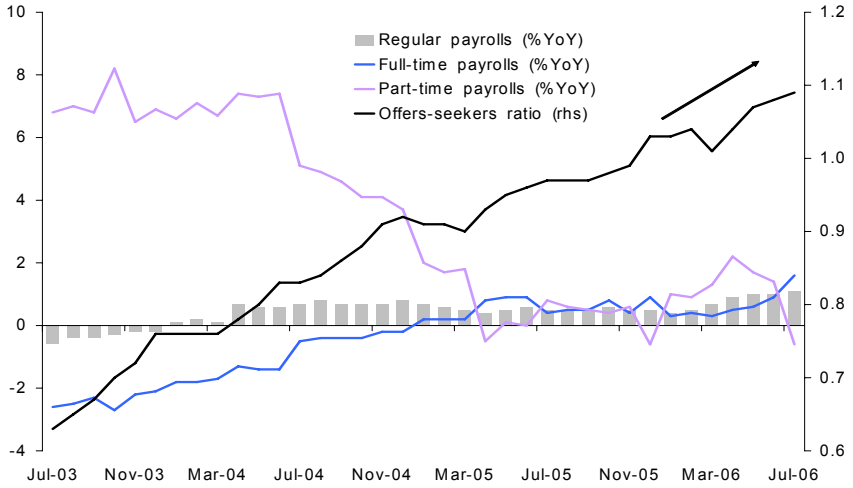
Note: Latest forecasts are as of 14 September 2006. Consolidated subsidiaries are excluded.
Source: Nomura

NOMURA

Japanese Economy

■ Job Market: Part-timers to regular employees

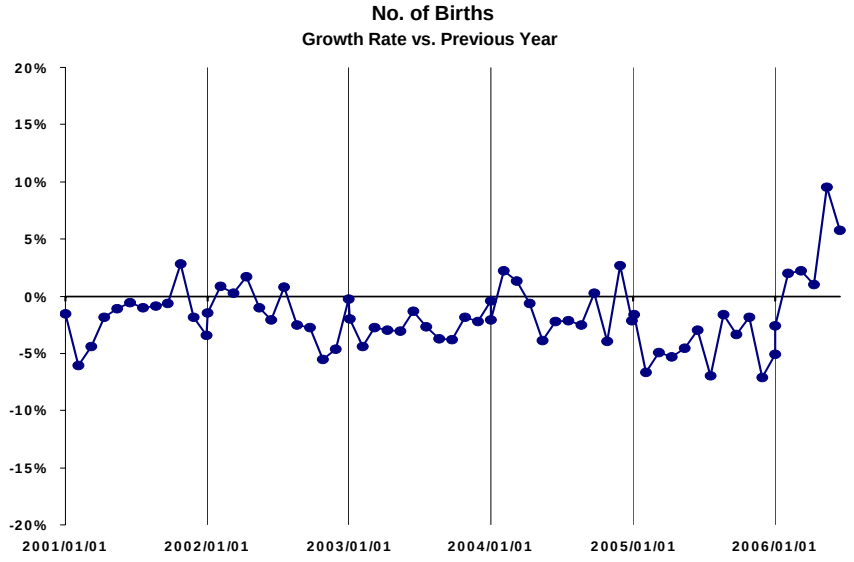
- Full time workers edging higher



Source: ESRI, MHLW, MIAC, BoJ

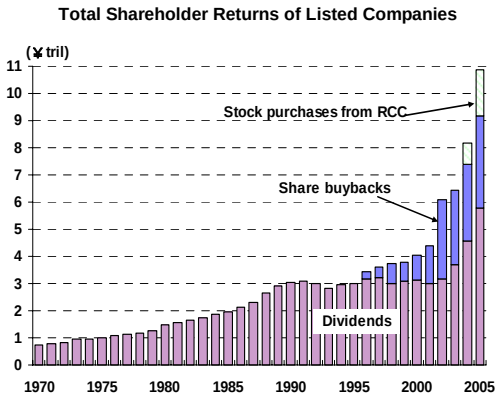
Japanese Economy

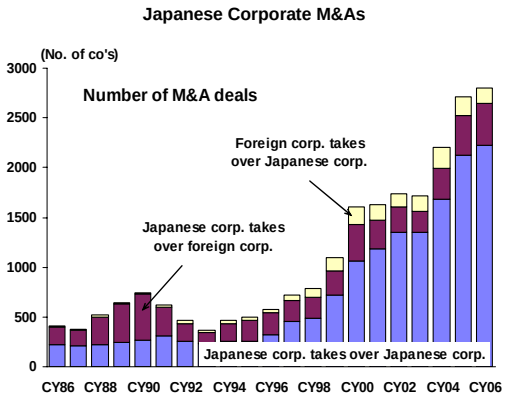
■ Increase in the number of births



Source: Ministry of Health, Labour and Welfare

Shift to Market-oriented Financial System





* RCC: The Resolution and Collection Corporation. RCC is the government-supported corporation which is engaged mainly in purchasing and collecting NPLs from bankrupt financial institutions. In the financial crisis in the late 1990's, RCC purchased the preferred stock that Japanese banks issued for recapitalization. After they turned around, the Japanese banks repurchased the stocks from RCC.
Source: Nomura, from company disclosure materials and Toyo Keizai materials

Note: M&A deals of group companies are excluded. Figures for 2006 are calculated based on actual (Jan.-July data) x 12/7.

Source: RECOF

Expansion of the Japanese Buyout Market

Disclosed Buyout Deals（Investors Gaining Majority Control）

Year	# of Deals	Deal Amount (JPY100mn)
1998	1	38
1999	10	149
2000	13	1,671
2001	31	2,292
2002	24	1,099
2003	49	8,000
2004	56	7,315
2005	41	4,642
2006 (1st half)	40	5,252
Total	265	30,458

(1) Deal made in Dec. '98 by JASCO has been set as the first known buyout deal in Japan.
(2) Undisclosed deal amount has not been added to total Deal Amount.
Source: Created by Mr. Sugiura, Japan Buy-out Research Institute

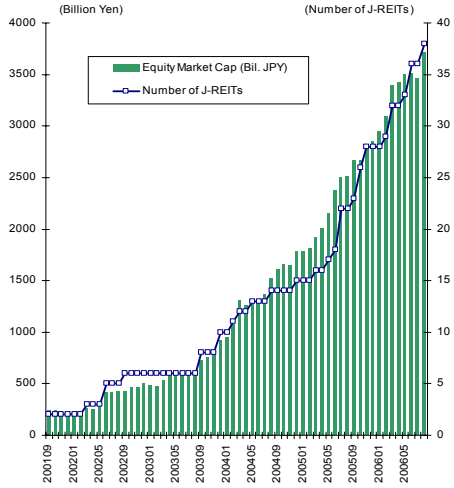
Representative Private Equity Deals in Japan

Shinsei Bank	■ Former Long-Term Credit Bank ■ Ripplewood Holdings LLC Acquired LTCB after its Bailout in 2000 ■ Exit: Went Public Again in February 2004 ■ Approximately USD 2 Billion Capital Gain
Wanbishi Archives	■ First Example of Large-Scale Buyout (Deal Value = Approx. USD 500 Million) ■ Nomura Principal Finance and Tokyo Marine Capital Sponsored the Restructuring of Information Storage/Database Business in March 2003 ■ Exit: Sale to Toyota Industries Corp. in January 2006
Japan Telecom	■ Deal Value: Approx. USD 2.2 Billion in November 2003 ■ Sponsor: Ripplewood Holdings LLC ■ Exit: Sale to Softbank in November 2004
World	■ Deal Value: Approx. USD 2.2 Billion in July 2005 ■ Going Private Transaction by Current Management of the Apparel Company ■ Motivated to Become a Private Company Amidst the Threat of Hostile Takeover Bid ■ 25.6% Premium Over Past 6-Months Average Market Price
Pokka	■ Deal Value: Approx. USD 220 Million in August 2005 ■ Going Private Transaction by Current Management of the Beverage Company and Advantage Partners ■ 20.0% Premium Over Past 6-Months Average Market Price

Growth of J-REIT Market

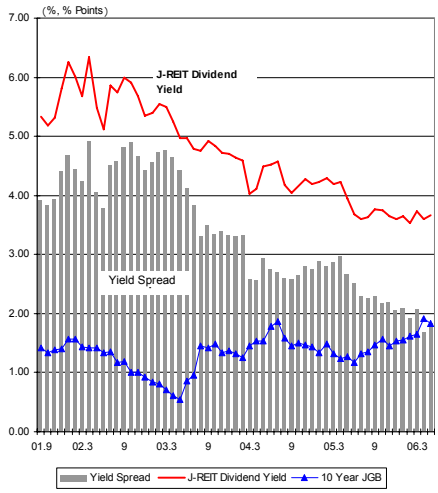
■ J-REIT market is becoming hot...

Total Market Cap and Number of Listed Funds



Source: Bloomberg

Dividend Yield of J-REITs



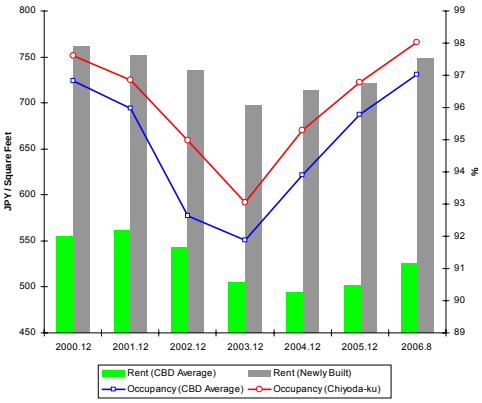
Note: Yield Spread = Dividend Yield of J-REIT – Interest Rate of 10 Year Government Bond

Source: Nomura Securities

Recovery of Property Market

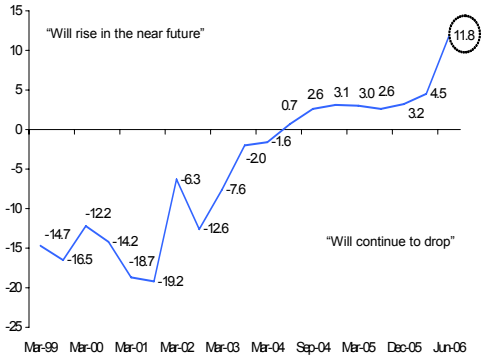
■ Office market is improving…

Tokyo CBD Office: Rent and Occupancy



Source: Miki Shoji

Land Price Expectations DI



Source: MLIT, JREI, BoJ

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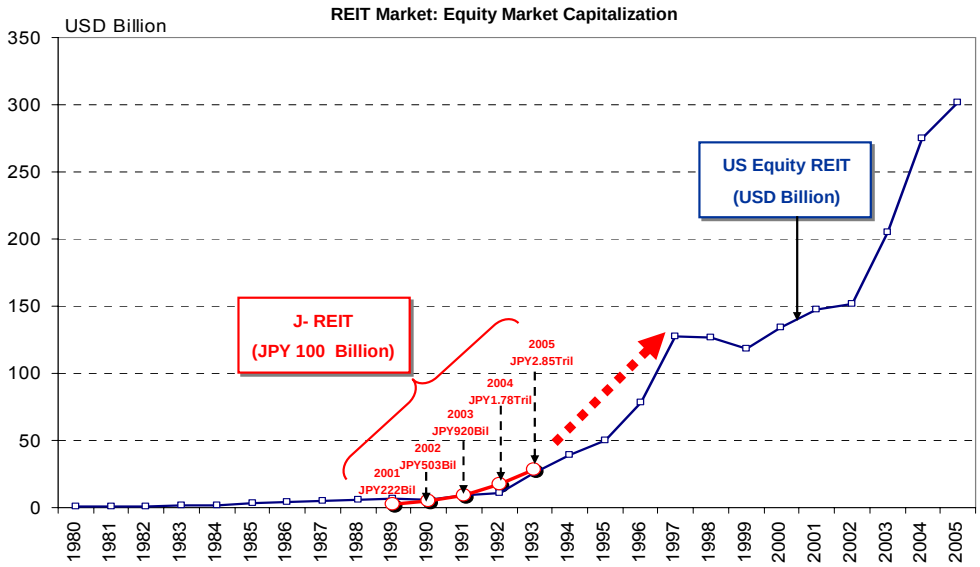
J-REIT Market: Chasing U.S. Experience?



Note: Market values are calculated based on the closing prices in the year-end.
In order to compare a transition, J-REIT 2001-2005 figures were compared with US Equity REIT 1989-1993 figures.

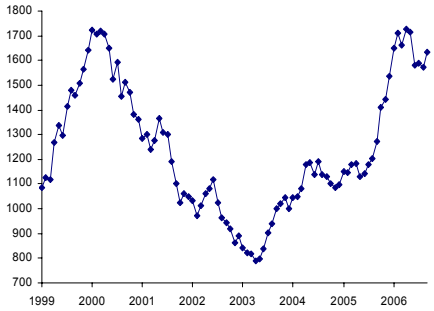
Source: NAREIT, Nomura Securities Co., Ltd.

NOMURA

Japanese Equity Market

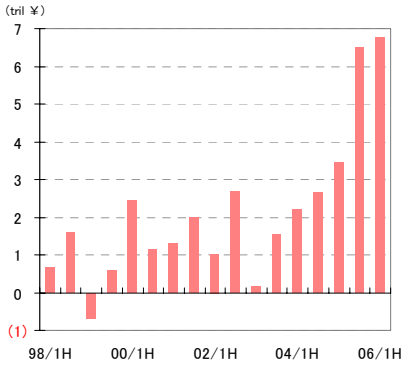
- **Stock prices are improving.**
- **New flow to Equity Mutual Funds is increasing.**

TOPIX



Source: Bloomberg

Net Flow to Equity Mutual Funds

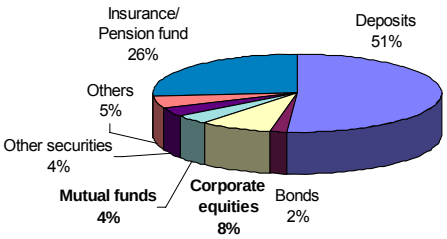


(*) Equity Mutual Funds include funds focused on investing in foreign bonds, and those owned by corporations.
Source: The Investment Trusts Association, Japan

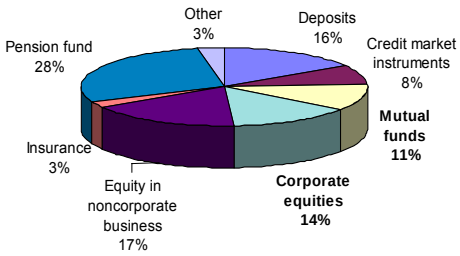
Household's Financial Assets

- **Japan: Corporate equities (8%) + Mutual Funds (4%) = 12%**
- **US: Corporate equities (14%) + Mutual Funds (11%) = 25%**

Japan (2006Q2)

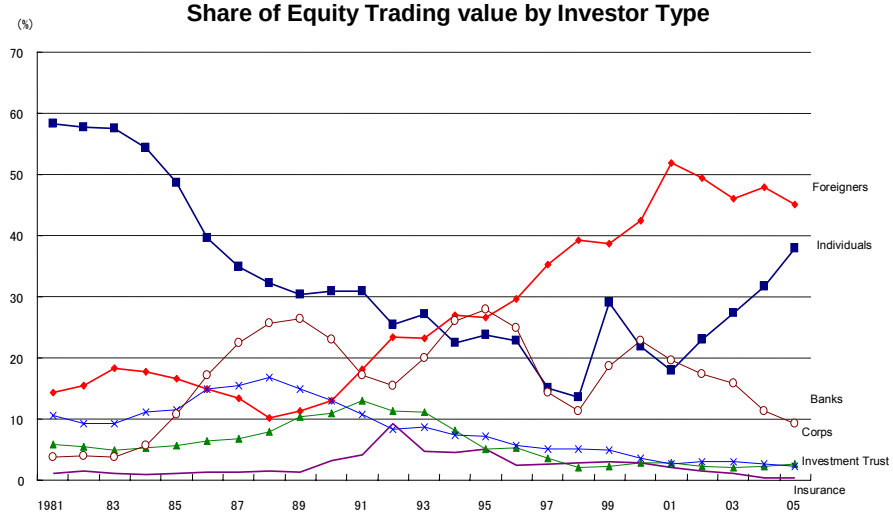


US (2006Q2)



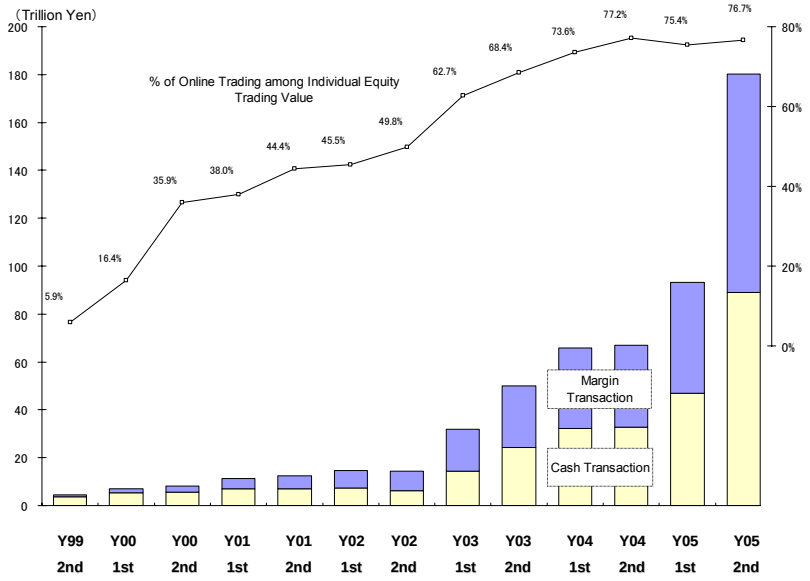
Active Equity Trading by Retail Investors

Share of Equity Trading value by Investor Type



Source: Tokyo Stock Exchange

Shift to Online Trading



Source: Japan Securities Dealers Association

Direction of The Abe Administration

- **Without growth, no fiscal reconstruction**
  - **Objective is real economic growth of 3%**
  - **High growth expected to promote fiscal reconstruction**
  - **Transformation from Koizumi administration's "contracted equilibrium" policy to "expanding equilibrium" policy**
  - **Consumption tax raise likely to remain within a narrow range**
- **Three driving elements helping to realize high growth**
  - **Improvement in productivity (especially in the service industry)**
  - **Technical innovation (intensive use of IT)**
  - **High value-added Japanese industries, developed via increased collaboration with Asia and other foreign countries**

NOMURA

Risks of The Abe Administration

- Results of next year's House of Councilors election
  (Huge victory, like last year's House of Representatives election, is not expected)
- Difficult policy decisions regarding China and North Korea

NOMURA

YO TAKEUCHI

Policy Finance Reform and the Future of DBJ

Yo Takeuchi
Senior Executive Director, Development Bank of Japan

It is a great pleasure to speak before such a distinguished audience.

Last year, when this meeting was held in Japan, I spoke about the privatization of the Japanese postal system. Today, after giving a progress report on postal privatization, I'd like to talk about the last project carried out by Prime Minister Koizumi during his term in office: the reorganization of Japan's policy finance institutions, part of the overall structural reforms implemented by Mr. Koizumi and former minister Heizo Takenaka.

As those familiar with Japanese affairs will already know, the Japanese government took charge of money deposited in postal savings accounts and pensions. Under the Fiscal Investment and Loan Program, these funds were lent to such as the Japan Highway Public Corporation for expressway construction and to the Japan Housing Corporation for the extension of housing loans. Programs like these were by no means limited to Japan. Similar systems helped Germany, France and other countries rebuild from the catastrophic damage that the war had wrought on their roads and homes. In Japan, however, the government was holding a huge amount of money, and the national credit system ballooned as well. In 2001, in a move in which Mr. Koizumi, then the Minister of Health and Welfare, played a central role, the government abolished this system, which had made the government's hold over the funds compulsory. I visited Mr. Koizumi's office at that time to discuss the system's abolition. Against a background of classical music and the scent of incense, he outlined the system's problems for me. It was leaked shortly afterward that a Finance Ministry official had been lobbying the Minister on the issue, leading to a strategic loss for our side. I should mention that the current Fiscal Investment and Loan Program is a market-oriented system, under which the government raises funds through bond issues and lends these funds to government-affiliated organizations. When he became a prime minister, he dissolved the Lower House for privatizing the postal service. After a landslide victory, the postal privatization was approved by both houses.

Under privatization, Japan Post will be broken up into four entities: mail delivery company, postal savings, bank, life insurance or called kanpo, and post office company equivalent to postal convenient stores. Today I'd like to focus on the Postal Savings Bank.

Set to open, like the other three corporations, in October of next year, the Postal Savings Bank will take over the banking functions of what is today the Japan Post. The opening may be extended by six months, however, if, in March, it is determined that the computer system will not be ready to operate by October. Since the computer system must be checked during a long bank holiday, the only appropriate time will be over New Year's holidays December 30 to January 3. It will be a difficult task to push forward with the privatization process in the two months left before the New Year's tests. If the system is found operational, the Postal Savings Bank will open as scheduled in

October, with 223 branches; 50 trillion yen, or 42 billion US dollars, in deposits; and a workforce of 11,400. On paper, the Postal Savings Bank will have assets of 226 trillion yen, or 190 billion US dollars – more than any other bank in the world. Of this amount, however, 150 billion dollars will consist of fixed assets in the form of government bonds, corresponding to the amount of fixed postal savings already on deposit. In terms of the amount of funds newly available for the bank's use, this will be the 42 billion dollars in deposits I've just mentioned. At this scale, the bank will be approximately the same size as the Norinchukin Bank.

What's different about the Postal Savings Bank is that, unlike the Norinchukin, it will have at its helm Mr. Yoshifumi Nishikawa, head of the special corporation that will serve as the new bank's parent company and former CEO of the Sumitomo Bank. Mr. Nishikawa plans a very aggressive business strategy for the new bank, involving personal loans, housing loans and other services to be provided at two hundred branches. Frankly speaking, Mr.Nishikawa's original plan is to establish 2000 branches not 200.2000 branches are more than total branches of three Japanese mega-banks.To observers in the private banking community, there is concern that this policy could jeopardize the level playing field that has existed up to now.

An aggressive stance is also planned for the insurance entity – something that, as I'm sure you know, has provoked concern among private insurers, foreign as well as Japanese.

Both the Postal Savings Bank and the insurance entity are to sell off one hundred percent of their shares within ten years of their establishment – that is, by the end of September, 2017. According to current plans, an IPO will be made by 2011, with the stock sale to take place about five years after that.

However, with only one-half the level of the Mizuho Bank in terms of return on equity, and about one-third the level of Mitsui Sumitomo in terms of return on assets, the Postal Savings Bank will have a long road ahead before it can achieve former Prime Minister Koizumi's goal of helping to reduce the national budget deficit.

Policy Finance Reform and the Future of DBJ

The Role of Policy Finance Institutions in Japan

There are eight policy finance institutions now operating in Japan. These are the National Life Finance Corporation, which serves individuals and micro-enterprises; the Japan Finance Corporation for Small and Medium Enterprise, which provides financing for small business; the Agriculture, Forestry and Fisheries Finance Corporation, which serves companies in those industries; the Okinawa Development Finance Corporation, which promotes the development of the economically disadvantaged Okinawan Islands; the Japan Bank for International Cooperation, which finances projects overseas; the Development Bank of Japan, which deals with such as large-scale projects and technology development; the Japan Finance Corporation for Municipal Enterprises,

which funds improvements to the projects including water supply and hospitals, carried out by local authorities; and the Shoko Chukin Bank, which was established through joint investment by the national government and small business associations. The purpose of each of these is to supplement the services of private-sector banks by extending low-interest, long-term funds at fixed interest to its particular clientele.

For the most part, these institutions were established in succession during the postwar reconstruction period, in order to achieve goals that included improving social capital, nurturing small and family-owned businesses, promoting regional development, and preserving such industries as agriculture, forestry and fisheries. They did this by supplying capital that would have been difficult to obtain from commercial banks. In Japan, policy lenders get their funds primarily from fiscal investments and loans program, which itself originates mainly in postal savings and pension payments collected from individuals at post offices nationwide. Backing up banks in the private sector, they played a vital role after the war by supplying funds that were needed for industrial development and the protection of agriculture and small business. Another, equally important function of these banks has been as a financial safety net in times of economic or social upheaval. Earthquakes, escalating crude oil prices, and credit crunches all require swift action, which policy lenders provide through urgent loans and guarantees.

Japan's policy finance institutions have proven an effective support for private banks throughout the postwar reconstruction period, the subsequent years of high economic growth, and the recent period of emergence from deflation. At the same time, however, they have drawn criticisms: for lending on a much larger scale than their counterparts in the industrialized West; for focusing too much on direct lending; for obstructing the development of capital markets and a vigorous economy; and for crowding out private banks from the market. Here are some current figures for four Western countries and Japan, comparing the ratios of policy finance to GDP in sectors excluding housing: The United States, 5.4 percent; the United Kingdom, 5.7 percent; Germany, 16.7 percent, France, 8.7 percent, and Japan … 19.7 percent. The figures for UK loans are as of the end of March, 2000; the balance for Japan is for the end of fiscal year 2000; the balances for other countries are for the end of calendar year 2000. Some of Japan's policy lenders are operating in the red, moreover, and rely on government expenditures to cover their losses. This has been another target of criticism.

This is not the first time that the reform of policy finance institutions has come up for debate. Banks have, indeed, been integrated or abolished in the past. But the reforms initiated by the Koizumi administration promise to be much more drastic than those attempted up to now. The reason is that former Prime Minister Koizumi and Heizo Takenaka, his Minister for Internal Affairs and Communications and Minister of State for Privatization of the Postal Services, saw policy finance

reform as coming immediately after the reform of the postal service, and set a course for the reduction of both services and loans outstanding that was not based upon the existing organization.

On November 29, 2005, at a meeting of the Council on Economic and Fiscal Policy, Prime Minister Koizumi, the meeting's chairman, and Mr. Tanaka, who served as coordinator, announced the Basic Policy on Organizational Reform of Eight Government Financial Institutions. The enactment of this policy vastly reduced the functions of policy lenders, effectively bringing their traditional roles to an end.

An Overview of Policy Finance Reform

Let's now take a look at the reforms planned for Japan's policy finance institutions. The Administrative Reform Law, enacted by the Diet this past May, provides an outline for the reform of Japan's government-affiliated lenders. In essence, the law provides for the reform of Japan's policy finance system, and its shift to a new system starting in fiscal year 2008, in accordance with the basic course set forth by the Council on Economic and Fiscal Policy.

The law rests on four basic principles, which I'll now summarize.

First, policy finance is defined as the supply of funds for the following specific purposes: to support the fund-raising efforts of very small businesses owned by individuals or families; to provide essential capital for the purchase of overseas resources required to carry out government policy or ensure the global competitiveness of Japanese firms; and to extend yen loans for aid and policy-based projects overseas.

Second, policy finance is to be cut by half in line with the nation's larger effort to achieve small, efficient government. In specific terms, the law aims at halving the ratio-to-GDP of loans outstanding by policy lenders by fiscal 2008.

Third, an efficient system is to be created by which financial institutions, including those in the private sector, can respond to natural disasters, financial crises and other emergency situations.

Fourth, policy lenders will pursue efficient management by making use of partial guarantees, securitization, indirect finance, and other tools to supplement the services of private lenders.

These principles guide a reorganization of the banks' areas of business. Briefly, the functions of policy finance institutions are as follows:

- Those from which the institutions will withdraw;
- Those in which they are needed, and therefore will be continued; and
- Those in which they are needed at present, but from which they will withdraw in the future.

With these categories in mind, the government reviewed the functions of individual policy lenders and determined a course for each. It was decided that five of the eight banks scheduled for reform would be consolidated into one new policy finance institution, while the remaining three would be either privatized or abolished.

Those to be absorbed into the new institution are the National Life Finance Corporation, the Japan Finance Corporation for Small and Medium Enterprise, the Agriculture, Forestry and Fisheries Finance Corporation, the Okinawa Development Finance Corporation and the Japan Bank for International Cooperation. A new policy finance institution incorporating these banks will open in fiscal year 2008, with the aim of reducing the total amount of loans outstanding. Of the three banks not included, the Japan Finance Corporation for Municipal Enterprises will be abolished and its functions transferred to regional governments. The Development Bank of Japan and the Shoko Chukin Bank are to be privatized. The functions of the Japan Bank for International Cooperation are to be divided. Its international finance operations, which aim at securing resources and international competitiveness, are to be integrated into the new institution. Its yen loan for aid division, which supplies ultra-low-interest funds to foreign borrowers, is to be absorbed by the Japan International Cooperation Agency. In addition to taking over ODA yen loans, the new institution will be responsible for grants-in-aid, which had previously been administered by the Ministry of Foreign Affairs. Thus yen loans for aid, grants-in-aid, and technological cooperation will be integrated within a unified system.

For some time now, Japan's government financial institutions have drawn public criticism in Japan itself. Dissatisfaction has focused primarily on two aspects of the country's government banks. One is their outsized presence when compared with the public institutions of other industrialized nations, specifically in regard to their excess of loans outstanding. The other is their tendency to lend directly in almost all cases, to the virtual exclusion of guarantees and agency loans – a practice that has led to diminished profit opportunities for private banks. The coming reforms should, at the very least, address the first of these issues by substantially reducing the loan balance of policy finance institutions over the next few years. The reforms will also bring to fruition another idea which has won wide support: the privatization of postal savings system, long advocated by Mr. Koizumi, along with the integration of nation's many policy finance institutions.

Privatization of Policy Finance Institutions: The Case of DBJ

In fiscal 2008, the Development Bank of Japan will become a private corporation, with the government owning one hundred percent of its shares. Within about five to seven years after that, plans call for the government to sell all of its shares to the private sector. DBJ, however, has a public responsibility as a "designated financial institution" – an agency the government looks to for aid in crisis situations. It was also necessary to minimize the effects that an abrupt change would have on

clients during the transition period. For some time, then, DBJ is likely to remain a policy-based lender, with many of the features of a government-affiliated institution, even as it moves toward privatization.

The majority of Japan's eight policy finance institutions may be headed for integration, but each will go on extending policy finance in much the same manner as in the past. The goal of this move will be to cut scale and raise efficiency, without too much effect on actual operations. Some observers see this as nothing more than a reorganization of the institutions, rather than a substantive change. In DBJ's case, however, the change will be significant. At the start of the privatization process, its shares will be 100-percent government owned. Gradually, total ownership will shift to the private sector. While DBJ will retain aspects of a government agency for some time, there will be substantial change in its organization. DBJ is thus in quite a different situation from the Shoko Chukin Bank, which even now has only partial government ownership.

If that's the case, then why is DBJ being privatized in the first place? There are a number of factors behind the decision. One is that, unlike other policy-based lenders, DBJ is in good financial shape. When, for reasons including political factors as well as the precarious state of the nation's finances, the government decided that it would be a good idea to cut back on the number of policy financial institutions, DBJ was the only one that was deemed appropriate for privatization. The fact that it has always turned in a good performance, without placing any undue burdens on the public budget, seems to have been an important factor in the government's decision. Risk management at DBJ, for example, compares favorably with the systems at other large financial institutions in Japan, and is of a quality unequalled among other policy-based lenders. When Japan's economic bubble collapsed toward the end of the 1980s, DBJ suffered fewer ill effects than any other bank, private or government-affiliated.

The Diet also considered DBJ's strengths as a source of broad-ranging policy proposals and useful information, and as a developer of new financial tools in advance of the nation's private banks. In the view of many experts, these assets could well be lost if DBJ were to be absorbed into a huge new government bank with five other widely varying institutions. This was another important reason for singling DBJ out for privatization.

In the end, the government decided that DBJ would be able to perform well as a government institution even when restructured as a superior private bank. Actually, government financial institutions such as DBJ are almost nonexistent in other countries. The European Investment Bank and Germany KfW provide similar services, but DBJ is unique in that it supports companies and projects by performing risk assessment and shouldering risk itself. And even while doing so, it has managed to keep credit costs lower than commercial banks and to perform well. Since this is an unusual phenomenon outside of Japan, DBJ can sometimes be hard for non-Japanese to understand. But by evaluating projects and companies from a long-term, neutral standpoint, DBJ has provided services that are unobtainable from private lenders. Its credit judgments have an important

influence on the credit judgments of other banks, and have exerted a decisive pump-priming effect in one important project after another. I will be pleased if my talk today leaves you with a better idea of DBJ's uniqueness in Japan and the reasons why so many experts believe that it is one government bank that can easily remain vital after privatization.

DBJ after Privatization

Once privatized, DBJ plans to become a bank with unique strengths. Japan's financial markets have been called overcrowded, especially in regard to lending institutions. There are, however, many services which have been left untouched by almost all of the private banks. DBJ wants to differentiate itself from other private banks, while at the same time cooperating closely with them through appropriate role-sharing. We can then be a force for a stronger Japanese economy overall and more robust economies on the regional scale.

In a sense, DBJ's future roles have much in common with its responsibilities up to now as a government financial institution. Still, we plan to do our utmost to ensure that its contribution is even greater after privatization than it ever was before. As it has always done, DBJ will support corporate growth by providing financing from a long-term point of view. It will continue to support companies, and industries, in their restructuring efforts. By increasing corporate value in this way, we will help to boost the competitive position of Japanese firms in world markets. In the process, we will supply risk money based on accurate risk assessments, using a variety of financial tools. As always, we will utilize skills at evaluating industries and projects that have been refined over many years. Viewing investment, finance and advice as parts of an integral whole, the new DBJ will provide its clients with the very best in both finance and service.

Up to now, no Japanese bank has been able to provide good-quality investment along with good-quality finance. Good-quality risk money, too, is available from only a few. At DBJ, each employee knows that the bank is founded upon the supply of low-interest, long-term funds obtained at favorable terms from the government. Implicit in this relationship, however, is the reality that DBJ, as a government-affiliated organization, has been unable to publicly express any opinion that would conflict with the views of its sole shareholder, the government. Nor can it deviate an inch from its position of neutrality. Factors like these have been a key reason that DBJ has chosen to hold back, as much as possible, from services other than financing, and especially from giving advice to corporate clients. Once it is privatized, however, DBJ will emphasize its consulting services, giving projects and companies the most appropriate advice at the most appropriate time. The possibility that interest rates may rise will be offset by the added value of the advice given and the more efficient provision of risk money under a unified system of investment and loans. For my part, I see the new DBJ as making an even greater contribution to the Japanese economy.

As I've already said, DBJ wants to differentiate its services from those of private financial institutions without jeopardizing the close ties that exist between them. At the same time, we want to

continue to lead other banks and private firms into areas such as the environment, disaster prevention, and corporate social responsibility, which have traditionally been of little interest to banks in Japan. We also want to maintain our relationships of mutual trust with public institutions, both national and local, and to play a central role in fostering stronger ties between government and the private sector – ties that many factors, such as the precarious state of Japan's regional economies, suggest will grow steadily more important in the years to come.

We know that the special kind of privatization we aim at for DBJ will be by no means easy to achieve. But I am confident that by performing consistently to the standard expected of DBJ, we'll be able to meet the expectations of our clients, private banks, and the many individuals with whom we do business – and that, ultimately, will make our privatization a success.

There are two more things I'd like to mention before I close.

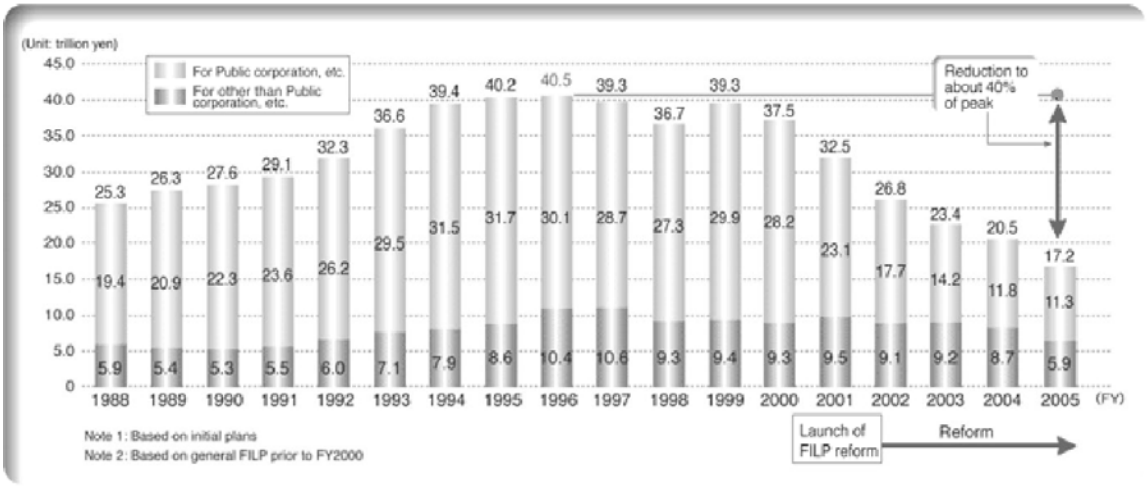
I am in the fairly unusual position of having worked not only on the privatization of the postal service, but also on the privatization of DBJ. With the Postal Savings Bank awash in capital and DBJ to have fewer sources for funds, there are some who have suggested merging the two. I have to say that I don't see any possibility of that happening.

The reason is that that would take us back to square one, before the fundamental reform of the Fiscal Investment and Loan Program promoted by former Prime Minister Koizumi.

I attended a party recently for the new CEO of Goldman Sachs in Tokyo, Lloyd Blankfein. Mr. Blankfein asked me what I saw as DBJ's goals. I told him that I thought DBJ's goal was to become Japan's Goldman Sachs. And if I say any more on this subject, I'll risk the anger of Mr. Koizumi, who has always been a great fan of that dreamer, Don Quixote. So I'll end here by thanking you for your attention.

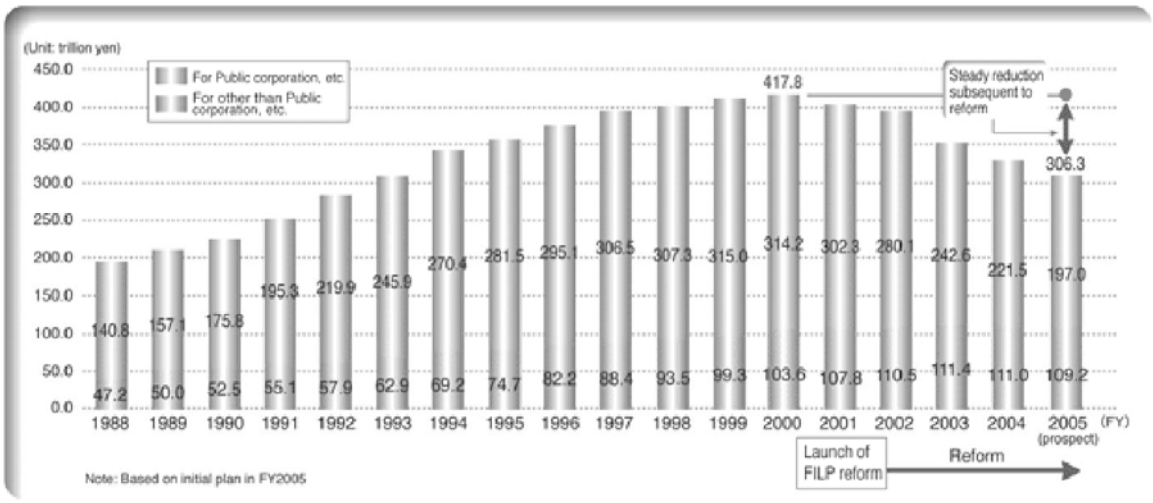
Thank you.

Transitions (flow) in FILP Plans



Source: FILP Report 2005 (Ministry of Finance)

Transitions (specifications) in FILP plan Balance

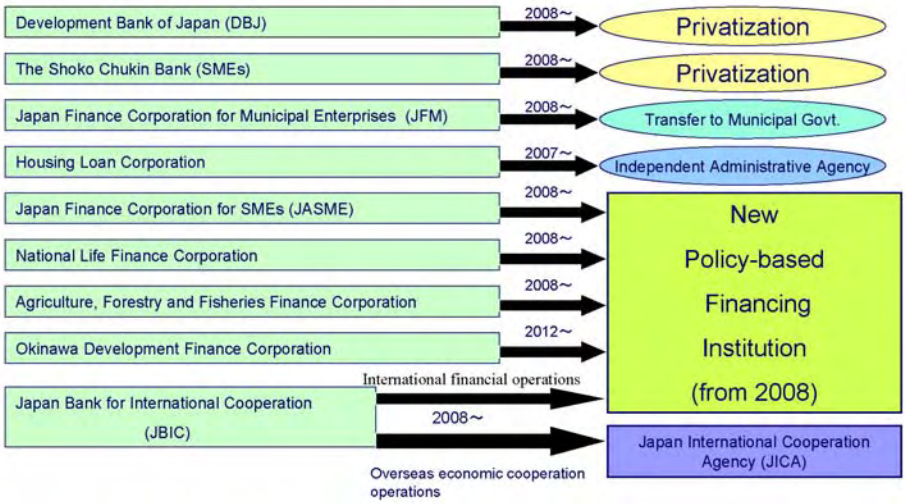


Source: FILP Report 2005 (Ministry of Finance)

Policy-based Finance Reform

DBJ
日本政策投資銀行
Development Bank of Japan

26.05.2006 :"Regulatory Reform Law", including streamlining of the public financial institutions, was passed by the Diet



Policy-based Financial Institutions in Japan

DBJ
日本政策投資銀行
Development Bank of Japan

		main function	number of employees	Loans outstanding (¥trn)	Total aseets (¥trn)	equity/ Total assets (%)	Net income (¥bn)	NPL's ratio (%) ***	Plan of Investments and Loans (¥bn)	Funds Plan of issuing JGGB (¥bn)
	Japan Finance Corp. for Municipal Enterprises (JFM)	financing for municipal enterprises operated by local governments	80	24.8	25.9	10.8%	340.6	0.0%	1,406.0	130.0
*	Japan Bank for International Co-operation (JBIC)	ODA, Export and Inport Loans	869	19.0	20.9	** 41.3%	309.5	3.3%	1,830.0	240.0
*	Development Bank of Japan (DBJ)	mid.- and long-term financing for policy-besed projects	1,352	12.9	13.7	** 14.7%	92.6	1.6%	1,110.0	190.0
	Japan Finance Corporation for SMEs (JASME)	financing for SMEs	2,095	7.0	7.8	8.3%	▲ 546.4	13.7%	1,640.3	40.0
*	Shoko Chukin Bank (SMEs)	financing for SMEs	4,424	9.4	11.5	5.8%	12.8	4.8%	–	–
	National Life Finance Corporation	financing for SEs	4,740	9.0	9.1	−1.2%	13.2	9.1%	3,059.3	–
	Agriculture, Forestry and Fisheries Finance Corporation	financing for Agriculture, Forestry and Fisheries	924	3.1	3.1	9.1%	▲ 0.6	6.1%	390.0	–
	Okinawa Development Finance Corporation	financing for the development of Okinawa prefecture	223	1.3	1.3	4.5%	10.3	8.5%	162.9	–
			as of Mar. 06				FY2005	as of Mar. 06	Initial Plan for FY2006	

* The financial statements has been audited and certified by Independent Auditors.
(the accounting figures of other institutions are based on the supposition to be audited by J-GAAP)
** BIS capital ratio: JBIC 40.5% (International Financial a/c 18.5%, Overseas Economic Coopeation a/c 56.1%)
DBJ 16.1%
JASME 8.1%
ave. of major banks 12.1% (MizuhoFG, MistuiSumitomoFG, Mistubishi UFJ FG)
***NPL's ratio: ave. of major banks 2.1%

Source: DBJ

APPENDIX II

CONCEPT PAPERS

JEFFREY R. BOHN

Why Is Loan Securitization and Syndication Important for Japan's Financial System?

Why is Loan Securitization and Syndication Important for Japan's Financial System?

Dr. Jeffrey R. Bohn
Head of Financial Strategies Division, Shinsei Bank

Part I: Real Estate Revisited

The recovering real estate market in Tokyo exposes some of the difficulties Japan has distributing risk in digestible chunks. The record price of 143 billion yen paid by DaVinci Advisors for the Tokyo "Battleship" building (Shiba Park Building) in a recent transaction (see Nikkei Net, July 4, 2006) suggests the creation of a new series of lumpy credit risk exposures entering Japanese bank portfolios. While the details are not available, it is likely that a good chunk of the acquisition price was in the form of non-recourse loans held by Japanese banks. In the U.S. and, to a growing extent, in Europe, these types of large, concentrated exposures can be transformed into smaller pieces of risk using syndication or securitization. In Japan, the infrastructure for transforming and distributing credit risk exposure is still in its infancy. The Japanese financial community in coordination with the regulators should work to accelerate the expansion of loan syndication and securitization. Otherwise, these lumpy exposures may come back to haunt the banks the next time the real estate market cycles back downward. In Japan, the expansion of real estate lending in the late 1980s followed by portfolio meltdowns provides a poignant example of what can happen. This kind of concentration risk leads to bank crises.

In order to better understand this prescription, let me explain the mechanics and motivation behind syndication and securitization in the context of this Battleship building transaction. Consider a bank willing to lend DaVinci Advisors a sizable portion of the 143 billion yen purchase price. This bank will likely have developed an expertise in real estate financing and already have or will have a number of real estate exposures on their balance sheet. What is interesting about this situation is that each loan in isolation may look like a great deal i.e. healthy return for minimal risk (in fact, real estate lending today in Japan looks like a great business in the current economic environment: the economy is recovering, rents are rising, and buyers have returned to the market.) However, the accumulation of many of these types of loans in large chunks creates correlation and concentration risk. If (when) the real estate sector becomes distressed, these large correlated concentrations place the entire financial institution at risk. If the exposure to each loan were smaller and more widely dispersed across portfolios around the world, then a down cycle will have much less severe impact. Each portfolio would take only a small, non-material hit. Herein lies the power of diversification.

The problem, of course, is that a financial institution cannot always move to a portfolio composition that reflects healthy diversification. Only a small number of market players have the expertise to originate a large loan on a transaction such as the Battleship building sale. If selling the loan after its origination is difficult and no instruments for hedging exist, the financial institution with the origination expertise can only originate and hope that no difficulties arise. Unfortunately, history tends to dash these hopes on the rocks of unexpected losses. Each developed country around the world has seen a bank crisis arising out of concentration risk in some particular product, sector, or region. At the time the loans were made, each transaction likely looked profitable. The difficulty arose from the natural concentrations that accumulated over time. The development of syndication and securitization markets provides an antidote to this creeping risk of crisis as concentrations deepen. Let us turn to how these financial technologies work.

Syndication is the process of gathering together a group of financial institutions so that the institution that originates the loan does not retain all the credit risk exposure. Members of the syndication agree to take on some of the risk. In this way, financial institutions without origination expertise in the particular segment (e.g. real estate) represented by the large loan can still add to their portfolio exposures that improve their portfolio's diversification profile.

Syndication transforms the existing debt exposure from one large lump into a number of smaller pieces. However, the underlying stand-alone risk of the exposures stays the same. The specific correlation and concentration characteristics of each institution's portfolio buying into the syndication will result in different contributions to their particular portfolio's risk. But this scenario only works when the return/risk characteristics of the specific loan make sense for the particular portfolio manager's portfolio. What if the stand-alone return and risk characteristics of the exposure are not appropriate for enough of the other financial institutions? What if no one else thinks that particular return-risk profile makes sense? Is the financial market still stuck with the correlation and concentration risk?

In recent years, the answer has moved from maybe in Japan to a qualified yes in Europe and a definitive yes in the U.S. The mechanism is securitization. Here is how securitization works: In the case of loans, a special purpose vehicle (SPV), which is a stand-alone entity, is created to receive the loan(s) as collateral. The cash flows associated with these loans are

distributed according to a set of rules called the “cash waterfall” to several claimants who have purchased what is called a “tranche.” A tranche is similar to a bond that has a promised payment on a regular basis plus the promised repayment of principal at maturity of the deal. Each tranche has an assigned coupon or fee to be paid by the cash flow from the collateral pool and reflects a different risk and return profile. The senior tranche holders receive their promised coupon first. The mezzanine tranche holders receive their promised payment second. And the subordinated tranche or equity holders receive whatever is left over. If a number of loans in the collateral pool default, the most junior claimants (e.g. equity holders) are the first to feel the pain. Depending how one specifies when one tranche absorbs loss over another tranche, the risk profile changes dramatically. The return profile is generally driven by market conditions for each level of risk. The power in this financial technology is the ability to take one type of exposure (e.g. moderately risky real estate) and convert it into a set of exposures that are nearly risk-free (e.g. senior tranches), moderately risky (e.g. mezzanine tranches) and very risky (e.g. equity tranches.) It’s as if we took milk and turned it into butter, cheese, and ice cream. Except here our transformation focuses on the return and risk characteristics of each exposure (and cannot be eaten.)

Without liquid syndication and securitization markets, Japanese financial institutions will continue to be stuck with large, correlated exposures that will set the stage for another financial crisis in the future. The U.S. has pioneered this technology and now securitizes mortgages (vehicle is called a mortgage-backed security or MBS), credit card receivables and auto loans (vehicle is called an asset-backed security or ABS), and loans and bonds (vehicle is called a collateralized debt obligation or CDO)—to name a few. Interestingly enough, other types of non-traditional assets such as rights to revenue from movies and music are finding there way into securitizations. Figure 1 shows the difference in the size of these markets around the world. Japan still has a long way to go to catch up.

Japan’s recovery may inadvertently set up the next crisis if large loan exposures such as those generated in the context of real estate transactions are not transformed into more manageable pieces. The days of liquidity crunches and a contracting economy may return if the structure of the market is not modified to better manage concentration risk. A rising number of portfolio managers outside of Japan at banks, hedge funds, and pension funds are looking to add real estate loans to their portfolios. The diversifying characteristic of these loans for non-Japanese portfolios makes them well suited for overseas investors. Japan could not ask for a

better set of circumstances to sell efficiently pieces of debt exposure so that everyone's portfolios are better off. The key is transformation of these large unwieldy exposures using syndication and securitization. Without the mechanisms for distributing and managing risk, Japan will forever lag the rest of the developed world in terms of financial market development and financial market competitiveness.

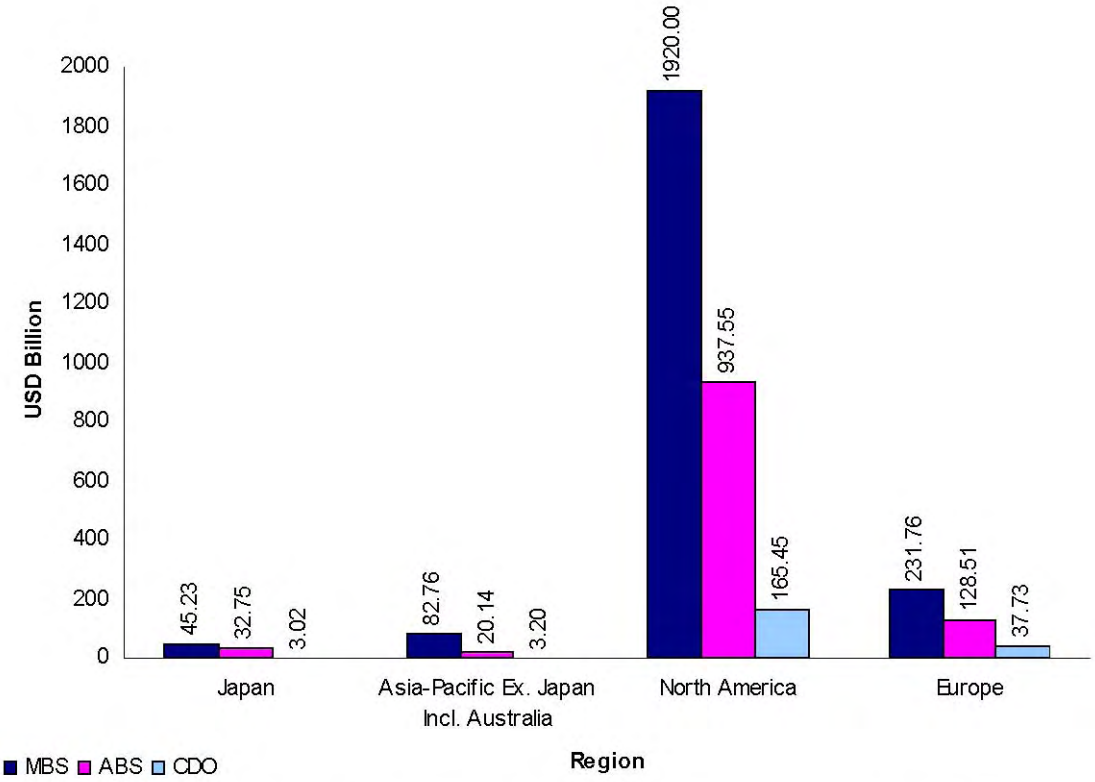


Figure 1: Aggregate collateral for different types of securitizations across regions. (Data collected from publicly available sources on the internet.)

Part II: Mid-size Company Malaise

As an economy develops, extension of credit becomes an important catalyst for further expansion of businesses. Most company owners and shareholders do not have the capital to fund business expansion by themselves. Consequently, they look to banks or capital markets to borrow money so they can retain control of their business, building, or other assets and still facilitate growth. Around the world, large, well known firms have typically had efficient and low-cost access to credit. In the U.S. and now to an increasing extent in Europe, this access to credit has become widely available to small and mid-size enterprises (SMEs), as well. The situation is different in Japan. As figures 2 and 3 show, Japan has lagged in terms of lending to these types of firms. While even large firms in Japan have leverage ratios (total debt/total market capitalization) less than their counterparts in the U.S., the difference is not large. It is small firms that show substantial differences in the extent of leverage.

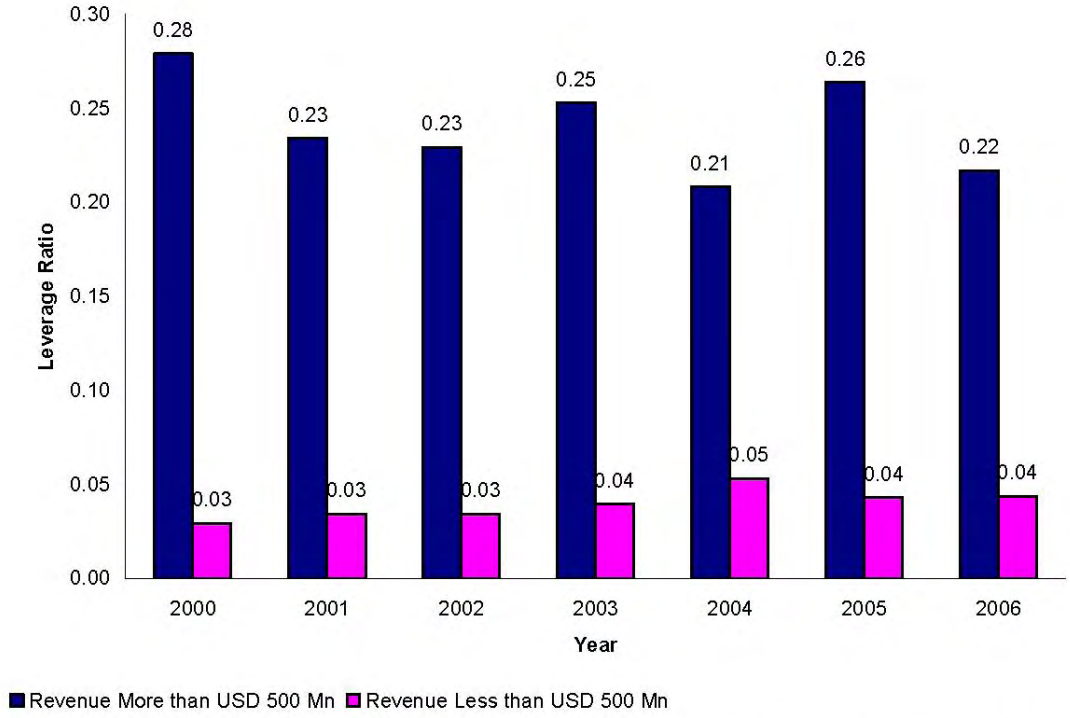


Figure 2: Total debt divided by total market capitalization for large and small publicly traded firms in Japan. (Source is Bloomberg.)

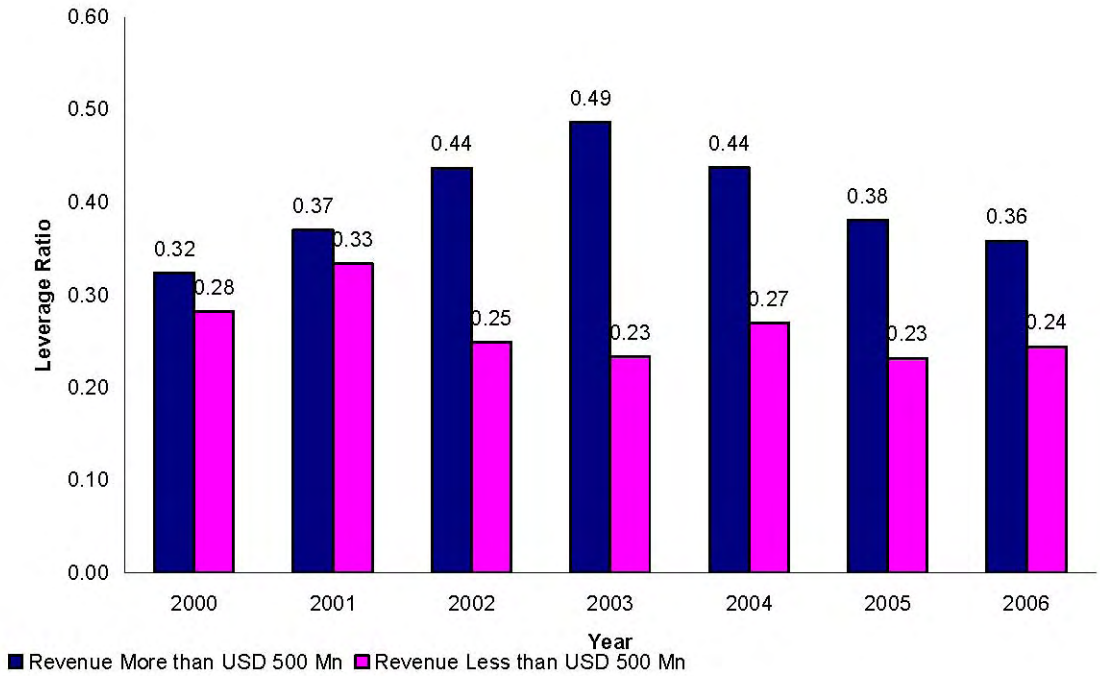


Figure 3: Total debt divided by total market capitalization for large and small publicly traded firms in the U.S. (Source is Bloomberg.)

The difficulty with lending to SMEs is a different problem than is faced when absorbing large chunks of real estate loans into a portfolio. Here we have many small exposures, which are good for diversification; however, risks can be quite high for each individual borrower. The costs of analyzing and monitoring each firm can also be a daunting task if an institution does not look to build a large portfolio of these companies. Nonetheless, SME growth is critical to sustainable economic growth as these firms as a group can be more adaptive to changing economic conditions and plant the seeds for creating the next generation of large firms. Japan's 15 years of economic difficulty is due in no small part to the lack of loans available to promising SMEs. In part I, I discussed how securitization facilitates continued lending in large chunks for real estate transactions without putting the financial system at risk. Here I will discuss how securitization can make it easier for SMEs to obtain access to credit.

The financial technology used in this transformation is called a collateralized loan obligations or CLO. A CLO is one type of a CDO discussed above. A large number of SME loans are placed in this CLO special purpose vehicle (SPV) and claims called tranches are sold to investors. As discussed before, a nearly risk-free senior tranche, a moderately risky mezzanine tranche, and a risky equity tranche now draw the cash flows from the CLO pool of

loans. The specific nature of the risk of each tranche depends on the rules for how cash is distributed (called a cash waterfall) and the size of each tranche. A bigger equity tranche will make the mezzanine and senior tranches safer (all else equal) since more of the losses can be absorbed by the equity tranche holders. The beauty of this structure is that a pool of moderately risky to very risk SME loans that may not be touched by a Japanese bank can now be converted into a mixture of securities with various return-risk profiles. Investors outside of Japan will likely find these tranches appealing given the low correlation with their existing portfolios. Securitization resolves the problem of granting credit to SMEs. Moreover, the development of CLO creation and distribution capacity reduces the risk that the economy unduly suffers when its domestic financial institutions are unwilling to loan money to this segment in the economy as has been the case for the past 15 years.

By using quantitative models and building large pools of these borrowers, the difficulties banks have had in monitoring these loans are mostly avoided. The distribution of the tranches into many different investors' portfolios reduces the concentration risk that may arise from lending to SMEs in the same country. While it will always be the case that many of these small firms will default and some may even commit fraud, the pooling of this risk subject to quantitative criteria makes it much easier to absorb these losses and still make credit available to those firms who are healthy. The fact that the risks are parceled out to many investors inside and outside Japan substantially reduces the long-term impact of these loss events and of the economic situation generally. The key is to have a well functioning market for the tranche claims. As long as there is liquidity, an investor somewhere will find each tranche attractive at a reasonable price given the risk.

Building a robust market for SME CLOs in Japan is an essential part of structural change in the economy to facilitate future growth. The experience in the U.S. and now in Europe demonstrates the value of opening up this channel for credit to SMEs. More and more non-Japanese investors are looking for this kind of exposure. And, most importantly, SMEs will see their businesses expand with this new source of funding. The result will be better economic growth for years to come.

MATTHEW GOODMAN

Japan’s Big Bang: Promise Fulfilled?

Japan's Big Bang: Promise Fulfilled?

Matthew Goodman
Managing Director, Stonebridge International LLC

Convening almost 10 years to the day after the Hashimoto Administration announced Japan's "Big Bang" financial reforms, this year's Symposium could usefully consider the following questions:

- Was Big Bang's promise of making Tokyo a "free, fair and global" financial market fulfilled?
- What have been the principal accomplishments of Big Bang, and where does work remain to be done?
- To what extent did the financial crisis of the late 1990s explain delays in, or failures to implement, aspects of the Big Bang program?
- Is Tokyo today a "fair" market, or in the words of the Big Bang document itself, a "transparent and credible market," in which the "own-risk principle" prevails?

The Finance Ministry's November 1996 summary of the Big Bang reform plan follows. (Provisional Translation)

Structural Reform of the Japanese Financial Market
- Toward the Revival of the Tokyo Market by the Year 2001 -

1. Goal - An International Market Comparable to the NY and London Markets by the Year 2001

(1) A superb financial system constitutes the foundation of a sound economy. In order for the Japanese economy to retain its vigor in the coming "aging society", it is essential to secure the supply of funds to newly rising industries as well as to establish a place for efficient asset management. It is equally important to ensure that Japan provides a smooth supply of funds to the rest of the world, if it is to make a contribution to international society commensurate with its economic strength.

Thus the Japanese financial market, which serves as the artery for the Japanese economy, needs to play its true role of optimal resource distribution, as the markets in NY and London do, so that Japanese individual savings of as much as 1200 trillion yen can be fully utilized.

(2) The financial markets of Europe and the United States have experienced drastic changes in the last ten years and are expecting dynamic development from now on. In Japan, we aim to revitalize the Tokyo market into an international financial market comparable to those of NY and London by the year 2001, five years away from now, while continuing the disposal of bad loans. To this end, it is necessary not only to transform the financial administration into a more transparent one based on the market mechanism, but also to vitalize the Tokyo market through structural reform.

(3) In order to achieve these goals, the government and the ruling party are determined to immediately begin examining the themes outlined below and to implement whatever individual reforms and necessary once a conclusion has been reached, and to complete all these reforms within five years.

2. Implementing Structural Reform: Two Themes ('Reform' and 'Bad Loan Disposal')

In order to revitalize the market in accordance with the aforementioned goals, we need to promote market reforms and bad loan disposal by financial institutions in tandem.

(1) Reform - Three Principles (Free, Fair, Global)

1) Free (toward a free market where the market mechanism prevails)
   To liberalize entry, products, prices, etc.
2) Fair (toward a transparent and credible market)
   To clarify and enhance transparency of rules and to protect investors' interests
3) Global (toward an international market ahead of its time)
   To establish a legal system, accounting system, and supervisory regime consistent with globalization

Note: In line with the aforementioned thorough reforms of financial markets, the tax system relating to financial activities will be reviewed in the context of the entire tax system, keeping in mind the principles of "fair, neutral, and simple" as well as the viewpoint of rationalization of taxation.

(2) No matter how indispensable it may be for the Japanese economy in the 21st century, such a thorough structural reform as above necessarily accompanies various pains. Since we have to execute this reform while swiftly disposing of the non-performing loans of financial institutions, the greatest possible care should be taken concerning the stability of financial system.

Examples of Concrete Items for Examination

Reform- Three Principles (Free, Fair, Global)

1. Free (toward a free market where market mechanism prevails)
    - Introduction of new vigor (promotion of entry into banking, securities, and insurance sectors)
    - Products and services responsive to a wide range of customer needs (abolition of product restrictions based on separation of long-term and short-term services, expansion of activities in which banks and securities companies can engage)
    - Diversified products and prices (liberalization of all kinds of commission)
    - Free external transactions (abolition of "foreign exchange bank principle")
    - Effective utilization of individual savings of as much as 1200 trillion yen (review of regulation of asset management activities and thorough and substantial disclosure)

2. Fair (toward a transparent and credible market)
    - Provision of information necessary to establish own-risk principle and clarification of rules (thorough and substantial disclosure)
    - Active application of punishment for rule violations

3. Global (toward an international market ahead of its time)
    - Preparation of a legal system that corresponds to the development of new financial products such as derivatives and an accounting system consistent with the international standard
    - Establishment of a global supervisory cooperation regime whose necessity has been confirmed at the G7 summit and Finance Ministers meeting.

KAZUTOSHI KUWAHARA
GEOFFREY MATSUNAGA

Mortgage Insurance: Enhancing Credit Risk Management in a Global Financial Center

Mortgage Insurance: Enhancing Credit Risk Management in a Global Financial Center

Kazutoshi Kuwahara, General Manager
Geoffrey Matsunaga, General Counsel
Genworth Mortgage Insurance Corporation, Japan Branch

Japanese banks appear finally to have recovered from the collapse of the bubble economy and, after a long period of retrenchment and restructuring, are seeking to make new loans and add assets to their books. In the absence of significant demand from corporate borrowers, most banks have turned to residential mortgage lending to generate revenues. The withdrawal of the Government Housing Loan Corporation from direct lending has created opportunities for banks and encouraged this trend.

Historically, the credit risk associated with residential mortgage loans has been regarded by Japanese banks as extremely low, and this has led in recent years to looser underwriting standards and more aggressive lending practices.

Residential mortgage lending, however, is not without its risks, and some bank analysts at rating agencies have begun to express concern with the aggressive lending practices of Japanese banks. In the United States, similar lending practices contributed, for example, to the real estate collapse in California in the early 1990s. A major factor in limiting losses to mortgage lenders as a result of defaulted loans then was mortgage insurance.

In the increasingly competitive mortgage loan market in Japan, mortgage insurance affords Japanese lenders a credit risk management tool that is widely used in other developed financial markets. As described below, mortgage insurance can contribute in many ways to enhancing the competitiveness of Tokyo as a global financial center.

Mortgage Insurance Is New to Japan

Mortgage insurance is new to Japan and has been available only since August 2005. It does not yet have regulatory support in Japan, and – partly as a consequence of this – it is not yet widely accepted in the lending market.

However, in many developed financial markets around the world, it is regarded as a useful, if not essential, credit risk mitigation instrument for mortgage lenders.

What is Mortgage Insurance?

Mortgage insurance provides protection to the mortgage lender in the event that a borrower defaults on a mortgage loan.

After a default has occurred and the lender has repossessed and liquidated the mortgaged property, there will often be a shortfall between the outstanding amount of the loan (plus unpaid interest and expenses associated with the sale) and the sale proceeds realized from the repossessed property. If there is such a shortfall, the mortgage insurer will pay an amount equal to such shortfall to the lender, subject to the limits of coverage set forth in the insurance policy. In this manner, mortgage insurance either eliminates or greatly reduces the loss suffered by the lender in the event of a default on an insured mortgage loan.

Mortgage insurance does not provide protection to the borrower. In the event of a default, the insurer has the right to pursue the borrower for the reimbursement of any amounts paid to the lender.

Mortgage Insurance in Developed Economies

Many developed economies of the world have an established mortgage insurance market. Where a mortgage insurance market exists, mortgage insurance is often required by lenders for loans with high loan-to-value (LTV) ratios, because high LTV loans tend to have a higher risk of default.

Loans with high LTV ratios allow borrowers to purchase housing with a smaller down payment, thus encouraging purchases to younger buyers and a higher overall rate of home ownership. The higher default risk associated with high LTV loans is absorbed not by the lender but by the mortgage insurer.

Table 1 - Comparison of mortgage insurance markets and home ownership in selected advanced economies

Country	Mortgage Insurance Market	Home ownership %
USA	Established	67%
Japan	New	60%
Germany	Small	40%
United Kingdom	Established	67%
France	Small	55%
Canada	Established	66%
Australia	Established	70%

Sources: *Canada – 2001 Census Data*
Australia – Australian Bureau of Statistics
Others – Japan Ministry of Land Infrastructure and Transport

Distinguishing Features of the Japanese Market

Japan's housing and mortgage loan market is similar in most respects to that of other countries. However, there are differences. The following factors would suggest the Japanese mortgage loan market may be relatively risky in international terms:

- Large proportion of high LTV lending in the current highly competitive mortgage loan market
- Improvements depreciate, leading to an effective increase in LTV
- High proportion of variable rate lending, resulting in greater sensitivity to interest rate movements
- Likelihood of interest rate hikes in the near future
- Demographic factors (such as an aging and decreasing population) that may lead to reduced demand for land and property, resulting in downward pressure on housing prices

On the other hand, there are some mitigating factors. Default rates in Japan have been low despite the long recession, although this can probably be attributed in large part to declining interest rates which lowered monthly mortgage payments for most borrowers. Also,

unemployment remains low by international standards, and divorce rates are also low. Unemployment and divorce are two common triggers of default.

Benefits of Mortgage Insurance

1. Mortgage Insurance Reduces Lender Credit Risk

As noted above, mortgage insurance provides protection to mortgage lenders against losses associated with defaults on mortgage loans. Mortgage lenders most often purchase, or require borrowers to purchase, mortgage insurance for high LTV loans because high LTV loans tend to be associated with a higher rate of default.

Mortgage insurance differs from the guaranties that Japanese banks typically require borrowers to purchase to guaranty the repayment of mortgage loans. First, mortgage insurance results in the transfer of credit risk to an independent third party insurance company. Mortgage loan guaranties, on the other hand, are usually issued by subsidiaries or affiliates of the lending bank, thus retaining the risk within the bank group. Second, mortgage insurance companies are typically rated AA or A by rating agencies, whereas bank-affiliated guaranty companies are usually unrated. Thus, mortgage insurance can confer benefits to the lender in securitization transactions and under the risk-weighted capital rules of Basel II.

2. Mortgage Insurance Increases Availability

In many countries, the introduction of mortgage insurance has led to an expansion in the availability of mortgage loans to consumers, in particular those without substantial savings and those with lower credit scores.

Partly as a result of this, the average age of the first-time homebuyer in countries with mortgage insurance tends to be lower than in countries without mortgage insurance. The average age of the first-time homebuyer in the United States, for example, is in the late 20's. The average age of the first-time homebuyer in Japan is in the upper 30's.

While high LTV loans are currently being made in Japan, this is due in large part to the refinancing of mortgage loans originally made during the "bubble" economy. As a result of falling property values for the last 15 years, the LTV ratios of such refinancing loans can be surprisingly high, often exceeding 200%.

3. Mortgage Insurance Increases Choice

Mortgage insurance also allows smaller lenders to compete on a level playing field with larger financial institutions. Smaller lenders are less well equipped to assess the credit risk of an individual, and in a market without mortgage insurance, this puts them at a significant competitive disadvantage.

The presence of smaller lenders in the mortgage market increases choice for consumers and improves its overall competitiveness. It also means that 'niche' lenders can serve the needs of particular community groups without putting them at a disadvantage.

4. Mortgage Insurance Reduces Cost

Mortgage insurance allows for diversification of credit default risk over time, geography, and a large numbers of borrowers. As such it should act to reduce overall capital requirements for mortgage lending. This is an important benefit for lenders, but it also benefits consumers as it should mean that the cost of mortgage loans is generally reduced.

5. Mortgage Insurance Facilitates Securitization

Mortgage insurance facilitates the securitization of high LTV mortgage loans, since it largely removes the credit default risk that is the main source of uncertainty in the underlying cash flows. Securitization is common in countries like the US, UK, Canada, and Australia, where mortgage insurance is the primary means of credit risk mitigation used in the mortgage market.

Securitization benefits consumers because it allows non-bank lenders to access capital and compete in the mortgage loan market, and also because it offers the choice of long-term fixed rate loans that might not otherwise be available. In addition, securitization benefits lenders by removing risk from the balance sheet and freeing up capital.

Mortgage insurance can increase the efficiency of securitization transactions by reducing the size of the equity or lower-rated portions and increasing the amount realized by the issuer/lender.

6. Mortgage Insurance Smoothes the Housing Cycle

Mortgage insurance can benefit consumers, lenders and the economy as a whole by helping to smooth out the housing cycle. Lenders become more cautious about making new loans at the bottom of the cycle, which tends to prolong periods of recession. On the other hand, lenders may lend too much at the top of the cycle, which leads to problems like those experienced in Japan as a result of the "bubble" economy.

Mortgage insurance providers have a longer term view. The fluctuations in risk across the cycle are expected, and are an accepted part of the mortgage insurance business. The mortgage insurer has an incentive to write business at the bottom of the cycle, to maintain its premium income – and also because business written after a crash is likely to be profitable. At the top of the cycle, the mortgage insurer has a strong interest in keeping a check on high-risk lending. These effects help to smooth out some of the effects of the housing cycle.

7. Mortgage Insurance Improves Transparency and Scrutiny

Mortgage insurance companies in Japan are subject to regulation by the FSA. The solvency position, financial performance, claims payment processes, management, and every aspect of the business are subject to the full scrutiny of the FSA. This has clear benefits for the FSA in monitoring the safety and soundness of the Japanese mortgage loan market.

The clarity of reporting and results is enhanced when the insurer operates as a monoline provider. In some countries – such as the US and Australia – it is a regulatory requirement that mortgage insurers operate as monoline insurers.

The monoline approach means that the insurer has to focus purely on the performance of the mortgage insurance risk. A multi-line insurer might be tempted to offer mortgage insurance as a loss leader to build a relationship with a lender (e.g., to encourage the lender to distribute the insurer's other products, such as fire insurance).

Mortgage insurers are also externally rated by agencies such as Moody's and Standard & Poor's, which provides further scrutiny and comfort about the ability of the insurer to pay claims.

The mortgage insurer can also act as a check on lenders. This works in a number of ways. The mortgage insurer clearly has a commercial interest in requiring the lender to practice good risk management, and is likely to specify and monitor underwriting requirements to ensure this.

The mortgage insurer also imposes reporting requirements on lenders. This in itself may help to manage risk. Insurers collect data from different lenders, and can therefore obtain a better view of trends in experience and also compare the performance of different lenders.

Furthermore, mortgage insurers sell mortgage insurance as a long-term commercial proposition. The insurer needs to provide an appropriate return on capital to its owners, and so this ensures that, for example, premiums are set at an economically viable level to reflect long-term loss expectations, and that the business is run soundly on a long-term basis.

Conclusion

Mortgage insurance is new to Japan but it is a widely accepted credit risk management tool in other developed economies. In addition to reducing the risk to mortgage lenders of losses resulting from defaults on mortgage loans in an increasingly competitive mortgage loan market in Japan, mortgage insurance can facilitate the securitization of mortgage loans, help reduce the volatility of the housing cycle, and encourage the more efficient allocation of capital. By doing so, mortgage insurance can contribute to enhancing the competitiveness of Tokyo as a global financial center.

JOHN H. MAKIN

Greenspan's Inflation Is Bernanke's Problem

Greenspan's Inflation Is Bernanke's Problem

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Since 1982, when the Federal Reserve under then-chairman Paul Volcker completed a dramatic victory over the double-digit inflation of the late 1970s and early 1980s, U.S. inflation has remained well under control. From the mid-1980s to the mid-1990s, inflation trended steadily lower with only occasional forays above 5 percent, such as occurred during a brief period of overheated growth in 1990 and 1991. Since 1993, inflation has generally kept below 3 percent and actually fell close to 1 percent during the deflation threat of 2003. Over the past ten years, the average inflation rate as measured by the Consumer Price Index (CPI) has been just 2.6 percent.

Conventional wisdom holds that the core inflation rate (which excludes fluctuations in food and energy prices) is a better guide to monetary policy than the overall rate. Indeed, the Federal Reserve has suggested that its goal is to see core inflation remain in a range between 1 and 2 percent. The implication of focus on the narrower core inflation rate is that most changes in food and energy prices are temporary and reversible, and therefore can be ignored as threats to inflation. However, one caveat applies: if higher energy prices or higher food prices persist, eventually, they are likely to spill through into the core inflation rate because fuel surcharges and higher transportation costs boost prices to suppliers, who then pass through elevated costs to final consumers in an effort to maintain profit margins. If energy inflation seeps into the cost of goods and services, the central bank responds with tighter monetary policy once the core inflation rate remains persistently above 2 percent on a year over- year basis. Like overall inflation, U.S. core inflation has been well contained for the last decade—averaging only 2.2 percent. The fact that core inflation has held below overall inflation over the last decades suggests that energy costs have risen modestly, but have not been passed through to non - energy goods or services.

Recent Jump in Core Inflation

History notwithstanding, inflation concerns have risen sharply—more than actual inflation— during the last two months, primarily since the 0.3 percent month-over-month April increase in the core CPI was reported in May. That announcement was followed a month later with the news of another 0.3 percent month-over-month rise in the May core CPI, which boosted the year-over-year core inflation rate (the target of policy) to 2.44 percent, close to half a percent

above the top of the Fed's desired range of 1 to 2 percent. Over the last three months, annualized core CPI inflation has jumped to 3.8 percent. The other measure of core inflation watched by the Fed, the Personal Consumption Expenditures (PCE) deflator, has risen in parallel, somewhat less than the core CPI, but it too has risen above 2 percent.

While the Federal Reserve is said to favor the core PCE deflator over the core CPI deflator as a guide to policy, there is a good case to be made for the core CPI as a better policy indicator. A large part of the difference between the two indexes is attributed to the larger weight of housing costs in the core CPI. The Federal Reserve's measure of the cost of housing services, "owners' equivalent rent," is the indicator for the cost of housing that is factored into the core CPI and the core PCE. That is, the indicator for the cost of housing employed in U.S. inflation indexes is not the price of houses, but rather the price of housing services as measured by rents. Obviously, had the actual price of houses been included in the core CPI, both core and overall inflation would long ago have risen much higher. House prices rose about 13 percent last year and are still rising at a 5 or 6 percent year-over-year rate based on most measures. Had the price of housing been included in the core CPI in 2005, the year-over-year inflation rate would have reached 5.5 percent, more than enough to trigger an aggressive Fed tightening.

Owners' equivalent rent has risen more rapidly in recent months because rents have risen. The lag in rents is a delayed indicator of higher house prices. As house prices have surged, sharply reducing housing affordability (the Housing Affordability Index has fallen sharply over the past year down to levels not seen since the tight money days of 1990); households have turned more to renting. Substitution of renting (a purchase of a flow of housing services) for the purchase of a house (the source of that flow of services), has boosted rents. Therefore, higher rents are a lagged reflection of the surge in house prices heretofore missing from core inflation measures. The Fed is correct to count higher core inflation measures driven by higher owner-occupied rent as an indication of additional inflation pressures that, in turn, may call for further tightening of monetary policy. Further, the core CPI reflects the lagged impact of higher house prices more fully than does the core PCE deflator and may therefore provide the Federal Reserve with a superior guide to higher living costs.

In fact, one could say that by eliminating house prices from measures of U.S. inflation, the Fed responds only with a lag to a persistent rise in house prices. This has happened over the past business cycle. The lagged response to higher house prices may itself be inflationary. If

higher house prices boost wealth and thereby boost aggregate demand and inflation pressure, the Fed's focus on the rental price of housing may result in delaying a needed tightening of monetary policy. If households feel better off because of substantial wealth gains from higher house prices, they spend more money and therefore drive the prices of goods and services higher, ultimately requiring a further tightening by the Federal Reserve in order to achieve target levels of core inflation.

The Fed's Policy Challenge

The Federal Reserve and its new chairman, Ben Bernanke, are in the midst of a difficult transition period for U.S. monetary policy. Substantial wealth gains over the past five years of more than $5.5 trillion have enabled U.S. households to maintain high spending levels at or above the level of income growth. Now that both measures of core inflation have moved well above 2 percent, with probable further upward moves in year-over-year inflation persisting at least over the next six months, the Fed, having hoped to end its tightening cycle at about 5 percent on the federal funds rate, will probably have to move to 6 percent by the end of 2006. If month-over-month core CPI increases on average 0.25 percent between now and December, the year-over-year core CPI inflation rate will be 3.1 percent, far above the Fed's desired 1 to 2 percent range for that variable.

Meanwhile, Fed tightening that has moved the fed funds rate to 5 percent from 1 percent at its June 2004 low, with increases to 5.5 percent deemed highly likely by most observers, has produced some signs of economic slowing. Smaller increases in housing prices, higher borrowing costs, and the drag from higher energy prices will probably slow U.S. growth from the 5.3 percent rate seen during the first quarter of 2006 to about 3 percent in the second quarter.

The real question mark about U.S. growth arises in the second half of 2006. Nervousness about the prospect of further Fed rate increases has produced a sell-off in stock markets that erased about $1.4 trillion of U.S. wealth between mid-May and mid-June. That figure represents about half of the increase in U.S. household net worth over the last year. In short, as persistent increases in year-over-year core inflation have forced the Fed to tighten further and further, the economic slowdown, or the prospect thereof, becomes more intense. Lower asset prices contribute to a self-reinforcing slowdown. Wealthier households, whose spending has held up very well thanks to past wealth gains, begin to slow spending and thereby to slow growth, thus further curbing wealth gains from higher prices of assets like stocks and

housing. A $1.4 trillion wealth loss is likely to cut growth over the following year by about one-half of one percent.

Meanwhile, higher energy prices have already reduced real incomes of poorer households that do not enjoy the cushion of wealth gains to help sustain their spending, as disposable incomes are reduced by higher energy costs. The 30 percent rise in energy costs over the past year is the equivalent of a tax increase on U.S. households and business that could reduce growth by about a percentage point. Taken together, higher energy costs and wealth losses that have already occurred may gradually lower U.S. growth from the current 3.5 percent rate to about 2 percent.

The Federal Reserve's tightening problem is complicated by some well-known characteristics of macroeconomic data. Macro trends usually persist for longer than many observers expect. Both growth and inflation are slow to come down as the Federal Reserve tightens. Once the inflation measure rises above the Fed's desired target range, as it has done this year, the Fed faces the problem of steadily rising inflation while growth persists. Since the Fed's only way to drive inflation back down is to force growth below trend levels, tension arises as inflation and growth persist, and markets therefore project further tightening by the Fed.

The combination during the second quarter of this year of targeted inflation measures above 2.5 percent, coinciding with growth at or close to the trend level of 3.5 percent, suggests the need for more tightening. The likely persistence of inflation, even as future growth slows, may well signal a need for more Fed tightening while weakening asset markets raise caution flags about the risks of over tightening. The awkward combination of inflation persisting as growth and asset prices fall—stagflation—makes the macroeconomic situation in 2006 the most challenging for a central bank to face. Certainly it is a scenario that Bernanke would not have chosen for himself. That said, the current challenging policy environment presents Chairman Bernanke and the Fed with a chance to prove to markets, households, and businesses their ability to manage monetary policy in the most difficult of circumstances. Chairman Bernanke's considerable abilities and sophistication as an astute student of U.S. business cycles provide him with an opportunity to build the public's confidence in the Fed.

Past Fed Policy Errors?

With the benefit of hindsight, it is possible to say that the Fed has tightened too slowly at 25 basis points per meeting since the tightening began in June 2004. That judgment follows simply from the fact that, in the process of moving the fed funds rate from 1 percent to 5 percent at a rate of 25 basis points per meeting, the Fed has failed to contain inflation within its target ranges. The gradual and gentle tightening has been undertaken consciously with the desire to avoid overly upsetting asset markets while simultaneously moving to reduce inflation pressure that results from higher demand growth, which in turn is driven, in part, by substantial wealth gains associated with higher asset markets. It may be fair to suggest that an understandable fear of hurting asset markets on the part of Alan Greenspan, Chairman Bernanke's predecessor, allowed inflation pressure to build to a point where the Bernanke Fed faces some painful choices. The likely persistence of inflation and growth may force a higher terminal fed funds rate, more slowing of growth, and additional wealth losses than would have occurred had more tightening by the Greenspan Fed preempted building inflation pressures.

The Goal Is to Maximize Growth

Through it all, markets should understand that the Fed will be unwavering in its determination to bring inflation back into the 1 to 2 percent target range. That is because the primary lesson of macroeconomic experience over the past half century has been that lower and more stable inflation go hand in hand and are associated with higher growth—and probably with gains in productivity and wealth. In effect, lower and more stable inflation reduces the economic energy that has to be devoted to managing the risks associated with higher and more volatile inflation and thereby enables higher and more stable growth as productivity improves.

Even if the Fed decides that it needs to slow the economy to growth rates well below potential in the 3 to 3.5 percent range in order to contain inflation, such measures should be viewed as an investment in maximizing the average growth rate over the next several years. Once the Fed achieves its inflation target and as markets understand, once again, the Fed's commitment to low and stable inflation, the growth of output and employment will be considerably higher than they would have been had the Fed simply allowed inflation to rise unchecked.

TADASHI NAKAMAE

What Is the Impact of Japan's Economic Resurgence on the U.S. - Japan Financial Relationship?

What Is the Impact of Japan's Economic Resurgence on the U.S. - Japan Financial Relationship?

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Attached are two papers: "What was the Koizumi Reform?" which details the nature of Japan's recent resurgence; and "What should follow Koizumi's reforms", which discusses the future path the nation should take. The ramifications of the way in which Japan has re-emerged and the direction it takes going forward will determine how US-Japan financial ties are affected.

If Japan persists as an export/investment-led economy, domestic consumption will remain depressed while the corporate sector continues to reap high profits. However, in this case, it would be very difficult for corporations to find good ways to invest their mounting cash, leading to a sustained trade surplus which would continue to help finance the US deficit. For the Japanese private sector, attractive investment opportunities in Japan would be hard to find. Therefore, households as well as corporations would invest funds overseas. At the same time, Japan would fail to attract foreign capital.

In the other case, Japan shifts to a domestic consumption-driven economy, via higher interest rates and a stronger yen – i.e. the reversal of income distribution from corporations to households. Newly stimulated domestic consumption would narrow the trade surplus and give foreign companies ample opportunities to invest in Japan. As trade imbalances are corrected, it would no longer be necessary for Japan to help finance the US deficit. Although this is the more desirable scenario, it is also the less likely one – at least for a while.

What Was the Koizumi Reform?

1. Introduction: A New Perception Gap

Deregulation continues to be crucial for the Japanese economy. On taking office five years ago, Junichiro Koizumi recognised this fact and acted accordingly. But deregulation without economic reform has had some perverse economic consequences, especially for small firms and for consumers.

In order to move the Japanese economy away from dependence on exports/investment and toward services/consumption-led growth, deregulation needed support from macro-economic policy. But no such support has ever materialized.

In the absence of any economic reform initiative, the default policy position has been zero interest rates. But zero interest rates were never a policy arising out of any sense of the Japanese economy's true direction — toward self-sustaining services/consumption-led growth. Rather, the zero interest rate policy was originally just a knee-jerk response to the banking crisis. The Koizumi administration inherited this policy, along with a budget deficit which ruled out any major fiscal policy initiative, and saw no option but to stick with it - even? though true economic progress has called for a 180-degree policy reversal in favour of higher interest rates.

Zero interest rates and the resultant weakening of the yen have greatly benefited large manufacturers, by reducing the burden of their interest payments and boosting the profitability of their exports.

Coincidentally, these same large manufacturers have also benefited from global developments. Firstly, global economic growth, led by galloping economies in the US and China, has given added vigor to Japanese exporters. Secondly, globalization and especially the emergence of China as a large exporter of consumer goods have put downward pressure on wages.

Thus, three factors, (1) deregulation, including the gradual abandonment of the lifetime employment/ seniority system, (2) Japanese domestic economic policy (or lack of it), and (3) expansion of the global economy, have all combined over the past five years to increase the power of one stakeholder within the Japanese economy: namely, large manufacturers.

This concentration of power enabled a vigorous but harsh restructuring of Japanese corporations, imposed from the top down. As a result, a dramatic improvement in corporate profits—especially at large firms—brought new streams of foreign investment into Japan, boosting stock prices. Free flowing cash and buoyant equities in turn helped resuscitate banks and life insurers, thereby attracting even more investment in an apparent virtuous circle.

Thus, in the eyes of large manufacturers—and also in the eyes of many foreign investors—Koizumi has tended to be seen as a champion of successful economic reform. But in reality, what was the Koizumi reform?

To his credit, Koizumi fought his corner for deregulation, and deregulation promoted corporate restructuring. Also the timing of Koizumi's push for deregulation was fortunate in that some of the pain of this restructuring was alleviated by timely global developments. But Japanese policymakers under Koizumi have never shown any awareness at all of where the macro-economy needs to go, stimulated by higher interest rates.

Thus, expectations of a Japanese economic renaissance following the Koizumi Reform era, raise the question: "Reform? What reform?"

The gap between perception and reality of the Japanese economy now is comparable to the perception gap that prevailed in the years before the bubble economy collapsed. A caveat to this statement is that, whereas the perception gap of the bubble years was almost all-pervasive, this time the majority of Japanese workers (those who belong to small firms), for example, are under no illusions. Many foreigners, however, have bought into an illusion about Japan's economic prospects. For this reason, at this critical juncture, with Koizumi's era of so-called reform due to end when he steps down in September, we are suspending our usual Quarterly Report format in order to focus in detail on what really happened under Koizumi and what needs to happen next in the way of real reform.

2. On the Surface: Successes of the Koizumi Era

Improved efficiency in the allocation of resources via deregulation is an essential aim in any market based drive for reform. Over the past five years, deregulation has indeed been a catalyst for corporate restructuring. Deregulation will continue to be necessary so that Japan looks not back to the old economic certainties of the 1960s, but forward to areas of potential growth in the 2010s and 2020s. As a proponent of deregulation, especially during his first two or three years in power, Koizumi should be credited with some degree of genuine success.

Again, it is undeniable that, during Koizumi's time in office, many Japanese corporations and particularly large ones have enjoyed tremendous success. As described above, zero interest rates have benefited all companies directly by reducing the burden of their interest payments. Zero interest rates have also benefited exporters indirectly, by weakening the yen, and thereby boosting their profitability.

Separately, zero interest rates have given rise to resurgent real estate activity in central Tokyo and other major cities, bringing relief to Japan's long-suffering property market.

The improvement in corporate profits—especially at large firms—and the recovery in real estate are seen as the twin triumphs of "Koizumi's reforms."

3. Beneath the Surface: Widening Gaps between Winners and Losers

Although zero interest rates and the resultant depreciation of the yen have clearly helped big corporations and financial institutions, when the rest of the economy is brought into focus, it is clear that the recovery is far from broad-based. Rather, the current recovery has actually exacerbated the problems of the two major groups who will eventually be the engines of Japan's future growth — namely, small companies and households/consumers.

The yen weakness that has benefited large exporters has shackled smaller firms—which are predominately domestic market-oriented—by raising input costs via more expensive imports. Furthermore, as globalized competition has supported a deflationary trend, large firms—eager to lower their own input costs— have leaned heavily on small domestic suppliers for discounts. Record profits at corporate giants and increasing cost pressures on lightweight firms mean the legacy of the Koizumi era will include severe polarization between large and small companies.

Over the past five years, the gap between corporations and households also has been widening. Zero interest rates, while reducing the debt repayment burdens of capital-intensive large firms and financial institutions, conversely deprive households of interest income. At the same time, corporate restructuring has increased job insecurity and adversely affected working conditions. The cutting of labour's share, while a boon to corporations, has further constrained households' income. And to make matters worse for consumers, the yen's decline has undermined purchasing power by raising import prices. In other words, the benefits that corporations have gained during Koizumi's time in power have come at the expense of households.

Meanwhile, the revival of property markets in major cities has created a third rift - one between big cities and rural areas.

4. In Detail: Zero Interest Rates as a Cause of Divisions and Imbalance

4.1 Large firms vs small firms

Let's begin with the disparate fortunes of large and small firms. The MoF's quarterly report of Statistics on Incorporated Enterprises (quarterly SIE) shows that the gap is most pronounced in terms of profits. (Note: The quarterly SIE covers non-financial incorporated enterprises with paid-in capital of more than Y10m. The number of non-manufacturing small firms—those with paid-in capital of Y10m to Y100m—covered by the SIE tends to grow every year. Aggregated sales and profit data for this group are thus inflated due to the rise in the number of firms covered. We will use per-employee figures, rather than aggregate figures, to avoid the distortion.)

According to the quarterly SIE, current profit per employee at large manufacturing firms (paid-in capital of more than Y1 billion) has surged from the recent trough of an annualized Y1.64m in Q4 2001 to Y5.4m in Q1 this year. Comparatively, current profit per worker at small manufacturers has changed little. It stood at Y0.76m in Q1 2006 and has remained below Y0.8m since 1992. In non-manufacturing, similarly, current profit per employee at large non-manufacturers has risen to Y4.3m in Q1 this year from Y2.2m in Q4 2001, while employees at smaller non-manufacturers earned less than Y0.8m in every quarter over the same period. In a comparison of large firms, while manufacturers' profits rose more than threefold, non-manufacturers' achieved not-quite double profit growth. (Chart 1, 2)

Chart 1. Current Profit per employee (MFG., sear, millions of yen)

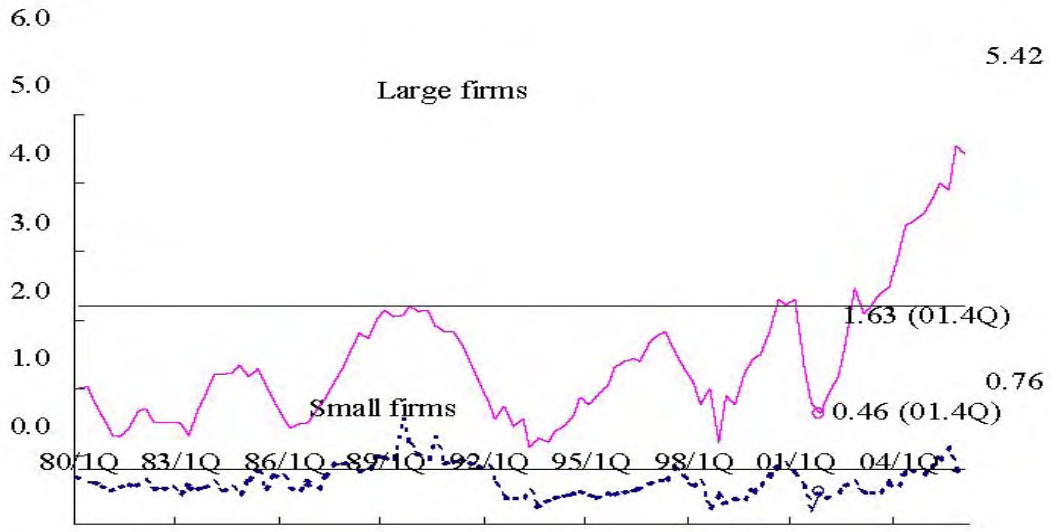
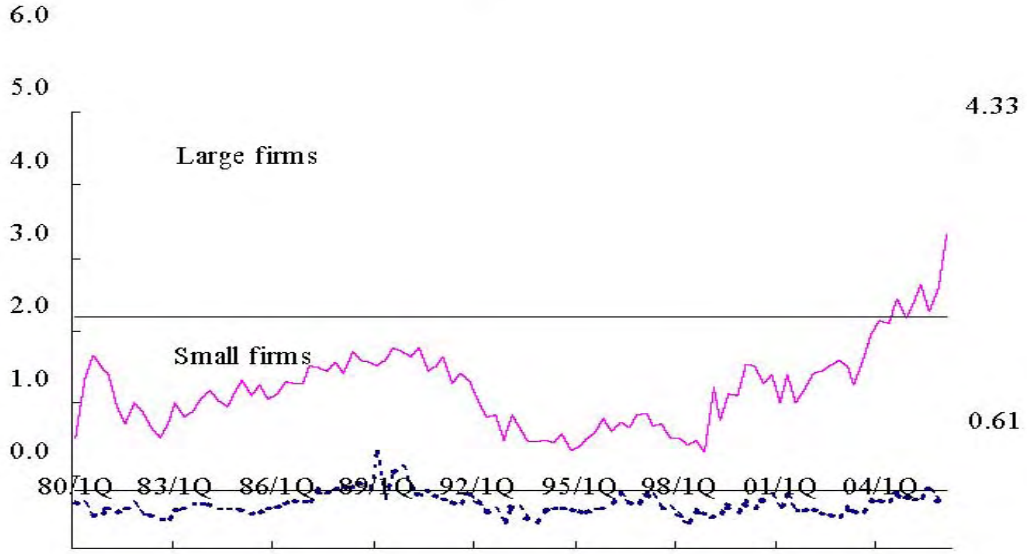


Chart 2. Current Profit per employee (Non-MFG., saar, millions of yen)



Regrettably, large manufacturing firms account for only a small fraction of the overall economy. Employment data from the FY2004 annual SIE (which covers all private non-financial firms in Japan, including very small firms with paid-in capital of less than Y10m) showed that large manufacturers employed just 6.6% of the 45.6m workers covered by the annual survey.

Large non-manufacturers employed another 8.3%, meaning that all large firms accounted for only 15% of the total. Small companies employed more than half of the total workforce, with an 11.7% share for manufacturers and a 39.9% share for non-manufacturers. The tally for very small firms—manufacturing and non-manufacturing combined—was 21.4% of total employment. Thus, companies with paid-in capital of less than Y100m accounted for 73% of total employment. (Table 1)

Table1. Employment and profit by firm size

	Employment (mil persons)		Operating profits (trillion yen)		Personnel expenses trillion yen	
	MFG	Non-MFG	MFG	Non-MFG	MFG	Non-MFG
Large	3.0	3.8	12.6	13.0	25.6	24.4
medium	1.4	4.1	2.4	4.3	7.9	19.5
small	5.3	18.2	3.2	7.2	21.1	65.3
very small	1.4	8.4	0.2	0.6	4.1	23.6
Total	11.1	34.5	18.4	25.1	58.7	132.8
share (%)						
Large	6.6	8.3	28.9	29.9	13.4	12.7
medium	3.1	9.0	5.5	9.9	4.1	10.2
small	11.7	39.9	7.5	16.6	11.0	34.1
very small	3.0	18.4	0.5	1.3	2.1	12.3
Total	24.4	75.6	42.3	57.7	30.7	69.3

Large frims: with paid-in capital of more than Y1bn
Medium: with paid-in capital of Y100m to Y1bn
Small: with paid-in capital of Y10m to Y100m, very small: capid-in capital of less than Y10m
Source: MoF, annual SIE

The BoJ's Tankan survey, covering firms with paid-in capital of more than Y20m, is one of the gauges used in setting monetary policy. But the annual SIE shows that firms not covered by the Tankan employ 48% of the private, non-financial workforce. This may be of no consequence to policymakers when business conditions at all companies are moving in the same direction. However, at times—like now— when large firms are soaring and small firms are suffering, it is folly to evaluate economic conditions based on data that omit the firms responsible for roughly half of all employment.

Tellingly, the ratios for shares of employment resurface in the results of opinion polls on economic conditions. In a recent survey by the Sankei newspaper, 74% of respondents answered "no" when asked if they thought the economy is recovering. It is no coincidence that this nearly matches the 73% of employment accounted for by the subset of private firms with paid-in capital of less than Y100m.

Data on added value per employee also point to a recovery concentrated among large firms. Large manufacturers have seen rises in added value and also in their annual personnel expenses per employee - i.e. workers' income. Large non-manufacturers have also seen improvement in added value, albeit less than that of large manufacturers, but these gains have not been accompanied by similar growth in employee income. Their personnel expenses per employee dropped from Y7.31m in Q1 1999 to Y6.44m in Q1 this year. All small companies—both manufacturers and non-manufacturers—have been hit by shrinking added value and employee income since the 1990s. Moreover, the absolute level of annual costs per employee for small firms is less than half of that for large manufacturing firms. The yearly expenses per employee at large manufacturers in Q1 this year stood at Y8.84m, versus Y4.08m and Y3.74sm for small manufacturers and non manufacturers, respectively. (Chart 3, 4, 5) The fact that large manufacturing—with its 6.6% share of non-financial private employment—is the only sector in which incomes are rising, does not bode well for a broad-based recovery in consumption.

Chart 3. Added Value per employee (MFG., saar, millions of yen)

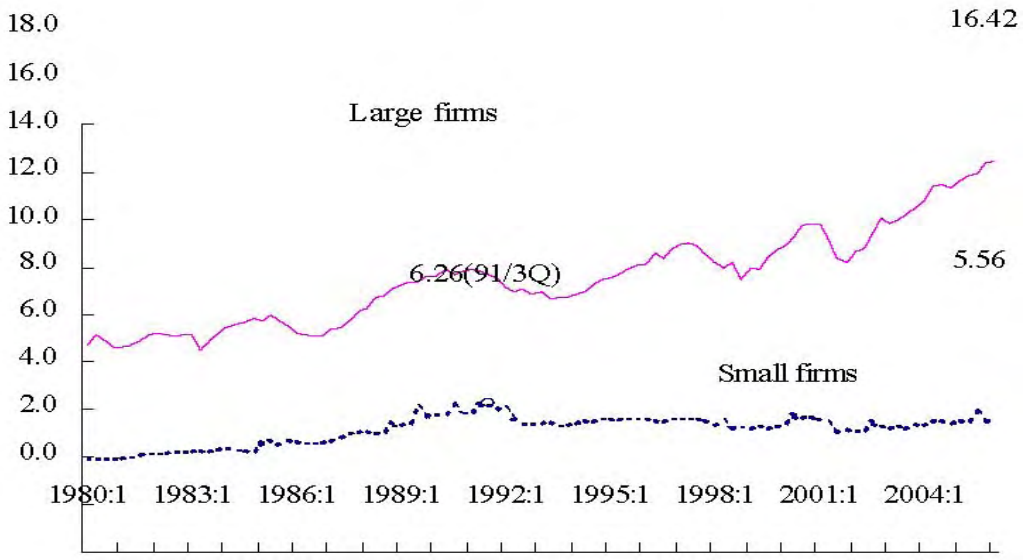


Chart 4. Personnel Expenses per employee (MFG., saar, millions of yen)

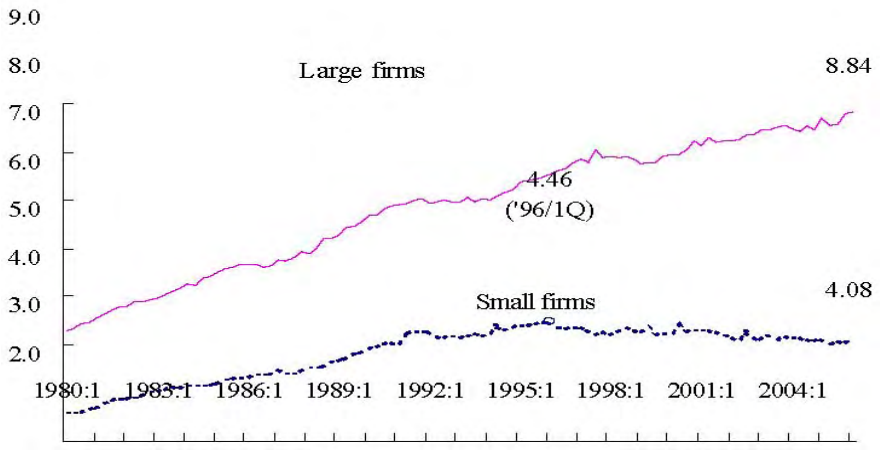
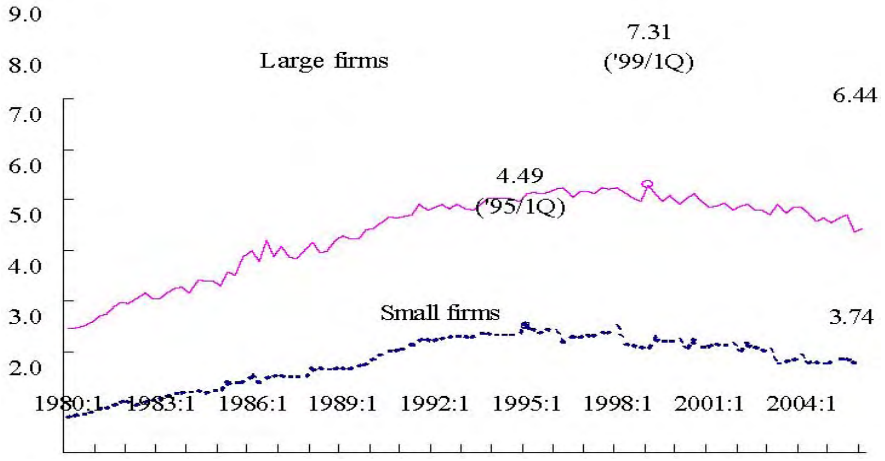
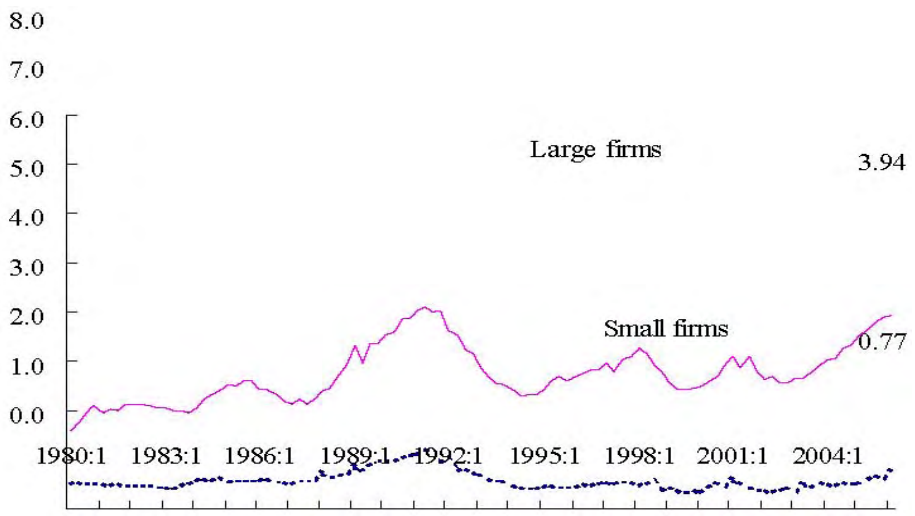


Chart 5.Personnel Expenses per Employee (Non-MFG., saar, millions of yen)

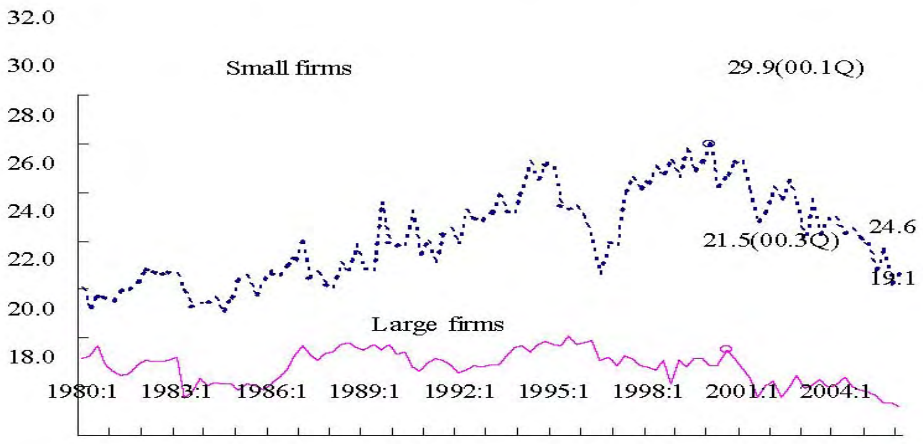


Again, large firms are leading the upturn in capital expenditure. (Chart 6) Small companies— plagued by lost added value—have little means to increase capex. Such narrowly focused capital spending will not foster the needed increase in capital efficiency which we shall consider shortly from a macro view. Higher capex by large firms may raise productivity in these firms, but as long as smaller firms' capex remains constrained, the productivity of small subcontractors will suffer. While this would hold down overall productivity in any economy, it is especially true in Japan, whose pyramid-shaped business structure has long been a source of economic strength.



The numbers so far clearly show Japan's corporate heavyweights coming out on top in the current recovery. The divergence between large and small firms is underlined by the way that their respective ratios of added value to sales have responded to deteriorating terms of trade. (Chart 7) Terms of trade for the overall economy have been deteriorating as input costs—led by oil and commodities—have been rising faster than output prices. While tighter terms of trade normally have a fairly uniform effect on companies, close scrutiny of the quarterly SIE reveals that the recent decline in the ratio of added value to sales has been less severe for large firms than for small ones. The survey showed that the ratio for large manufacturing firms dropped by 2.4 percentage points to 19.1% in Q1 this year from the recent peak of 21.5% in Q3 2000. The ratio at small manufacturing firms dropped by 5.5 percentage points—more than twice as fast—to 24.6% in Q1 this year from its recent high of 29.9% in Q1 2000. Large companies' demands for lower prices from small subcontractors have made it practically impossible for smaller firms to raise their selling prices. This is why small firms have had a much steeper fall in their ratio of added value to sales. Large manufacturers have been offsetting deterioration in their terms of trade by squeezing smaller subcontractors.

Chart 7. Added Value to Sales ratio (MFG., %)



4.2 Corporate borrowers vs household savers

Zero interest rates have dealt a huge blow to households, through loss of interest income. According to the Annual Report on National Accounts for FY2004 (the latest available), the savings rate for the household sector fell to 2.7% in FY2004, compared with 11.5% in FY1997. Though it is commonly said that a rise in consumption was mainly responsible for the drop in savings, a close look at the consumption and income figures indicates that this was not the case. The report shows that household consumption has risen negligibly, nudging up from Y277 trillion in FY1997 to Y279 trillion in FY2004. Meanwhile, disposable personal income dropped from Y309 trillion to Y287 trillion over the same period. Therefore, decreasing income—not increasing consumption—is the main cause of the plunge in the savings rate. (Chart 8, 9)

Chart 8. Japan Private consumption and Disposable Personal Income (trillions of yen)

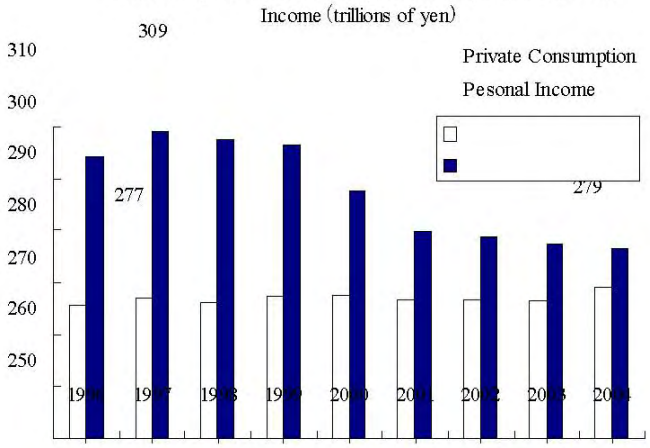
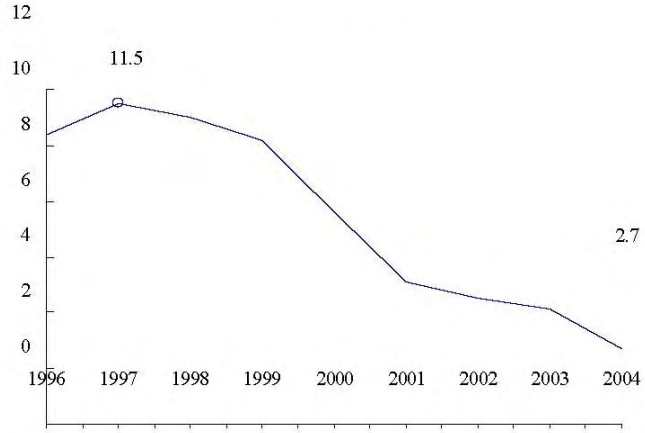


Chart 9. Saving Rate



Households have suffered a double-punch from a reversal in their balance of interest payments and from a corporate restructuring drive that has marginalized labour. Due to corporate cost-cutting, wages earned by households shrank to Y219 trillion in FY2004 from Y241 trillion in FY1997. And with interest income largely wiped out, households have been net payers of interest since 1996. Households paid a net Y9.2 trillion in FY2004.

Japanese households tend to hold more financial assets than the households of other developed economies, and a disproportionately large chunk of those assets are deposited with banks. Therefore, interest rates play a key role in determining the purchasing potential of consumers. According to the OECD, the net financial wealth of Japanese households equalled 359% of disposable income in 2004, compared with 298% in the US and 253% in the UK. A breakdown by asset class showed that equities accounted for only 39% of disposable income in Japan, compared with 116% in the US. On the other hand, Japanese households kept a much larger share of fixed-interest-income assets—such as bank deposits and bonds—than did their US counterparts. The weight of such assets to disposable income amounted to 320% in Japan, while it stood at 182% for the US. So unlike their peers in the US, Japanese households benefit little from appreciating stock prices, whereas rising interest rates, especially rates on bank deposits, significantly boost their financial standing.

On top of the double punch from loss of interest income and declining labour share, the Japanese household sector can be said to be suffering from a third punch arising from its own rapid ageing. Zero interest rates have thwarted the plans of retirees who had hoped to rely on returns on deposits as their main source of income in their twilight years. Plus, cuts in social security benefits have pinched disposable income at households with elderly family members. Caught in such a squeeze, seniors have apparently been forgoing savings to maintain their lifestyles, as revealed in the 2005 Annual Report on the Family Income and Expenditure Survey. The report showed that households headed by an individual aged 70 or over received an average Y168,439 per month in social security benefits in 2003. But the sum plunged to Y117,561 in 2005. This led a drop in disposable income from a monthly average of Y354,951 in 2003 to Y287,767 in 2005. The survey showed that, faced with drastically lower income, these households slashed their monthly savings to Y4,897 in 2005 from Y85,557 in 2003. Households headed by individuals aged between 60 and 69 also greatly reduced their savings to support spending.

Average monthly savings for this group dropped to Y25,257 from Y70,235 in 2000. (Table 2)

	aged between 60 and 69						aged 70 or over						average					
	wages & salaries	social security benefits	consumption	disposable income	savings	saving rate	wages & salaries	social security benefits	consumption	disposable income	savings	saving rate	wages & salaries	social security benefits	consumption	disposable income	savings	saving rate
CY2000	311590	97381	300900	371134	70235	18.9	203239	147962	256053	329730	73677	22.3	478717	15693	307317	429338	122021	28.4
2001	299766	93005	289336	355798	66463	18.7	210476	175101	250207	357060	106853	29.9	466164	16765	298733	419505	120772	28.8
2002	291400	78099	287501	334449	46948	14.0	196146	149424	269803	332435	62631	18.8	459911	13930	296037	409619	113582	27.7
2003	286372	79434	283873	326412	42539	13.0	214876	168439	269394	354951	85557	24.1	450956	14503	292217	401787	109570	27.3
2004	287593	69586	288728	315650	26922	8.5	205195	155780	232872	310360	77488	25.0	457521	13119	296725	405591	108866	26.8
2005	284771	75628	301967	327224	25257	7.7	186658	117561	239670	287767	4897	1.7	445850	14662	296790	398856	102066	25.6
2000=100																		
2000	100.0	100.0	100.0	100.0	100.0		100.0	100.0	100.0	100.0	100.0		100.0	100.0	100.0	100.0	100.0	
2001	96.2	95.5	96.2	95.9	94.6		103.6	118.3	97.7	108.3	145.0		97.4	106.8	97.2	97.7	99.0	
2002	93.5	80.2	95.5	90.1	66.8		96.5	101.0	105.4	100.8	85.0		96.1	88.8	96.3	95.4	93.1	
2003	91.9	81.6	94.3	87.9	60.6		105.7	113.8	105.2	107.6	116.1		94.2	92.4	95.1	93.6	89.8	
2004	92.3	71.5	96.0	85.1	38.3		101.0	105.3	90.9	94.1	105.2		95.6	83.6	96.6	94.5	89.2	
2005	91.4	77.7	100.4	88.2	36.0		91.8	79.5	93.6	87.3	6.6		93.1	93.4	96.6	92.9	83.6	

Source: Government Statistical Bureau, 'Annual Report on the Family Income and Expenditure survey'

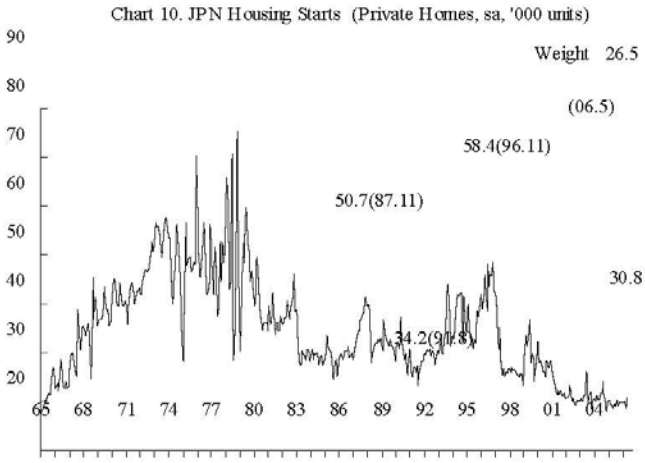
4.3 Booming speculative housing starts vs declining real demand

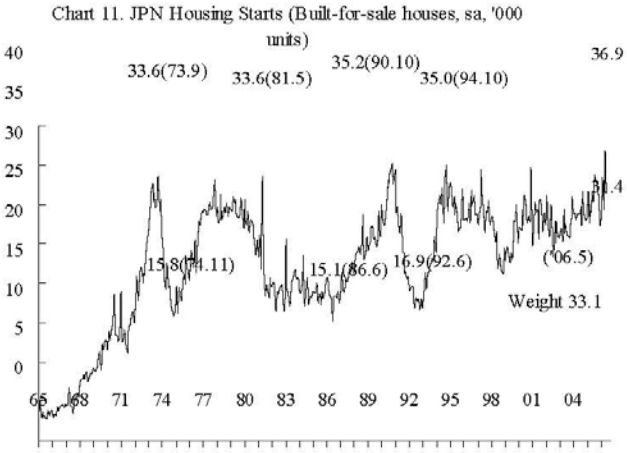
The prolonged zero interest rate policy, by creating excess liquidity, has fuelled a property boom. And further fuel has been provided by one of Koizumi's deregulation measures: namely, raising the limit on the ratio of floor space to building lots in urban areas. The combined result is the current property bubble in major cities, particularly in Tokyo.

Housing bubbles have regularly surfaced in Japan's economy over the past two decades. During the bubble period of the late 1980s, housing starts took off - led by rental properties and built-for-sale houses. After the bubble burst, lower interest rates and tax breaks—part of a stimulus package to revive the economy—fuelled a resurgence in housing starts, largely for privately owned homes. Since 2004, a third bubble in housing investment has been forming.

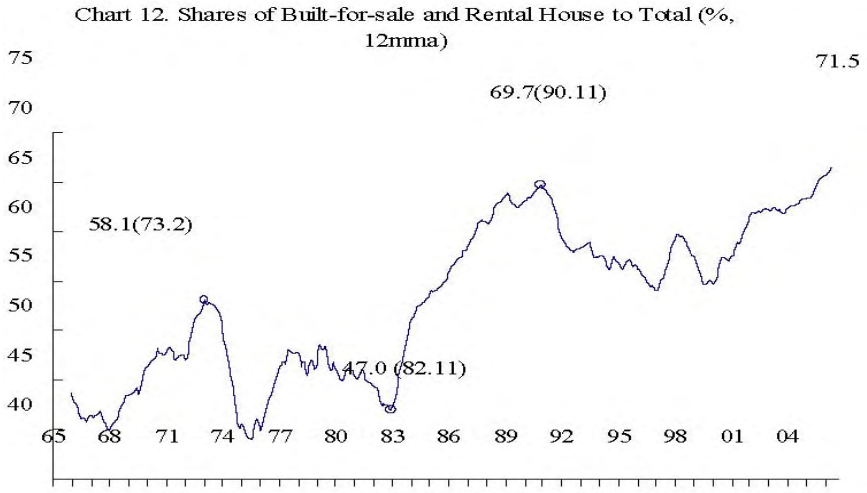
As in the bubble of the late 1980s, the major drivers of the current boom are starts of built-for-sale houses and rental properties, while private home construction is in a slump. According to the land ministry's monthly construction statistics, starts for private homes, after hitting a recent peak of 58,400 units in November 1996, have lately been hovering at around 30,000 units per month - the lowest level since 1965. In contrast, starts for built-for-sale houses—mainly condominiums—increased to 36,900 units in April this year, surpassing the

previous record of 35,200 units marked in October 1990. Starts for rental properties have also grown, but at a more modest pace. (Chart 10, 11)





Due to the changing makeup of construction, the share of private home-building to total housing starts dropped to 28% (12-mma) this May, while the shares of built-for-sale houses and rental units increased to 29.8% and 41.7%, respectively. To gauge bubbles, housing starts can be divided into two categories: one supported by real demand and another driven by speculation. By this measure, construction supported by real demand—which comprises starts for private homes—is now 28%, versus more than 50% in early 1983. The speculative category—which includes built-for-sale houses and rental properties— accounts for an astonishing 71.5% share of total starts.(Chart 12) Speculative starts have rarely accounted for such a large share of total construction. In the early 1970s, Kakuei Tanaka's "Transformation of the Japanese Archipelago" policies propelled a construction boom that by February 1973 had lifted speculative activity's share of total starts to 58.1%. Again, as a result of the late 1980s bubble, combined starts for built-for-sale houses and rental properties made up 69.7% of overall starts in November 1990 - up from 47% in November 1982. The upshot: today's 71.5% figure makes the ongoing property bubble in Japan the worst to date in terms of imputed speculative activity. Although it may be less visible than past bubbles because it is concentrated in select cities, the fallout could be devastating considering that Japan's shrinking population casts doubt on whether new demand will materialize to match speculators' bets.



The concentration of speculative investment in big cities exacerbates another problem: the polarization between urban and rural areas. On top of the shrinking and ageing of Japan's population, property bubbles centered on big cities hasten the hollowing out of rural areas by stimulating migration to metropolitan hubs. The BoJ is said to be worried about the current boom in speculative real estate investment. Typically, Japan's central bank sees the accelerating property bubble (rather than the fundamental rationale of steering the economy to consumption-led growth, by helping households/savers) as a reason to normalize monetary policy.

5. Related Macro-Economic Problems and Constraints

5.1 Low capital efficiency

One fundamental problem preventing a sustainable broad-based capex recovery is chronically low capital efficiency. The average annual growth rate of Japan's real GDP over the 10 years to 2005 was 1.3% - compared with 3.3% for the US, 2.8% for the UK, 2.2% for France and 1.4% for Germany. At the same time, the capital spending revival at large firms has helped lift Japan's ratio of capex to nominal GDP. Japan's capex share stood at 15.3% in Q1 this year, against the recent trough of 13.2% in Q2 2002. Even the low figure is much higher than the ratio in most other mature economies. The capex ratio to GDP for the US was 10.7% in 2005, while the ratios for Germany and the UK were 10.4% and 9.3%, respectively. The combination of a high investment ratio and low GDP growth signals that Japan's return on new investment is extremely low.

Capital stock efficiency—the ratio of GDP to capital stock—is another troubled area. All-industry capital efficiency (1995=100) dropped to 84 in 2004 from 156 in 1980. When overseas markets falter in the wake of a slowing US economy, Japanese exports will slide and domestic production—in the absence of healthy domestic demand—will drop. In this light, the recent uptick in capex led by large manufacturers will, in the end, only contribute to a domestic over-investment problem that will lower capital stock efficiency further.

Japan is long overdue in improving returns on new investment and raising capital stock efficiency. Until these tasks are completed—by paring excess capacity and lowering the capex-to-GDP ratio to the norms for developed economies—the chances of steady, broad-based growth in capital spending remain slim.

5.2 Unfavourable terms of trade

According to the BoJ's input-output price index for the manufacturing industry, terms of trade dropped sharply to 89.6 this May from a recent peak of 101.6 in March 2002. So far, as documented earlier, smaller firms have borne the brunt of this deterioration in Japan's terms of trade. (Chart 13, 14) From now on, even if input costs fall due to easing commodities prices, terms of trade are unlikely to improve. Rather, manufacturers may well be forced to cut output prices as slowing overseas demand tips the export-dependent economy back into recession. With domestic demand weak and exports slowing, domestic production will unwind and lead to deceleration in productivity growth. This means manufacturers will be unable to rely on faster productivity growth to counter deterioration in terms of trade. In this situation, even large manufacturers will be unable to stave off profit pressures.

Chart 13. JPN Input & Output Prices (MFG., 2000=100)

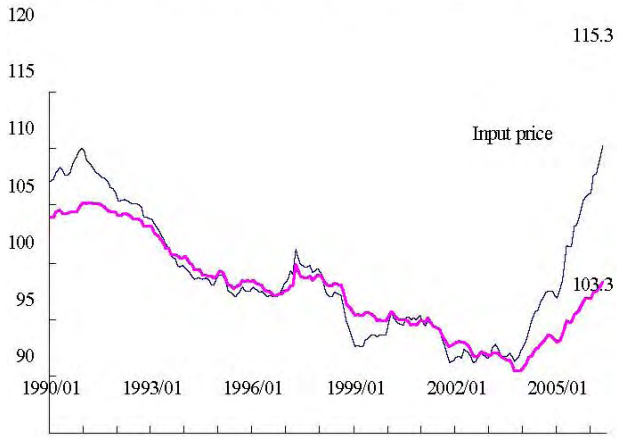
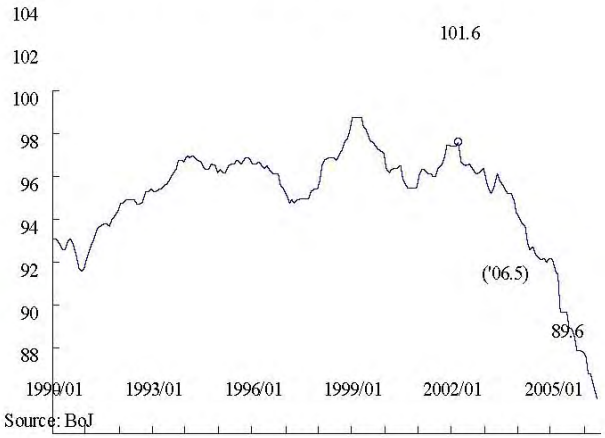


Chart 14. JPN Output Price/Input Price (MFG., 2000=100)



Source: BoJ

5.3 Labour's share at rock bottom

The fact that labour's share seems to be squeezed to the limit removes another profit-boosting recourse for large manufacturers. First, demographic change is tightening the supply/demand situation in the labour market. Firms are stepping up hiring of new graduates in anticipation of outflows of baby boomers, who start reaching retirement age next year. At the same time, the population of 20- to 24-year-olds is falling, which means fewer potential new entrants to the workforce and more competitive recruitment. (According to the Nikkei newspaper, the population of 20- to 24-year-olds is estimated at 7.52m. That is 23% smaller than the 30- to 34-year-old population.) Second, there are increasing political risks to allowing further falls in labour's share. Ahead of the Upper House election next summer, the growing wage gap is already becoming a focus of discontent among voters.

Indeed, some hard data confirm that the fall in labour's share is already coming to an end. According to the monthly Labour Survey, wages at firms with five or more employees rose an average 0.3% YoY in the first five months of this year. While overall growth is still lacklustre, the survey showed that wages at large firms have been increasing at a faster pace. Wages at firms with 30 or more employees rose an average 1% YoY over the same period. Rises in unit labour costs will take a bite out of corporate profits, and large firms will feel the most pain.

6. A Truly Reformist Post-Koizumi Government? An Unlikely Scenario.

All in all, the process whereby winners have continued to benefit at the expense of losers, may now be hitting a wall, for the following specific reasons:

- Corporations have no more leeway to reduce labour's share of added value, firstly because labour's share is already low by historical standards, and secondly because the dwindling youth population is creating tight supply/demand conditions for labour.
- Small subcontractors will soon be unable to accommodate additional requests for cuts in prices.
- Continued yen weakness will eventually lead to a pickup in inflation, which would prop up the yen in real terms.
- Interest rates can fall no further.

The stage is therefore set for the coincidence of an economic turning point and, as Koizumi steps down, a political turning point.

Political fallout from Koizumi's five-year stint in power is now beginning to be felt in two main areas: First, the drop in labour's share has become a hot political issue. Second, there is growing awareness that the plight of small companies has widened the gulf between the rich and the poor. Also, as zero interest rates have showered benefits on large firms and financial institutions while devastating households, resentment among the public toward the BoJ has been mounting. This is partly why the revelation of the BoJ governor's investment in the Murakami fund, whose founder was arrested on suspicion of insider trading, has become such a big scandal.

So what political developments can we expect in the immediate post-Koizumi era? For the sake of simplicity, let us consider three scenarios.

In Scenario 1 a proponent of "Koizumi Reform" succeeds him as prime minister. In this case, given that the processes associated with the so-called Koizumi Reform seem to have reached their natural limits, the next government will probably be short-lived.

In Scenarios 2 and 3, the next prime minister breaks with Koizumi's policies, in either one of two directions.

In Scenario 2 the next prime minister emerges from the LDP's old guard, meaning the new government will backtrack on deregulation and reinstate policies that focus on the distribution of wealth. In response to economic weakness, low interest rates will be kept in place, with the bad consequences already described for households/savers and the economy as a whole.

Scenario 3 envisions a new truly reformist movement. The government makes a clean break from current macro-economic policy. Economic reform would be led by the goal of establishing self-sustaining, consumption-led growth, with a policy mix of normal interest rates and a strong yen. Regrettably, it is difficult to envisage such a reversal of macro-economic policy taking place in Japan until things get really bad.

Under the much more probable first two Scenarios, either with a Koizumi disciple or an old-guard conservative, low interest rates and a weak yen policy are likely to continue to be the main macroeconomic strategies. Because the export-led economic structure would then remain intact, the slowing of external demand would bring painful economic deterioration. But for the longer-term health of the economy, this may be a necessary development. Probably only a deepening recession can create the conditions for a government to arise that embraces real reform.

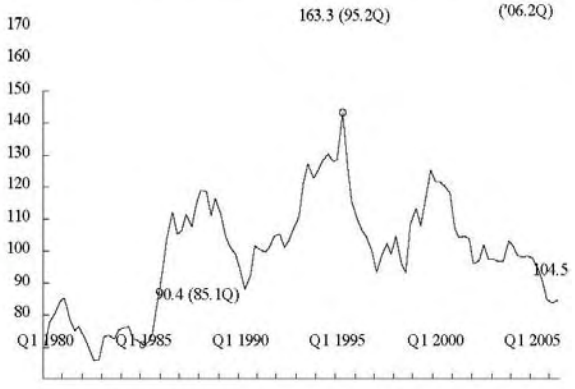
7. Japan's Vulnerability to the Coming Structural Adjustment in the US

In the US, what is needed is a shift in the economy from import/consumption-led growth to export/ investment-driven expansion. Any near-term structural adjustments in the US, however, are more likely to entail a fall in imports than a rise in exports. The implication for Japan is that, whereas on Koizumi's watch Japan benefited from robust US growth and became even more export-dependent, Koizumi's successor will be faced with a harsher international environment and even sterner domestic imperatives.

Shifting to a consumption-driven economy has been the paramount challenge for the Japanese economy since the 1980s. Policymakers' passive acceptance during the past five years of zero interest rates, perversely, has actually entrenched Japan's export-dependency. The ratio of exports to GDP has increased from 10.4% in Q4 2001 to 15.5% in Q1 this year - surpassing the peak marked just before the Plaza Accord. (Chart 15, 16) Reversing the trend by developing a domestic demand-led economic base is the most fundamental imperative. The first step toward meeting that challenge is raising interest rates, and raising interest rates on deposits in particular, in order to breathe new life into consumers.

Chart 15. JPN Export Ratio (As % of Nominal GDP, %)

Chart 16. Yen's Real Effective rate (1973.3=100)



What Should Follow Koizumi's Reforms

Tadashi Nakamae
Tomoko Saito

The ultimate goal of economic reform in Japan is to shift from an export and investment-led to a consumption-driven economy. Living standards in Japan can improve only when household income and consumption rise. Deregulation that strengthens the corporate sector and privatization of public firms are only means to that end, not ends in themselves.

Japan's nominal GDP stood at Y505 trillion in 2005, while disposal personal income and household consumption totaled Y287 trillion and Y284 trillion, respectively. This equals a disposable income-to-GDP ratio of 57% and a consumption ratio of 56%. In the US, the ratios are much higher at 72% for disposable income and 73% for consumption.

Conversely, the ratio of capital investment to GDP in Japan is 15%, against the ratio in the US of 10%. Despite the comparatively high investment ratio, the average annual growth rate of Japan's real GDP in the 10 years to 2005 was 1.2%, compared with 3.2% in the US over the same period, meaning Japan's return on investment is extremely low.

There is a clear pattern of under-consumption and overinvestment in Japan vs. over-consumption and underinvestment in the US. As a result, Japan—like many other Asian nations—has seen its dependency on US-bound exports increase significantly over the past several years. This is a highly vulnerable economic structure. If the US economy slips into recession, Japan would lose a condition for growth.

Another problem with an export-driven economy is that large manufacturers dominate most export activity, so the benefits of increased exports do little to help small firms and domestic-oriented industries. This creates severe imbalances between large and small companies, urban and rural areas, and corporations and households.

To correct the economy's over-dependence on exports, it is necessary to facilitate income transfer from corporations to households. The first step must be to revive household interest income by lifting rates on deposits. No progress can be made as long as Japanese households' Y1, 500 trillion in financial assets yields virtually no returns. Interest rate increases

should continue until a trend of yen appreciation clearly takes hold, for a stronger yen enhances consumer buying power.

In sum, the economy must be revitalized via higher interest rates, a stronger yen and higher consumption. This has long been the imperative of Japanese economic reform.

TAKEHIKO NAKAO

Resurgence of the Japanese Economy and Opportunities in Asia

Resurgence of the Japanese Economy and Opportunities in Asia

June 27, 2006
Nikkei Seminar in New York

Takehiko Nakao
Minister (Finance), Embassy of Japan

Main Points of This Presentation

I. **Resurgence of the Japanese economy and opportunities**

II. **What has brought about the resurgence?**

III. **Policy challenges for the Japanese economy**

IV. **The rise of China as a great economic and political power**

V. **Greater opportunities in East Asia and India**

I. Resurgence of the Japanese economy and opportunities

- Mere size of the Japanese economy matters
- Growth rates picking up led by private consumption and investment
- Non-performing loans further decreasing and three excesses ending (production capacity, labor, and indebtedness)
- Strong recovery of earnings of banks and non-financial corporations
- Stock prices jumping, and land prices stabilizing with some increase in part of Tokyo
- Opportunities for foreign investors: in addition to the above,
  1) strong legal frameworks, 2) more inward-FDI-friendly environment,
  3) demanding but reliable consumers, 4) network with Asia

G7 and Emerging Market Economies (in 2004)

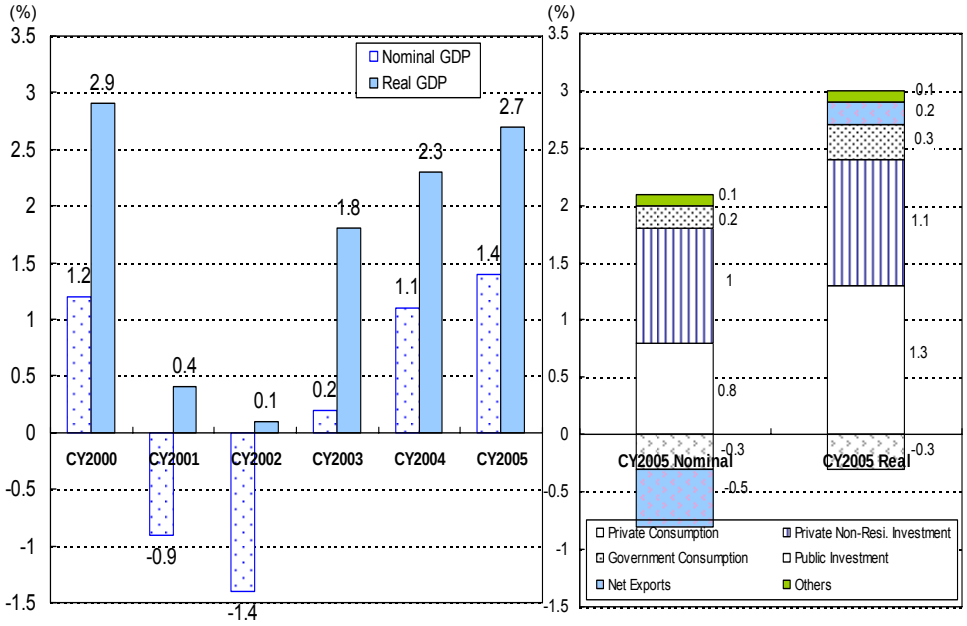
Country	GNI ($ billion)	Ratio of GNI in the world (%)	Per capita GNI ($)	Population (million)
USA	12,169	30.2	41,440	294
Japan	4,734	11.8	37,050	128
Germany	2,532	6.3	30,690	83
England	2,013	5.0	33,630	60
France	1,888	4.7	30,370	60
Italy	1,513	3.8	26,280	58
Canada	905	2.2	28,310	32
Total for G7	**25,755**	**63.9**	**-**	**715**
China	1,938	4.8	1,500	1,296
India	673.2	1.7	620	1,080
Brazil	551.6	1.4	3,000	184
Russia	488.5	1.2	3,400	144
Total for BRICs	**3,651**	**9.1**	**-**	**2,704**
Total in the World	**40,282**	**100.0**	**-**	**6,365**

(Note) BRICs: China, India, Brazil and Russia
(Source) World Bank: World Development Indicators Database (March, 2006)

Developments of Real and Nominal GDP

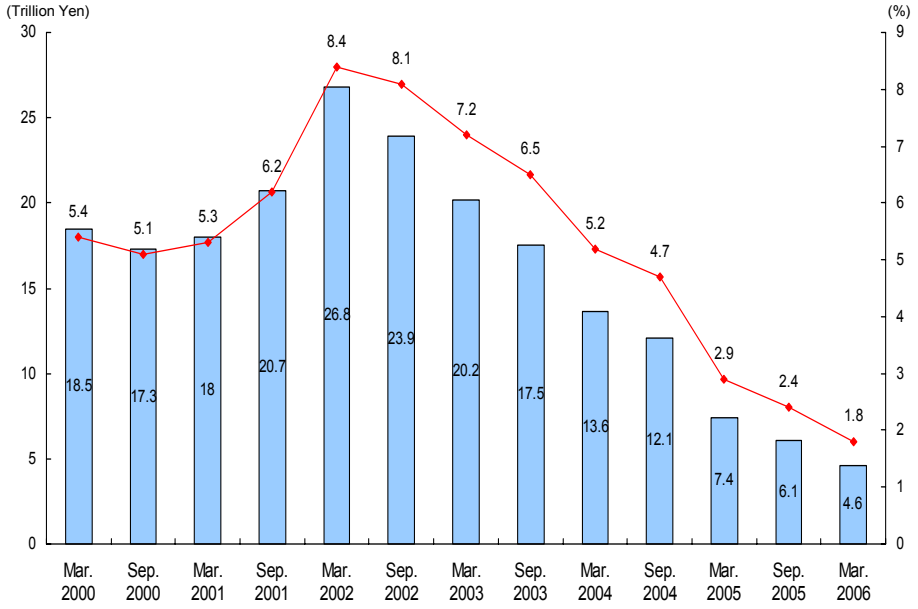
◆The economy is recovering.

◆Growth (annualized) in 1 qtr. 2006 is also strong; 3.1% real and 1.6% nominal.



(Source) Cabinet Office

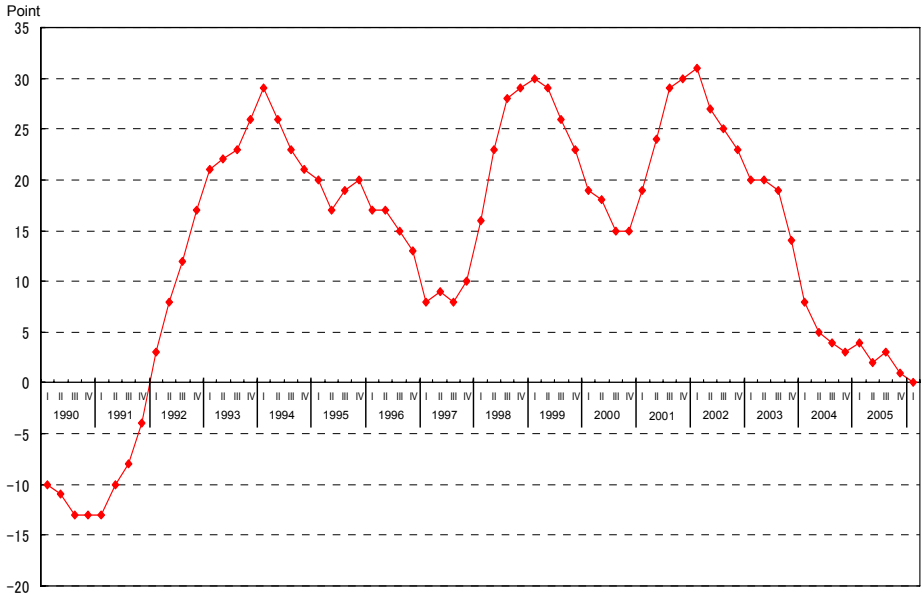
Non-Performing Loans and Ratio of NPLs to Total Loans (Major Banks)



(Note) The figures are based on the Financial Reconstruction Law. "NPLs" refer to "Special Attention" loans or below.

Firms' Judgment on Production Capacity
DI of "Excessive Capacity"- " Insufficient Capacity"

[Excessive] – [Insufficient}

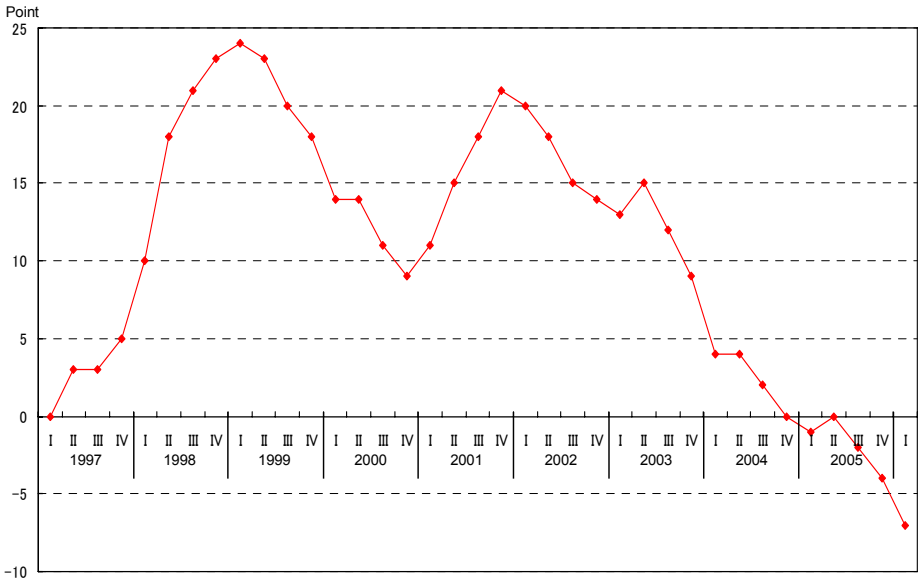


All enterprises (manufacturing)

(Source) Bank of Japan

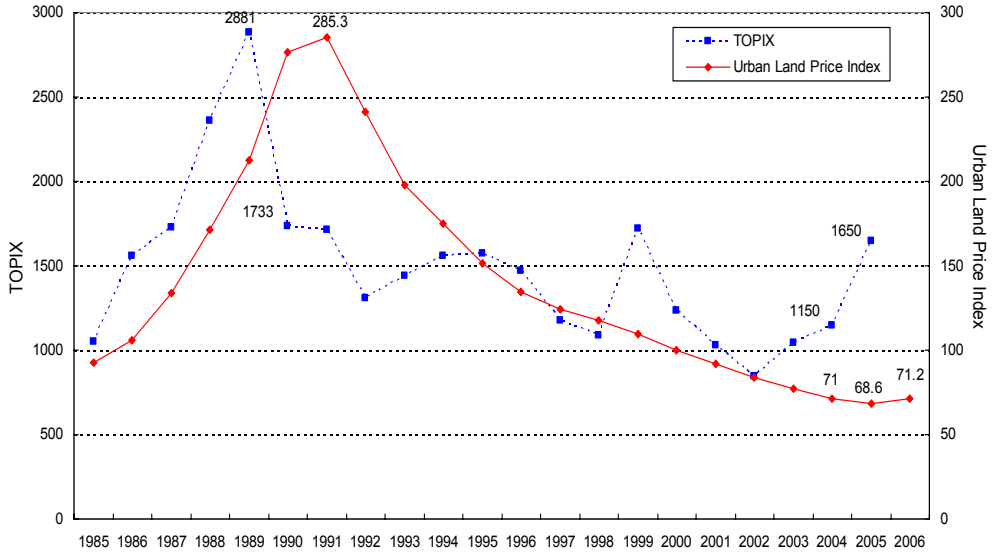
Firms' Judgment on Employment Conditions
DI of "Excessive Employment"- " Insufficient Employment"

[Excessive] – [Insufficient}



(Source) Bank of Japan

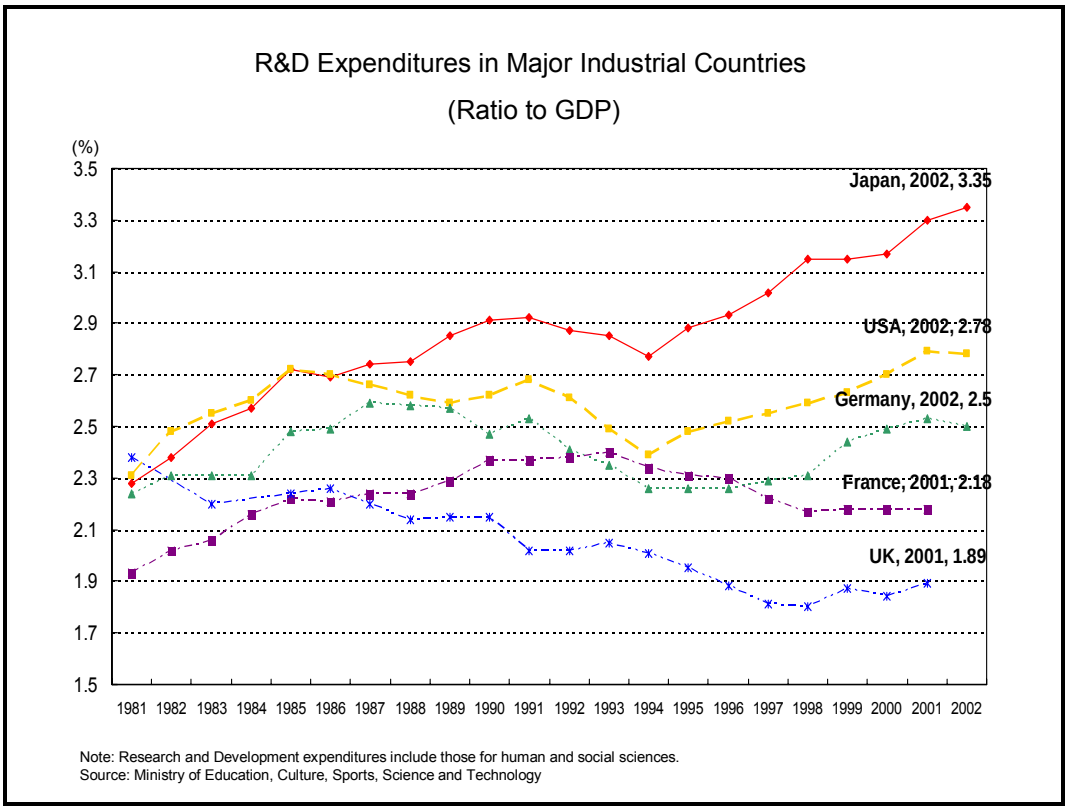
Trends of the Tokyo Stock Price Index & Urban Land Price Index

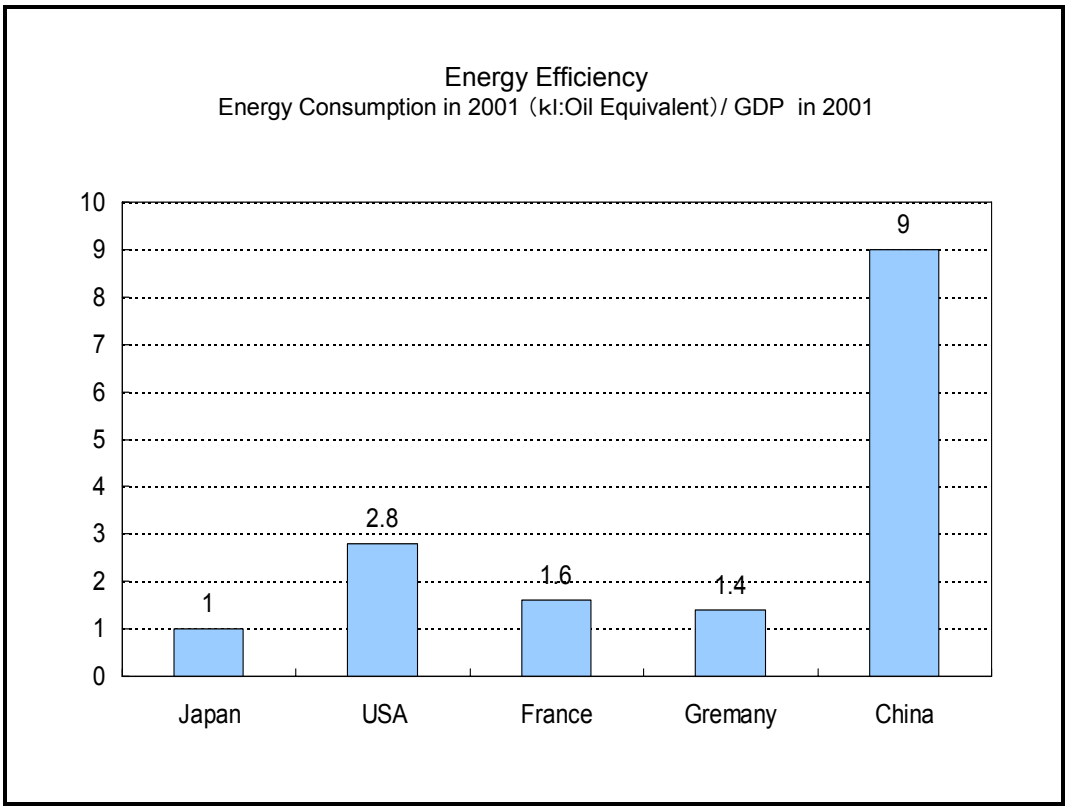


(Source) Tokyo Stock Price Index (TOPIX)
Urban Land Price Index of the 6 Large City Areas (Japan Real Estate Institute "Urban Land Price Indices")
(Note) TOPIX: Year End (CY), January 4th, 1968 = 100
Urban Land Price Index: As of March 31st of Each Year, March 31st, 2000 = 100

II. What has brought about the resurgence?

- Salient structural reforms under PM Koizumi such as privatization of postal services and national highways, but not just that
- Enduring efforts by corporate and banking sectors to restructure their business and resolve bad debts
- Maintained efforts for technology and service innovations
- Continuing structural reforms through 1990s to today
  - Deregulations in transportation, communications, utilities, etc.
  - Strengthening commercial and bankruptcy laws
  - Transformation of the labor market
  - Administrative reforms based on the idea of New Public Management (Disclosure of Public Information Act, Evaluation of Policy Act, establishment of Financial Service Agency, etc.)

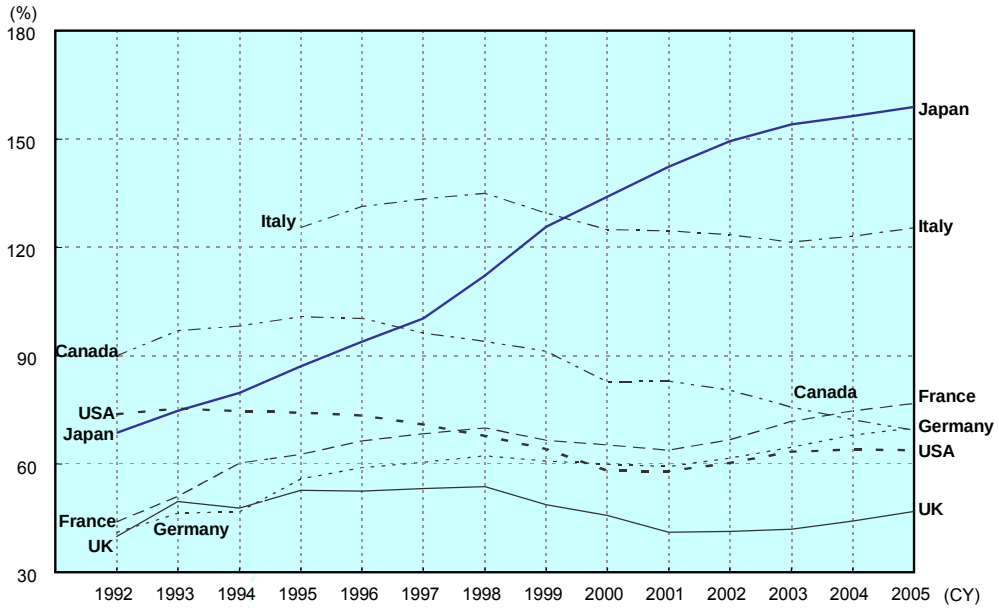

R&D Expenditures in Major Industrial Countries
(Ratio to GDP)
(%)
3.5
3.3
3.1
2.9
2.7
2.5
2.3
2.1
1.9
1.7
1.5
Japan, 2002, 3.35
USA, 2002, 2.78
Germany, 2002, 2.5
France, 2001, 2.18
UK, 2001, 1.89
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002
Note: Research and Development expenditures include those for human and social sciences.
Source: Ministry of Education, Culture, Sports, Science and Technology


Energy Efficiency
Energy Consumption in 2001（kl:Oil Equivalent）/ GDP in 2001
10
9
8
7
6
5
4
3
2
1
0
1
2.8
1.6
1.4
9
Japan
USA
France
Gremany
China

III. Policy challenges for the Japanese economy

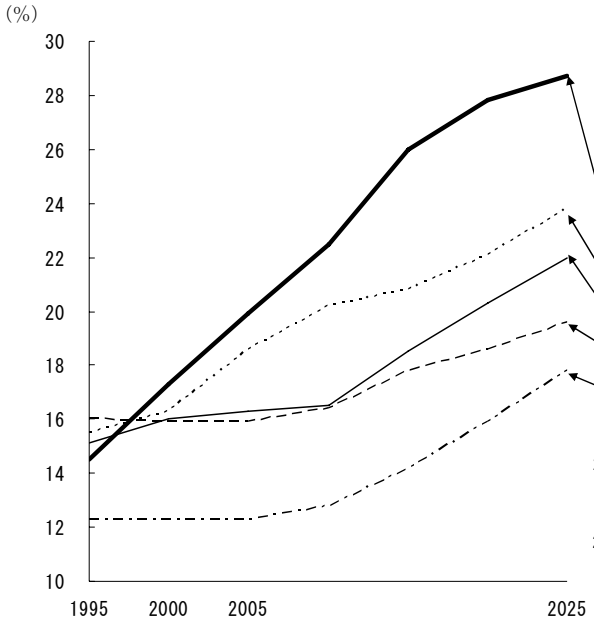
- Need to regain fiscal sustainability (now, gross debt exceeding 160% of GDP)
- Declining and aging population
- Need for continuing structural reforms
- Ensuring competitive environment while maintaining the integrity of the society
- Need to redefine the core competences of the Japanese economy

General Government Gross Debt
(International Comparison)



Aging of the Population in G5

Ratio of People Older than 65 within the Total Population



(%)

(CY)	1995	2000	2005	2025
Japan	14.5	17.3	19.9	28.7
Germany	15.5	16.3	18.6	23.8
France	15.1	16.0	16.3	22.0
UK	16.0	15.9	15.9	19.6
USA	12.3	12.3	12.3	17.8

(Note)

1. Figures for Japan from "National Census" and "Japanese Future Demographic Projections" (National Institute of Population and Social Security Research, January 2002)
2. Figures for other nations from UN projections

IV. The rise of China as a great economic and political power

- Some historical perspectives on Japan-China relation
  - Long history of peaceful co-existence
  - Expressing "feeling of deep remorse and heartfelt apology"
- Growing economic tie between Japan and China
- Deepening relations between Japan and China in other areas
- Challenges for China
  - More balanced growth pattern (more domestic consumption)
  - More flexible exchange rates
  - Promotion of financial and service sectors
  - Reform of state-owned enterprises
  - Social safety net, gap between regions and between sectors
  - Environment and energy
  - Stronger governance and legal frameworks including IPR
- China as a great opportunity

Japan's Trade with China and Hong Kong

(Unit: 10 billion yen)

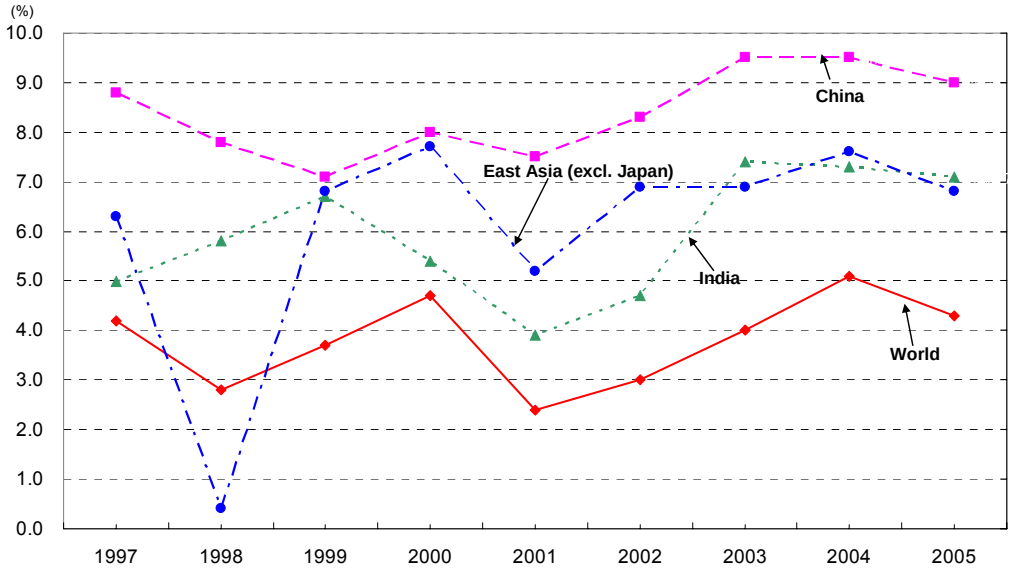
CY	With China and Hong Kong				
	Export		Import		Balance
		Change		Change	
1999	516	-7.3%	508	0.2%	8.6
2000	620	20.1%	612	20.5%	8.3
2001	659	6.2%	720	17.7%	-61.4
2002	816	23.8%	791	9.7%	25.0
2003	1009	23.7%	889	12.4%	120.4
2004	1183	17.2%	1037	16.7%	145.0
2005	1281	8.3%	1214	17.0%	66.8
Share in Total	19.5%	—	21.3%	—	—

Data: Custom's Statistics, Ministry of Finance, Japan

V. Greater Opportunities in East Asia and India

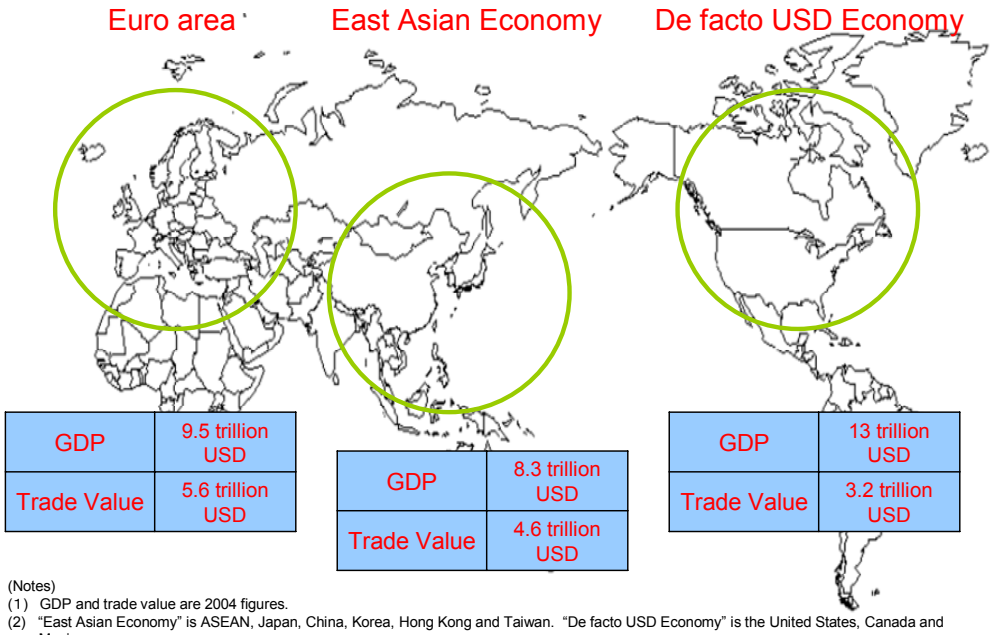
- High growth rates in East Asia and India and reform efforts in economic policy and governance
- Intensifying economic integration in East Asia; should be open and promote reform
- East Asian economies as increasingly important trade partners for Japan and the US
- India's opportunities
  - Reform efforts from the early 1990s and high growth
  - Huge potential market of 1.1 billion people, and young labor force
  - Rich human resources in technology and science
  - Fast growing IT-related "business process outsourcing"
  - Chances for pharmaceutical, medical and automobile industries
- Some caveats
  - Still very low per capita income of US$620 (China; US$1500)
  - Still minor trade partners for Japan and the US (shares at 1%)
  - Under-developed infrastructure (highways, electricity, airports)
  - Lower FDI and domestic savings compared to China
  - Remaining red tapes, and strict labor laws

Real GDP Growth Rate of Asia



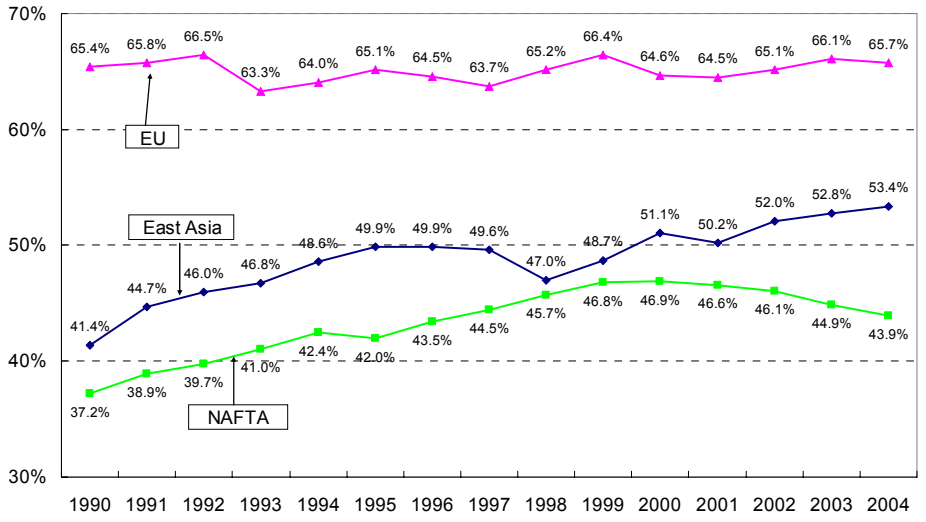
（Note1） East Asia includes ASEAN (excluding Myanmar and Brunei Darussalam), Korea and China.
（Note2） 2005 of China, India, Aggregate World and East Asia is the predictive value.
（Sources） East Asia: ADB "Asian Economic Monitor 2005", Others: IMF "World Economic Outlook Database 2005 September"

Three Economic Areas in the World



(Notes)
(1) GDP and trade value are 2004 figures.
(2) "East Asian Economy" is ASEAN, Japan, China, Korea, Hong Kong and Taiwan. "De facto USD Economy" is the United States, Canada and Mexico.
（Sources）IMF " International Financial Statistics", IMF "World Economic Outlook Database 2005 September", and IMF " Direction of Trade Statistics"

Share of Intraregional Trade in East Asia, EU, NAFTA



(Note 1) The trade amount is the sum of imports and exports.
(Note 2) East Asia: ASEAN, Japan, China, Korea, Taiwan, and Hong Kong, EU: 25 countries, NAFTA: North American Free Trade Agreement
(Source) IMF "Direction of Trade Statistics"

Japanese Trade Partners (CY 2005)

(Unit: billion yen)

	Export		Import		Balance
		Share (%)		Share (%)	
Asia	31,798	48.4	25,258	44.4	6,540
China & Hong Kong	12,808	19.5	12,140	21.3	668
Taiwan	4,810	7.3	1,991	3.5	2,818
South Korea	5,143	7.8	2,696	4.7	2,447
India	388	0.6	352	0.6	36
ASEAN	8,342	12.7	8,004	14.1	338
USA	14,807	22.6	7,071	12.4	7,736
EU	9,653	14.7	6,467	11.4	3,186
Russia	495	0.8	682	1.2	-187
CIS (excl. Russia) & Central Europe	9,653	14.7	6,467	11.4	3,186
Middle East	1,823	2.8	9,660	17.0	-7,837
Total in the world	65,662	100.0	56,881	100.0	8,782

(Source) Ministry of Finance

The US's Trade with Japan, China, India & ASEAN (CY 2005)

(Unit: billion dollars)

	Export		Import		Balance
		Share (%)		Share (%)	
Japan	55.5	6.1	138.0	8.2	-82.5
China	58.3	6.4	252.4	15.1	-194.1
India	8.0	0.9	18.8	1.1	-10.8
ASEAN	49.6	5.5	98.9	5.9	-49.3
Total in the world	906.0	100.0	1,673.5	100.0	-767.5

(Source) U.S. Census Bureau: U.S. International Trade in Goods and Services - Annual Revision for 2005

The Ease of Doing Business Index Economy Rankings

Overall Ranking	Economics	Rankings of Selected Topics
1	New Zealand	
2	Singapore	
3	**USA**	**Starting a business 3, Dealing with licenses 17, Protecting investors 7, Trading across borders 17, Enforcing contracts 10**
	⋮	
9	England	
10	**Japan**	**Starting a business 81, Dealing with licenses 5, Protecting investors 14, Trading across borders 12, Enforcing contracts 3**
	⋮	
19	Germany	
20	Thailand	
	⋮	
44	France	**Starting a business 126, Dealing with licenses 136, Protecting investors 100, Trading across borders 48, Enforcing contracts 47**
	⋮	
70	Italy	
	⋮	
91	**China**	
	⋮	
116	**India**	**Starting a business 90, Dealing with licenses 124, Protecting investors 29, Trading across borders 130, Enforcing contracts 138**
	⋮	
155	Congo Dem. Rep.	

(Note) Overall ranking is based on the simple average of country percentile rankings on each of the 10 topics:

①Starting a business, ②Dealing with licenses, ③Hiring and firing workers, ④Registering property, ⑤Getting credit, ⑥Protecting investors, ⑦Paying taxes, ⑧Trading across borders, ⑨Enforcing contracts, and ⑩Closing a business

(Source) "Doing Business in 2006" by Lex Mundi; the World Bank and the International Finance Corporation

TOMOO NISHIKAWA

Globalization, the Key to Competitiveness, Is Achieved by Localization

Globalization, the Key to Competitiveness, Is Achieved by Localization

Tomoo Nishikawa
Managing Partner, Sidley Austin/Nishikawa & Partners

In this paper, I shall take up financial institutions as an example in my attempt to illustrate what sorts of issues to address and choices to make may be in front of a foreign company that wishes to successfully compete in Japan and what should be done in Japan to make Tokyo continue to be competitive as a global financial market center.

In order to ensure that Tokyo continue to be a globally competitive market center, it seems useful for financial institutions to be always aware of the importance of customizing their products as well as their operational systems to the needs and standards of the foreign markets they operate in.

True globalization is proper “localization”, and such localization is achieved by the customization to meet various local requirements.

In the last couple of years, there have been more than a few instances in which the Financial Services Agency of Japan, FSA, took administrative actions such as issuance of business improvement orders, disciplinary actions and even a revocation order, against some of the foreign financial institutions operating in Japan. FSA stated that there were fundamental problems with their compliance and internal control systems and serious violations of the relevant laws and regulations, among other things.

What we must derive from such instances is that simply duplicating the product, idea, structures and systems, methods, etc, that worked in one country may not necessarily be conducive to successful operation in another. Strict adherence to the Japanese laws and regulations (particularly when there exist rooms to argue) was sometimes compromised, and the Japanese business culture was not necessarily duly respected by some of the foreign financial institutions operating in Japan. Products and ideas, organizational structures and systems, and marketing methods were sometimes implanted into Japan without due localization. Some of these foreign financial institutions may have unfortunately believed, quite ingenuously, that their way was the most appropriate way to do business, regardless of where they operated.

In this paper I would like to present some details on the three categories of issues for foreign financial institutions, namely, products and ideas, organizational structures and systems, and marketing methods.

Products and Ideas

The increasingly more accessible Japanese financial market has not necessarily meant the Japanese customers shifting their main businesses from Japanese to foreign financial institutions. The Japanese customers may still feel more comfortable continuing their traditional business relations with Japanese financial institutions. If so, foreign financial institutions would have difficulties competing with their Japanese counterparts on such products as plain short term loans, simple foreign exchange services, etc., since such competition would be on equal footing, that is, there would only be price competition with no value added.

Under such circumstances, foreign financial institutions may be strongly inclined to market "new" or what may be called "value added" products, which are in fact products, or products based on the ideas, that are straight out of their home countries, because this is faster, simpler and cheaper, given the existing infrastructure and support system. "Newness" or novelty of such products may also cater to the Japanese tendency to jump onto something new.

Marketing such "new" or "value added" products and ideas in Japan without customizing them to meet the Japanese needs and standards may be tempting from a short-term business point of view, but not necessarily advisable from legal and long-term business points of view. For instance, these new products may be more complicated because of the incorporation of some derivatives elements, etc., which means that the customers may sometimes be unable to accurately grasp their structure, risk involved, and other important factors. Although they may have welcomed and happily purchased these products, such inability may lead to questions of misrepresentation on the part of foreign financial institutions.

Organizational Structures and Systems

Many of the foreign financial institutions operating in Japan have the organizational structures and systems that are the same as or similar to those used in their home countries for their Japanese operations. In other words, within their Japanese operations, departments and their reporting lines are fragmented. In concrete terms, despite the presence of their representatives in Japan who are respectively supposed to oversee their Japanese operations, the departments

within their Japanese operations may tend to remain independent of each other, and instead be looking mainly and sometimes only to their counterparts in the headquarters in the home countries. In such instances, there may be little integration and coordination among these different departments within Japan. This would especially be the case when budgets and business plans were to be established and performance reviews were to be conducted (and eventual monetary compensations were to be allocated) within each of the departments.

There may also be a risk that the structures and systems for compliance and internal control in the Japanese operations of foreign financial institutions may not function as effectively as they should. To be successful in Japan or any other country, financial institutions must build and maintain the confidence of investors and the public in general, in addition to the regulators. This cannot be achieved merely by satisfying the investors with the returns on their investments. The Japanese investors and public, as is the case in many other countries, value strict compliance with the relevant laws and regulations and solid internal control. Any problem concerning compliance or internal control would possibly greatly undermine the competitiveness of foreign financial institutions operating in Japan.

Here again, localization could be the key. In order to ensure the independence and effectiveness of the compliance and internal control systems and better synergy between the departments within the Japanese operations, foreign financial institutions may find ways to more localize their Japanese operations, by such means as making them companies established under the Japanese law, rather than branches of foreign companies when appropriate.

Marketing Methods

To a Japanese observer, some foreign financial institutions may appear to be too eager to make, or to place too much emphasis on, profits. Such financial institutions may rely too heavily on monetary incentives, such as bonuses, to motivate the marketing staff, which could distort marketing. Representatives of such foreign institutions may sell to customers the products that the customers cannot fully comprehend the operations and structures of, or that have high risk profiles. The suitability check to compare the risks of products against the risk allowance levels of customers, a critical element of the marketing process, could be neglected if sales and profits were to be of primary importance. It would then be no longer clear whether such sales are for the benefits of customers or of foreign financial institutions and their representatives. On marketing methods as well, foreign financial institutions could better compete by motivating their

representatives to tailor their marketing methods to the Japanese needs and standards rather than relying too much on monetary incentives.

Need for More Predictability and Transparency on the Regulators' Side

There certainly are problems on the Japanese side to be addressed for realizing localization. Of particular urgency amongst them are lack of enough predictability and transparency in the regulators' decision making process, which still exist despite various efforts made by regulators.

Before any "new" product, idea, structure, system, method, etc., is to be introduced in Japan, financial institutions, Japanese or otherwise, would most likely and still tend to go to FSA for the latter's judgment on whether or not the product, idea, etc., concerned is in compliance with the relevant laws and regulations, guidelines, etc. In general, the Japanese laws and regulations are often drafted rather broadly, and not keeping up perfectly with the rapid pace of developments of new products and ideas. While I commend FSA and other regulatory bodies for their very earnest efforts at filling in the time gap between the development of new products and establishment of laws and regulations or guidelines thereon, there is more to be done.

This means that there may be no clear norms, or even worse, no norms at all, that FSA could rely on to make a judgment on a new product. The businesses may never know if, when, how, and what judgments could be made, and, may still never know how to translate the judgment made into comprehensible Japanese. Such lack of predictability and transparency could be a formidable obstacle to any business, Japanese or otherwise. In addition, the inspection officers of the FSA do quite often require that the list of problems and questions pointed out by the authorities must never be shown to the counsel. This is another salient example of lack of transparency.

FSA simply shares the problems that the Japanese governmental system as a whole has, and should not be singled out. The laws and regulations that provide for the power, authorities and scope of discretion of the Japanese governmental organs tend to be rather vague, while each of such organs is constantly faced with insufficient staffing and/or capabilities to deal with all the questions on interpretations of the laws and regulations. Unless the laws and regulations are either amended or newly established to clearly demarcate the scope of discretion for each governmental organ, this sorry situation will not disappear, and predictability and transparency will remain sacrificed.

In this regard, the Japanese No-Action Letter system does have a significant role to play in increasing the predictability and transparency in the Japanese regulatory systems, and has been effective in some cases. Under this system, private businesses, Japanese or otherwise, may submit applications for government confirmation on whether the new business or transaction it plans to conduct may require permission, registration, etc., and whether conducting such business or transaction may incur suspension of its business operations, revocation of its license, or other disadvantages. Under these terms and conditions, any business can in theory begin the process for No-Action Letter by submitting an application to FSA, and FSA needs to respond in writing in principle within 30 days after the receipt of the application. However, the process takes much longer and is more complex in reality, as it requires lengthy and careful consultations with FSA in private prior to the actual submission of the application.

Quite regrettably, this system cannot solve the problems mentioned alone, as it only concerns new products or transactions. What may be required is an automatic clearing system. For instance, a system may be created in which FSA shall say “No” within a certain period of time in order to disapprove a product, or otherwise it shall be automatically approved. Such an automatic clearing system seems more open and transparent, as well as better fit for achieving a vibrant and globalized market environment.

Regulators, legislators and financial institutions, Japanese or otherwise, should maintain a relationship with a positive sense of tension, or of check and balance for each other, in order to make clearer the rules that apply to financial institutions under the laws and regulations through better legislation and predictability and transparency. This would greatly help foreign financial institutions meet the needs of customers in full compliance with the laws and regulations in the Japanese financial market.

Conclusion

The Japanese authorities, together with the legislators, businesses and public, must make the market environment more open and transparent by establishing clearer rules and more predictable and transparent systems. Less ambiguity will take away some of the existing obstacles to market entry as well as to successful localization of products. This is a true step to globalization and an effective way to ensure competitiveness of Tokyo as a global financial market center.

HUGH PATRICK

Japan's Economy: Finally Finding Its Way to Full Employment and Sustained Growth

Japan's Economy:
Finally Finding Its Way to Full Employment and Sustained Growth

Hugh Patrick
Director, Center on Japanese Economy and Business
Columbia Business School

With 2005 recording the best economic performance in the past decade, continued growth in 2006, and only a moderate slowdown likely in 2007, Japan finally is escaping its mediocre performance trap. The economy is moving reasonably well from recovery to full employment and sustained growth. GDP grew 3.2 percent in fiscal 2005, ending March 2006. The consensus is that growth will probably be at least 2.5 percent in fiscal 2006, and then slow to a slightly better than 2 percent rate in fiscal 2007.

The highly regarded Bank of Japan (BoJ) *Tankan* quarterly survey at June end indicates business expectations support the widespread optimism permeating Japan. In response to these better economic conditions, the BoJ terminated its five-year zero interest rate policy on July 14, a major shift in monetary policy.

I am more optimistic about the Japanese economy than I have been for fifteen years, though that is not saying much. But concerns persist: the economy has not yet returned to full employment growth, deflation has not quite ended, considerable employment slack remains, and the surprisingly low annualized growth rate of 1.0 percent for the April–June 2006 quarter is a splash of cold water, though it is less bad than it seems. I think domestic demand-side challenges will continue to dominate well into 2007, and perhaps beyond.

Near-term uncertainties are greater than usual. One major near-term uncertainty in early autumn 2006 is political. As expected, Shinzo Abe was elected President of the Liberal Democratic Party (LDP) on September 20 and Prime Minister on September 26, replacing Junichiro Koizumi. The Abe administration rhetoric on economic policy has been good but it remains to be seen how fully and well policy proposals, still rather general, will be implemented. A further concern is that the recently released monthly economic performance indicators for summer 2006 are mixed, and not great.

Major international concerns include the future price of oil; slowing growth of the United States economy; incipient global inflationary pressures; the global trade imbalances centering on the huge and increasing U.S. trade and current account deficits and Chinese surpluses; and the implications for the yen-dollar rate. A different type of concern is that Japan's current

economic success will generate complacency among public and private decision-makers such that still-needed public and private sector reforms are not fully carried out.

Despite these concerns, I anticipate that Japan will indeed achieve sustained growth with full employment over the course of the next two to three years.

Subsequent sections address Japan's recent economic performance; near-term prospects; government economic policy, with special focus on the monetary and fiscal policy components of macroeconomic policy; increasing income inequality; the financial sector; corporate management and governance; Japan in the global economy; and implications of economic maturity and declining population in the long run. I end with brief concluding comments.

1 Recent Economic Performance

For three decades, Japan has had a structural problem of deficient domestic private aggregate demand. In macroeconomic terms, Japan's high private saving rate was significantly greater than its high private business investment rate, and the gap was too large to be absorbed by an export and current account surplus. This was exacerbated over the past fifteen years, necessitating huge government deficit spending to prevent a serious recession. However, the private sector saving-investment gap has decreased significantly, and so will be much less of a problem. The household gross saving rate, some 15 percent of GDP in 1991 and 11.6 percent in 1998, declined to 6.0 percent in 2004 and even lower in 2005. This was due in large part to the increase in the elderly population and to a widespread desire to maintain consumption levels. While corporate saving rates have risen, now that balance sheet health has been restored, companies are prepared to invest more rather than paying down debt.

Excellent growth in fiscal 2005 was driven by consumption expenditures, business investment, and exports. Consumption increased 2.4 percent, substantially better than any year since 1996, and provided half of domestic demand growth. Business fixed investment rose 7.5 percent, providing another two-fifths of growth. Exports rose 9.2 percent; however, imports rose 6.8 percent in real terms, and even more in current prices, so net external demand was only one-sixth of real GDP growth. After several negative years, government demand in fiscal 2005 temporarily rose slightly, comprising 0.2 percentage points of the 3.2 percent GDP growth; this was mainly due to the substantial slowing of the decrease in government public works investment of previous years.

Despite the erratic and somewhat unreliable monthly movements of many economic indicators, on a quarterly basis they demonstrate that the recovery has been strong and broad-based, and is continuing to move into expansion mode. The economy started 2006 with a continuation of good growth, at a 2.7 percent clip (seasonally adjusted annual rate). While more mixed indicators led the consensus of experts to expect some slowdown to a 1.8 percent rate in the April–June quarter, the government's first preliminary estimate on August 11 was only a disappointing 0.8 percent. The second preliminary estimate, released on September 11, inched the annual GDP growth rate estimate up to 1.0 percent, but the substance was basically unchanged. The good news was that domestic private demand—consumption and business investment—continued to grow well, at a 2.9 percent rate. Moreover, the slowdown was due predominantly to a decline in inventories and in government spending, which in fact is not bad news.

Importantly, national average land prices rose by 0.9 percent in 2005, the first increase since 1992. While in some prefectures land prices are still falling, though more slowly, they are rising in major cities, notably Tokyo. Bank lending has turned positive, and increased notably in July. Industrial production and exports continue to rise, and services are growing reasonably well. The sharp decline in July in core machinery orders is worrisome, only partially offset by an increase in August. Hopefully this is only a temporary aberration.

The private sector is an ever-more important driver of the economy. The corporate sector has resurged. Successful restructuring has reduced costs, worker productivity has continued to increase and unit labor costs to decrease; even without price increases, profits rose by an impressive 12.5 percent in 2005 for larger firms, and 10.4 percent for small and medium enterprises (SMEs).

While not yet satisfactory, labor markets are improving. Unemployment, 4.1 percent in August, continues its slow decrease. The quality of employment has turned around. The number of full-time workers has begun to rise, and the still-too-high share of part-time workers and contract workers has leveled off at about a third of employees. However, persisting labor slack is evidenced in the reality that compensation of employees, based on rises in regular employees of 0.5 percent and in earnings of 0.7 percent, increased only 1.3 percent in 2005 and is not yet rising significantly. The summer 2006 wage bonus for some 800 large firms rose 1.79 percent, only 239 yen (0.08 percentage points) more than summer 2005.

2 Near Term Prospects

The data now available, and the various private forecasts, suggest that the July-September quarter performance will be somewhat better than the weak previous quarter, but not strong enough to fully alleviate concerns about slowdown. Nonetheless, the September – end Tankan of business sentiments and expectations was once again strong, more than expected, which suggests recovery and growth will be sustained. The first preliminary estimates of July – September GDP growth will be announced on November 14; that will provide a better sense of how the economy is doing.

The Economist consensus of foreign financial institutions as of early October is that real GDP will grow 2.8 percent in 2006, with a 2.6 – 3.0 range and 2.1 percent in 2007, with a 1.6 – 3.1 range. Consumer prices are forecast to increase 0.3 percent in 2006 and 0.5 percent in 2007. Since estimates of the longer-run potential growth are 1.5–2 percent, this is good news. The government, Bank of Japan, IMF and OECD forecasts tend to be more cautious but are nonetheless good. Growth depends on the demand side on how rapidly consumption increases, as well as business fixed investment and exports; and on the supply side the degree of slack in the economy, especially labor slack, and relatedly, the size of the output gap.

2.1 Labor Slack

Japan's labor force as of spring 2006 totaled 67.25 million, of whom 64.84 million have jobs. Labor slack is still substantial. Of the 50.0 million employees (excluding corporate executives), 16.6 million (33.2 percent) are not regular employees. This includes 7.8 million part-time workers (of whom 7 million are women), 3.4 million temporary workers, and 5.4 million contract or dispatched workers. Full-time employees have decreased by 5 percent since 2000, while part-time and others have risen by 25 percent.

The labor slack includes unemployed seeking jobs, those who have reluctantly withdrawn from the labor force, the many part-timers who desire regular full-time jobs, and many of those who reluctantly accepted early retirement, as well as the elderly who would like at least part-time employment. It is important to distinguish between those who work part time by choice, predominantly married women, and those, especially temporary workers, who cannot obtain satisfactory full-time employment.

Some of the greatest costs of Japan's mediocre economic performance over the past fifteen years have been inflicted on young Japanese. They have disproportionately been

unemployed or underemployed in part-time work. They are not receiving adequate on-the-job training. Many have stopped actively seeking work, or have dropped out of the labor market. Although some have deliberately chosen alternative life styles, most seek full-time work in a suitable occupation. New terms have entered the language: freeters (part-time and temporary workers), NEETs (those not in education, employment, or training). As of 2005, of those aged 15 to 34, 2,132,000 were unemployed (including about 640,000 NEETs), and another 2,010,000 were freeters, including many high school dropouts. Most NEETs come from poor families and have low educational attainment.

Sustained economic growth, creating demand for workers, is the solution. While we do not know just how young people will respond to better job opportunities, I consider this potential labor supply to be the major resource to sustain rapid growth for another two years at least. However, some 60 percent of the freeters and NEETs are 25 or older; rigid recruiting age norms are an obstacle to their obtaining regular fulltime jobs. They probably will not be absorbed until labor markets become quite tight.

Some 19.4 percent of Japanese 65 or over are employed. This is higher than in other countries, though the rate has decreased over the past 15 years. Many baby boomers retiring from full-time, regular jobs will seek continued employment. How large a labor reservoir older people are is unclear.

Japan's traditional large-firm permanent employment system has not disappeared, but it has become more narrowly defined. Many companies impose a hierarchy of job categories: permanent regular full-time employees (the core), essentially permanent part-time workers (mostly women), contract employees (one year or so), workers temporarily dispatched from another firm, ordinary part-time workers, temporary part-time workers (often on specific projects), and casual day laborers. Most of these categories are mainly for blue collar or clerical work. Management-track employees are key members of the core. The weak labor market of the past fifteen years has enabled firms to shift more flexibly to lower-wage categories.

There are grounds for optimism that full-time employment will increase and that unemployment and part-time employment will decline significantly. This is because GDP will grow faster than 2 percent for the next two years and because the surge of early postwar baby boomers will begin to retire from 2007. With labor markets tightening as labor slack evaporates, wages eventually will have to rise. Better employment and higher wages will accordingly

generate higher household consumption, an essential ingredient to sustain growth. The key is how quickly and strongly this process will take place.

2.2 The Output Gap

Two major objectives of economic policy are simultaneously to achieve and maintain both full-employment potential growth and price stability. In any forecasts, the size of the output gap—the amount of slack in the economy—is a key factor in estimating growth. The gap between actual output (GDP) and potential output under conditions of full employment of resources and price stability may be conceptually clear, but empirically it is difficult to measure, especially in an advanced economy where services rather than goods comprise most of the output. As Japan demonstrates, this empirical difficulty is exacerbated when an economy undergoes a long period of below-potential growth combined with modest deflation. The size of the output gap depends on the amount of slack in the economy, as well as future employment, capacity utilization, and labor productivity growth.

I share the view that the estimates of the output gap made by the government and the BoJ have been too small, and that slack in the economy is still substantial. Part has to do with the estimates of long-run potential growth, which are too cautious. Part has to do with the difficulties in measuring capacity (and, indeed, output) in services, now more than three-quarters of GDP. Even with good growth, slack will exist so long as prices are not increasing, wage rises are small, and unemployment and underemployment persist. Improvements in these indicators, rather than direct estimates of the presumed output gap, will tell us when the economy is back to normal.

An additional uncertainty is the degree to which labor productivity will grow, due not only to public and private sector reforms and restructuring but, more fundamentally, to the rate of technological progress. Japan has the potential to increase its rate of productivity growth from technological change and its diffusion as well as from increased efficiency in the allocation and utilization of labor and capital. Total factor productivity (TFP) growth slowed to 0.45 percent between 1995 and 2003, far below the 1980–1990 rate of 1.25 percent. This occurred despite the rise in capital investment in, output of, and TFP in information technology (IT) industries. The spread of IT to non-IT sectors has lagged. This provides Japan with an opportunity to increase labor productivity and total factor productivity.

2.3 Deflation

While real economic performance will probably continue to do reasonably well, still being debated in Japan is whether deflation has finally come to an end. Obviously, much depends on how deflation is defined. The core CPI based on 2000 prices maintained very small positive monthly increases from November 2005, and in June continued at a 0.6 percent annual rate after the 0.5 percent rate for the first four months of the year. That was sufficient to persuade the BoJ that ending its zero interest rate policy (ZIRP) was appropriate and desirable.

The August 25 revision of the CPI index to a 2005 price benchmark is another splash of cold water. The downward revision of the new core CPI was 0.4 percent for July and 0.5 percent for the January–July period, substantially larger than expected. Accordingly, the July core CPI increased only 0.2 percent, and basically only became positive in June 2006, unlike the 2000 measure, which had become positive in November 2005. This will certainly reduce forecasts for the core CPI for this year and 2007.

I am concerned both that deflation has not yet completely ended and that price stability will be fragile. The dangers of deflation outweigh inflation, and their costs are disproportionately large. Financial markets evidently have a similar view, as indicated by the still-low yields on Japanese government bonds (JGBs). As of October 11, the yield on ten-year JGBs was 1.74 percent. The yield was 2.23 percent on twenty-year JGBs, and 2.51 percent on thirty-year. These suggest an expectation that price stability will continue with the CPI near the Bank of Japan's zero lower bound.

3 Government Economic Policy

Prime Minister Abe, his economic policy team, and the LDP face a host of economic policy issues. Abe's initial statements regarding his economic policy intentions are straightforward and good. They represent basically a continuation of Koizumi's policies but with somewhat different emphases and nuances. The focus is on growth of 3 percent in nominal GDP, combined with continued government expenditure tightness. Increased tax revenues thus will be the means of government budget deficit reduction, rather than an early increase in the consumption tax. In principle, Abe will preserve and implement the reform agenda of regulation and privatization. He has outlined a longer-term economic growth strategy focusing on innovation, technology, and productivity; educational reform; and a more flexible economic system to provide losers a second chance (whatever that means). How rapid nominal growth will be achieved in the near term is not at all clear.

The key will be the nature and degree of policy implementation. It is unclear how strongly Abe will exercise leadership in carrying out economic policies and how effective the results will be. He apparently is concentrating economic policy power in the Prime Minister's office. Will the reconstituted Council on Economic and Fiscal Policy, even with its strong private sector members, once again become a powerful economic policy-making institution? In what ways will there be political support in the Diet for still-needed reforms? How about the still-powerful central government bureaucracy, which opposes reforms reducing its power? In what ways will the policy agenda be shaped by the summer 2007 Upper House elections, in which LDP control is at risk? Agricultural sector reform is essential to implement any foreign trade initiative. How likely is that?

Together with reduction of protectionist regulation, the government appropriately has enacted prudential, pro-market regulation to enhance market transparency, efficiency, and competitiveness. However, Japan still has a long way to go on deregulation and liberalization, even apart from agriculture.

Prime Minister Abe, his Cabinet, and his economic advisors will need to make their own strong commitment to sustain and enhance economic reform measures in order to provide the government policy foundation for sustained growth. While the coming year will be good economically, it will be unsettled politically. Given the current political and government bureaucrat backlash against Koizumi's free market agenda, there is a real danger the government's economic reform program will slow substantially.

Prime Minister Abe's most dramatic and indeed welcome action has been to quickly begin the process of repairing political relations with China and South Korea by his weekend trip to Beijing on October 7 to meet with President Hu Jintao, and then to Seoul on October 8 to meet with President Roh Moo-Hyun. Those meetings, desired by all three leaders, were constructive, and presumably will put Japan on a better path in its relations with them. Of course, the situation has been made considerably more complicated by North Korea's announcement of its nuclear bomb test on October 9.

3.1 Fiscal Policy

Reducing the still-huge budget deficit and restoring fiscal balance continues to be a top priority under the Abe administration. Key issues are how rapidly to reduce the deficit, the relative contribution of expenditure cuts and tax revenue increases, what kinds of taxes to raise,

and by how much. Koizumi's final package of economic and fiscal-policy guidelines for fiscal 2007- 2011 was finalized in July and approved by the Cabinet, and apparently has been accepted by Abe, not surprising since he was directly involved.

Although fiscal stimulus was essential in the 1990s in order to maintain aggregate demand sufficient to prevent a crisis or serious recession, the government budget deficit became enormous, and government debt ballooned. With recovery beginning in 2002, the government has been able to pursue an appropriately moderate fiscal tightening policy, on the order of 0.5 percent of GDP a year. The combined budget deficit for both central and local governments, 8.0 percent of GDP in 2002, has declined to 6.0 percent in 2005 and a projected 5.2 percent in 2006. With the economy now well along its recovery path, the fiscal 2006 budget deficit may actually be somewhat smaller as revenues increase beyond official cautious projections.

An ongoing debate in the LDP has been whether to give priority to expenditure cuts or to consumption tax increases. That has been resolved in favor of the former by the Abe administration, coupled with the new goal of substantial nominal growth. Koizumi's fiscal priority was first to restrain and then to reduce expenditures, as the fiscal 2006 budget proposals demonstrate. Flat expenditures combined with revenue growth since 2004 have reduced the deficit absolutely as well as a share of GDP. With good growth performance, government revenues have been rising significantly. The government terminated its 1999 income tax cuts, instituted small annual (but cumulatively important) increases in social security taxes on wages, and is increasing private co-payments for the government national health care program.

On July 21, guidelines were announced for the fiscal 2007 budget. Central government general-account expenditures are to be ¥46.8 trillion, below ¥47 trillion for the first time in nine years. Expenditure cuts are not across the board as before, but instead range from 1 percent to 3 percent. Public works and official development assistance (foreign aid) are cut 3 percent, defense by 1 percent.

The government's five-year target is to return to budget primary balance by 2011, meaning that the budget deficit excluding government interest payments on its net debt will be zero. By the end of fiscal 2006 the primary deficit, 5.7 percent of GDP in 2002, is projected to be 2.8 percent. The long-run goal is to run a primary surplus by 2015 sufficient to achieve a balanced or even surplus government budget. These projections are founded on important

assumptions, particularly that private aggregate demand will be sufficient to sustain the potential growth rate, both nominal and real.

To achieve primary balance by 2011, the government will have to overcome a projected five-year budget shortfall of ¥16.5 trillion. In July the Cabinet adopted guidelines that require most (between 69 percent and 86 percent) to be covered by reductions in expenditures, and the remainder by tax increases. These projections are based on the assumptions that current-price GDP growth will average 3 percent, and real growth 2.2 percent. Implicit is the expectation that economic reforms and total factor productivity increases, plus absorption of remaining slack, will generate this growth.

The projected expenditure cut targets are unlikely to be fully achieved. The summer 2007 Upper House election puts great pressure on the LDP to halt the large declines in government local public works projects, and to increase transfers to local governments. In the longer run, public pension payments will increase as the population ages. Importantly, Japan's defense share of the costs of the planned relocation of U.S. military forces in Okinawa is ¥1.9 trillion spread over eight years, and is not in the proposed budgets. The longer-run fiscal wild card is national security: will the North Korean nuclear and missile threat and other security concerns lead to significantly increased defense expenditures?

Cuts in government expenditures and rises in revenues have significantly altered the nature of the ongoing tax policy debate. The main issue is the consumption tax, currently 5 percent. A rise of 1 percentage point in the consumption tax increases government revenues (and reduces aggregate demand) about 0.5 percent of GDP. In 2005 the debate was whether to raise the tax 5 or 10 percentage points and whether to start in fiscal 2007. Now the starting date is no sooner than 2008, more likely 2009, and possibly not until 2010. And the question is whether the long-term increase should be 1 to 2 percentage points or 5 percentage points. The risk of premature fiscal tightening is currently considerably lower than before. I expect that the government will need to raise the consumption tax at some point. When and by how much depends on real and current price economic performance, social welfare programs, and national security expenditures.

3.2 Monetary Policy

The Bank of Japan dramatically altered macroeconomic policy, beginning in March, by shifting from a policy of extraordinary monetary ease to one of still considerable ease. The BoJ

thereby began the process of implementing the three sequential policy steps essential to restore a normal monetary policy. These are: (1) reversing its quantitative easing policy by withdrawing excess liquidity in the system; (2) terminating the zero interest rate policy (ZIRP); and (3) gradually raising interest rates to a neutral level once sustained, full-employment growth consistent with price stability is achieved. The first two steps have been taken. The key policy issue now is how frequently and how far the BoJ will raise interest rates over the next year or two.

The BoJ also adopted a new monetary policy framework, which embodies transparent and flexible perspectives. It provides the Monetary Policy Board's "understanding" of price stability in the medium to longer term as being a CPI range of 0 percent to 2 percent. This provides an anchor for price expectations.

The new framework also is more forward looking. That is, policy will depend more on expected CPI and economic performance movements than on actual data, which in practice are backward looking. A potential danger of a forward-looking approach is that it may ignore the legacy effects of past poor economic growth and modest deflation. Effective BoJ communication, which Governor Toshihiko Fukui has done extremely well, will be even more important in implementing the new framework.

The BoJ successfully removed from the system most of the ¥24 trillion in excess reserves generated by the quantitative easing policy. That was necessary before it could restore its main policy instrument, namely changes in short-term interest rates. On the whole, the termination of quantitative easing has been accomplished quite smoothly, simply by letting BoJ holdings of short-term government debt run off. Excess reserve reduction alone was not sufficient to end ZIRP. For that, economic conditions and the CPI both had to be improving sufficiently and be expected to continue to improve.

On July 14 the BoJ ended ZIRP, as was widely expected. It raised the overnight call rate from 0 to 0.25 percent, and the basic lending rate at which banks can readily borrow from the BoJ (the "Lombard rate") from 0.1 percent to 0.4 percent. Further, it stated that an "accommodating monetary environment ensuing from very low interest rates will probably be maintained for some time." The ending of ZIRP and restoring of interest rate policy flexibility was an important signal affecting expectations. Of course, the direct interest rate effect on borrowers, lenders, and depositors has been small.

For optimal macroeconomic results, fiscal and monetary policies have to operate in tandem. For the next decade or so, fiscal policy will continue to focus on budget consolidation. This means a moderate fiscal drag on aggregate demand will persist. Fiscal policy is implemented through budget policy. That is inherently a political process involving Diet decisions on the mix of government expenditure reductions and tax increases. The BoJ has to accept this contractionary fiscal policy as a given, and adjust monetary policy so as to achieve adequate levels of aggregate demand consistent with price stability. The future will be a mix of relatively tight fiscal policy and relatively easy monetary policy.

The key policy objective of the Bank of Japan, as with all central banks, is price stability. The definition of price stability is just as important as its measurement. Price stability is not a single point on a price index (or weighted average of different price indices), but a range. Given imperfect data, imperfect knowledge of the future, and inevitable random economic shocks, this is appropriate. As in other advanced countries, the BoJ essentially measures price stability by consumer prices. The BoJ has been using as its primary measure of price stability the core Consumer Price Index (CPI), which excludes fresh foods. Unlike the United States and many other countries, Japan's core CPI does not exclude energy.

The BoJ Monetary Policy Board now defines price stability as a range of 0–2 percent increase in the overall CPI, referred to as "headline CPI," lower than the U.S. Fed and European Central Bank, which both have an implicit range of 1–3 percent. The differences apparently lie in different perceptions of the degree of upward bias in the CPI measurement and of the safety buffer needed for the lower bound. It is generally accepted that the CPI inadequately handles technology-driven quality improvements, business price discounting practices, and lags in data, despite the improvement of using a hedonic price index to adjust quality for some items. In addition, there are technical debates on the best price index formula, as well as inevitable measurement errors. The general view is that in the United States the CPI has an annual upward bias of up to 1 percent. The Federal Reserve Board's implicit lower bound for price stability is a 1 percent rise in the core personal consumption expenditures (PCE) measure it uses. My guess is that Japan's core CPI has an upward bias of at least 0.5 percent, even following the August 25 revision.

All this makes the BoJ March statement that the Japanese consumer price index has no significant bias astounding. So too is its assertion that, in light of BoJ flexibility and macroeconomic policy effectiveness, it does not need a safety margin for its lower bound to act

as a buffer against the risk of declining prices. Given measurement uncertainties and random shocks, it is risky for the BoJ to accept 0 percent as a lower bound for policy guidance. I would like the BoJ to adopt a 1–3 percent CPI increase as its measure of price stability, more like other central banks.

The BoJ monetary policy framework is in transition. I expect it to evolve as relevant conceptual issues are further analyzed and new empirical evidence becomes available. The BoJ has stated it will review its understanding of price stability every year in light of the structural changes in the economy. I do not expect the BoJ to adopt explicit inflation targeting any time soon, but I expect that at some point it will move its “understanding” of price stability to a 1–3 percent range, with 2 percent as the desired midpoint.

Other price measures are also relevant. The most important is the GDP deflator, which measures whether prices for total output are rising or falling. It is now 10 percent below the 1997 level, having declined every year; accordingly, current-price (nominal) GDP has been below real GDP. Many forecast the GDP deflator will flatten out and turn positive next year. To achieve the government’s 3 percent nominal growth target, it will have to.

The most important monetary policy issue now is the course of further interest rate increases. The BoJ has stressed that it will pragmatically and flexibly respond to economic conditions, including price movements, as they develop. It also depends on the course of government fiscal and other economic policies. The Monetary Policy Board’s semi-annual forecasts of GDP growth and CPI movements will be announced on October 31; that will provide some insight into the policy thinking of the members.

An intense debate is going on between hawkish and dovish commentators on how soon, how rapidly, and how steadily the BoJ will raise interest rates. It rests on different interpretations of BoJ statements, as well as its past behavior. Obviously a great deal depends on how the economy performs and whether deflation has indeed been brought to an end. The BoJ evidently does not expect a significant resurgence of deflation, presumably defined as several months of negative changes in the core CPI.

I consider the ongoing implementation of these three steps of monetary restraint more a lessening of the previous extraordinarily easy monetary policy than a tightening. Future BoJ policy should continue on this path, without premature tightening, until sustained, full

employment growth and a comfortable degree of price stability are achieved. The recently revised CPI index suggests that the BoJ should not raise interest rates very soon.

4 Increasing Income Inequality

By the 1980s, prosperity and homogeneity had created the widespread perception that virtually every Japanese was middle class. However, subsequent fundamental economic and social transformations, combined with the unemployment and other adverse effects of poor economic performance, have led to a focus on the widening inequality of income distribution, an awareness of differences in lifestyles, and a newly articulated sense of unfairness between the wealthy and the poor. Opponents of free-market reforms are vigorously blaming Koizumi's policies. This is surely too simplistic, and almost impossible to demonstrate. But it is true that, thus far, government policy has not done much to counter the increasing inequality.

The government's summer 2006 economic white paper addresses the income distribution issue. The Gini coefficient, the standard measure of income inequality, has been slightly rising in Japan ever since it was first officially estimated by the Ministry of Health, Labor, and Welfare in 1987. After adjusting for declining household size, the coefficient increased modestly, by 0.012, between 1989 and 2004. Between 1992 and 2002, inequality in labor income increased in every age bracket. In Japan, as in all countries, it is very difficult to estimate the income of the wealthy, there are other data difficulties, and there are substantial lags in data availability.

An OECD study both documents Japan's increasing income inequality and places it in comparative perspective with other advanced industrial countries based on data for 2000, the latest available. The simple average of the Gini coefficients of OECD countries is 0.306. Japan, at 0.314, and five other countries are close to the average. The United States, at 0.357, has the highest observed inequalities; Denmark, with 0.225, has the most equal income distribution.

According to the OECD study, Japan's Gini coefficient increased by 0.017 between the mid-1980s and mid-1990s, and a further 0.019 in the five years to 2000. Japan's top fifth of the working-age population received 37.5 percent of disposable income, up 1.3 percentage points since 1995; the bottom fifth received 6.7 percent, down 0.7 percentage points.

Two major causes of increasing income inequality have been labor market weaknesses and demographic changes. Wages of part-time and contract workers are significantly below

those of regular full-time workers, and their share in employment has risen substantially. In Japan, unlike other countries, the unemployed are only about 10 percent of the poor.

The OECD study estimates that the disposable income of Japanese elderly households was 89.9 percent of the average in 2000, but the Gini coefficient is considerably higher for such households, and their share of the population is rising. Japanese 66 and older were 21.1 percent of the population in 2000, an increase of 5.1 percentage points in five years. About 70 percent of Japan's social welfare expenditures are for the elderly, about 4 percent for baby births and child rearing. The elderly hold their financial assets overwhelmingly in the form of deposits, which means for many years their interest income has been virtually zero.

Solving the financing of retired workers' pensions and expanding health care, while restoring budget equilibrium, is a major challenge. However, these problems are widely understood by political leaders and government bureaucrats, as well as the Japanese public, so they will be resolved more readily than some of the other challenges Japan faces. The fundamental issue will be to determine what kind of welfare system Japan wants, how large social welfare expenditure should be, and, accordingly, how much taxes will have to be raised as a share of GDP.

5 Finance

Banks continue to be the core of Japan's financial system for both borrowers and savers, so bank performance is important both in its own right and as an indicator of the economy more broadly. The net profits of the six major bank groups soared to a record ¥3.1 trillion ($27.0 billion) in the year to March 2006. That, however, exaggerates their fundamental strength. The banks did not pay any income taxes because they have large deferred tax credits (loss carry-forwards). Moreover, about a tenth of reported profits are from reducing loan loss reserves.

This was possible because the nonperforming loan (NPL) problems of almost all banks were resolved by last year. NPL were only 1.8 percent of total loans for the major banks. While the NPL average for regional banks is 4.5 percent, the range is wide, and dangerously high for perhaps a dozen or so smaller banks. The major banks are now using profits to pay back the government capital received during the banking crisis.

However, large-bank profitability is still low; the pre-tax return on assets in 2005 was 0.84 percent, far below the 2.06 percent of major U.S. banks, though comparable to major banks in a number of continental European countries. A prime reason is that interest rate

spreads on lending are still too narrow; they do not incorporate credit risk adequately. The spread for fifteen large Japanese banks was 1.07 percent, compared to 2.65 percent for twelve U.S. banks. With relatively low core capital ratios, Japanese banks are not internationally competitive. Most foreign loans are to finance the activities of their Japanese multinational corporation clients. Moreover, the IT and financial technologies of most banks are not yet state of the art.

Following its outstanding performance through 2005 from its April 2003 trough, the stock market retreated 19 percent in the spring and summer of 2006 from its Nikkei index high of 17,563 on April 7 to its June 13 low before beginning to meander upward. With 2005's run up, price-earnings ratios were high by international comparison, and corporate profit growth is projected to slow somewhat this year. The shift to quality on international financial markets, in response to increasingly uncertain economic prospects, has been a negative factor. Foreign institutional purchases (and sales) continue to be important. By March's end 2006 foreigners owned 26.7 percent of the Japanese stock market, up 3 percentage points from a year earlier and from 18.6 percent in 2000, a profound change from the 4.9 percent share in 1990. Japanese households, with huge savings in deposit form, have thus far been slow to purchase Japanese shares directly or through investment trusts (mutual funds).

The bond market provides important indicators of expectations about the economy's future performance, particularly inflationary expectations. With short-term interest rates expected to rise, the yields on benchmark ten-year JGBs and other government securities have begun to rise but not very much, notable given the increased uncertainty. Since many financial institution holders of JGBs also hold Japanese equities, capital losses due to interest rate rises will be offset, in many cases more than fully, by good economic performance (and stock price increases) that justifies and indeed requires appropriate interest rate increases.

Hedge fund and private equity fund activity, though still modest, continues to develop. It involves Japanese financial institutions investing mainly in foreign alternative investment instruments, but gradually increasing in Japan as well. A relatively small number of dedicated foreign funds invest predominantly in Japan; that too is rising.

Significant capital market imperfections persist despite real improvements over the past several years. The market for the junk bonds and higher-yield bank loans of less-creditworthy large and medium firms remains underdeveloped. Capable credit-risk evaluation of SMEs is

weak. For small firms and consumer finance, a key issue is whether the government will reduce the interest rate ceiling from 29.2 percent to 20.0 percent, in legislation scheduled for this fall. While that is likely, also likely are exceptions for smaller loans, possibly with a ceiling higher than the level of most current loans, and a significant delay before the new regulations are implemented.

A pro-market, prudential regulatory system, essential for financial market efficiency, continues to be put into place, though loopholes remain. Equally important is effective implementation of existing rules and regulations.

With the NPL problem behind it, the Financial Services Agency (FSA) has been able to turn to proactive reform of the financial system. The FSA has vigorously opened investigations, and has imposed business suspension, improvement orders, or other significant sanctions and penalties on leading firms throughout the sector. This includes both domestic and foreign firms and auditors (the Kanebo case), as well as fraudulent behavior scandals at specific companies such as the Livedoor and Murakami melodramas. The FSA is working to establish a rules-based system with accountability and transparency. One danger is that those supplying risk capital, Japanese and foreign, will be targeted, particularly in the media, as part of the backlash against still needed reforms.

In addition to ongoing FSA activities, further reform of Japan's financial institutions is both needed and, by and large, moving ahead.

The Tokyo Stock Exchange, plagued by a series of embarrassing incidents revealing its technological inadequacies and inefficiencies, is committed to major investment in infrastructure so as to become world class. The Securities and Exchange Surveillance Commission (SESC), under the FSA, has been increasing staff to investigate securities violations, though it still needs considerably more professionals with requisite technical skills. It probably should become an independent government agency.

Reform of government financial institutions (GFI) is moving ahead. Consolidation is underway, and two of the eight GFI will be privatized. Importantly, government (and Japan Post) provision of funding for these lending institutions will continue to decrease significantly. The great question marks for GFI reform are the specifics as to how Japan Post is privatized.

6 Corporate Japan

The corporate sector has changed dramatically in the past two decades. The traditional pillars of the postwar economic system are evolving: the permanent employment commitment is being narrowed to a smaller core of full-time regular employees; while still bank based, corporate finance relies more on capital markets and is more responsive to their signals; and entrenched corporate management autonomy is weakened by new rules on transparency, disclosure, and modifications in corporate governance.

Most firms have engaged in restructuring, consolidation, and reduction of their work force by attrition and early retirement. With continued improvements in labor productivity and reduction in costs, firms have become quite profitable without significant increases in sales. Considerable consolidation and restructuring through friendly mergers negotiated directly between managements have taken place in major industries, notably steel, vehicles, paper and pulp, chemicals, pharmaceuticals, banks, and insurance companies.

Japan's business system is even more rooted in long-term relationships than most other countries. While the economist's abstract ideal may be spot markets, the important reality is that most business transactions are regularly repeated over extended periods of time. This is typically the case with the suppliers of inputs: workers, component parts makers, service providers, creditors. Sustained relationships require and engender trust, and under most circumstances are economically beneficial. When economic conditions significantly change however, so that resources need to be transferred to more efficient uses, binding relationships can become liabilities. Moreover, some relationships become too cozy, self serving, and even collusive.

Japan's economy is in the long-run process of becoming more competitive and market oriented. Inefficient relationships are being eroded, even ended. The past fifteen years have seen many such cases of changing relationships: Nissan and its excess number of parts suppliers, banks continuing to lend to weak companies with nonperforming loans, the Ministry of Finance convoy system of financial institution regulation, government officials retiring into cushy corporate positions *(amakudari)*, bank-client cross-shareholding, and the permanent employment system. Efficient and effective relationships will persist, but they will be more conditional, which means less strong and probably less long term.

6.1 Corporate Governance

Japan's corporate governance system continues to evolve. Global convergence proceeds in terms of the overarching principles of transparency, disclosure, honesty, accountability, and responsibility. However, important specific differences in how these principles are interpreted and implemented persist in each country. Japan is considering legislation based on the U.S. Sarbanes-Oxley law, referred to as J-Sox. The results of the debate will further shape the legal basis for corporate governance behavior.

Japan will not wholeheartedly adopt an Anglo-Saxon model of corporate governance. The overwhelming majority of Japanese listed companies will continue to be controlled by entrenched management as members of the board of directors, even with the legal changes that mandate that a majority of the separate board of auditors must be outsiders. Relatively few companies will choose to use an American-type committee board system. For most listed companies, one or a few members of the board of directors will be from the outside, but they will not control the board.

A major lesson of the past fifteen years is that good profits, if not actual profit maximization, are essential to all stakeholders – not just shareholders, but also management, employees, creditors, and suppliers. While management has certainly become much more responsive to company share prices and other shareholder interests, companies will continue to weigh heavily the interests of their regular, long-term employees, especially those on the management track. After all, these employees embody the technology and know-how essential to produce goods and services efficiently and competitively, and to sustain the management system over the longer run.

The infamous thirty or so distressed large companies termed "zombies" have been resuscitated or otherwise dealt with. Nonetheless, many weak companies, both large and small, persist. They are still kept afloat by banks at interest rates completely unrelated to credit risk. Until July the prime rate was 1.375 percent. At the end of May 2006 loans and discounts with an interest rate less than 1.0 percent amounted to 27.7 percent of total bank loans, an increase from 20.0 percent in May 2002 when the economic recovery was beginning. Loans at less than 0.5 percent interest were 13.0 percent of the total, up from 8.2 percent in 2002. The bank prime lending rate will surely continue to increase over the next two years. Will these weak borrowers improve their businesses sufficiently to pay increasing loan charges? If not, will they go under, or will they continue to be kept alive by their banks, at increasing cost to bank profitability?

Perhaps a more serious potential problem is how successful firms will behave. While managements have identified their company's core competencies, they have not yet completed the process of divesting divisions or activities that are no longer central. Mergers and acquisitions involving outside players, though actually always friendly, are still relatively few; they will increase only gradually.

Japan has yet to fully develop a hostile takeover bid (TOB) market. Though unsuccessful, Oji Paper's hostile bid for Hokuetsu Paper this summer, also involving Nippon Paper Group and Mitsubishi Corporation, represents a significant qualitative change. Unlike the attempt by upstart Livedoor to take over Nippon Broadcasting in 2005, this pitted large, long-established, traditional Japanese companies against each other. Many such companies now have ample cash; the TOB market may finally emerge in Japan.

A real danger now is that managements will squander cash on new but unprofitable domestic investment projects. They should distribute substantially more profits to shareholders through dividend increases and share buybacks. However, managers want their empires to be larger. Such behavior in these good times would set back the still-incomplete process of allocating resources more efficiently.

7 External Economic Relations

Large current-account surpluses, achieved by significant increases in exports, have long played an important role in maintaining Japan's aggregate demand, despite trade's relatively small share in GDP. This reflects Japan's manufacturing competitiveness, as well as surplus savings being lent abroad. In fiscal 2005, Japan's current account surplus was a hefty 3.7 percent of GDP. The surplus is expected to persist for 2006 and narrow in 2007 as export growth is projected to slow.

Japan's balance of payments position is being significantly influenced by two relatively new factors: its role as a creditor and the likely continued high level of oil prices.

In 2005, Japan's net surplus of ¥12.5 trillion ($109 billion) on its income account—interest and dividends—surpassed its trade surplus. Japan is a mature creditor country, the largest in the world. As a result of annual current account surpluses since 1980, Japan is a global net creditor on the order of ¥184 trillion ($1.6 trillion). About half is in the form of government foreign exchange reserves. About 9 percent are the assets (undervalued in fact) of Japanese multinational foreign direct investments (FDI). Japanese FDI outflow in 2005

amounted to $46 billion, the highest since 1990; most was in the form of reinvested profits. In contrast, Japan continues to be a low recipient of FDI; the inflow of $2.8 billion in 2005 was below the $7.8 billion in 2004.

Japan has to import essentially all its oil and natural gas. The world price went from $45 a barrel in fiscal 2004 to $60 in 2005, and may average $70 in fiscal 2006, despite the recent sharp decline of more than 20 percent to about $60. These movements have not yet seriously affected Japan's CPI.

The actual global supply-demand situation for oil is not clear, and the price has been subject to considerable volatility. In the short run, oil shocks significantly interrupting supply are accidents waiting to happen. And, given the course of human history, they probably will. Sustained oil price spikes are probably the single greatest economic threat to Japan and the world economy. Japan would be harmed mainly by the slowing of world growth, global inflationary pressures, and export slowdown if oil prices rise further. It can absorb the direct effects of its increased oil costs reasonably well.

I have been surprised by the yen's weakness over the past year, given the economic fundamentals. However, the large and widening interest rate gap between yen and dollar financial assets has had a significant impact, generating huge net financial outflows from Japan. As the economy continues to improve and as Japanese interest rates rise while they level off in the United States, I expect the yen to appreciate somewhat against the dollar, but I am not sure how soon this will occur. That is quite aside from whether the dollar will decline significantly versus other currencies because of the huge U.S. current account deficit.

8 The Longer Run

Japan's two fundamental realities are that its population has peaked and will decline, and now that it has become a mature economy the long-run potential growth rate is not likely to be much more than 2 percent per capita at best. Consequently, Japan's economic structure will profoundly change over the long run.

Projections of Japan's demographic transition indicate the population will decline slightly over the next five years or so (-0.1 percent annual rate), then more rapidly (-0.3 percent) until 2020, and at a further -0.5 percent rate during the following 30 years. The population is projected to decrease to 121.1 million in 2025 from 127.7 million today, and to about 100 million in 2050. As context, the population was 94.8 million in 1960, including Okinawa. The share of

the population 65 and older, now 20.6 percent, will rise to about 27.8 percent by 2020. Those 15 to 65, termed the working age population, will continue to decline annually about 0.7 percent until 2010, and then 1.1 percent until 2015.

With decreasing supplies of workers, labor markets will be tight. Wages will be bid up, especially for 3D jobs (dirty, dangerous, difficult). Government pension and health care costs will rise as a share of GDP, and so, too, will revenues (taxes). Large-scale immigration sufficient to maintain the labor force and the population is unlikely. At most, foreign contract guest workers will be tolerated in order to ameliorate labor shortages in 3D jobs and health care. It is possible that at some point in the distant future Japan's total fertility rate, now only 1.25, will rise to the 2.1 sufficient to maintain a level population. For that, profound changes in values and behavior, as well as in institutions, will have to take place.

As an advanced, high income, wealthy, mature economy with a sophisticated technological base, Japan's potential GDP growth rate may be about 2 percent per capita. That has been the experience of other economies more or less at the global technology and productivity frontier. However since labor input will decrease, many argue the potential total GDP growth rate will be only about 1.5 percent. The key to Japan's sustained growth will be continually improving labor productivity. That depends fundamentally on technological innovations and their diffusion, enhanced education and training, and better capital (machinery, buildings, software) per worker.

Japan's standard of living will double every thirty-six years if GDP per capita grows at 2 percent annually. Even if it only grows at 1 percent—slightly worse than its performance over the past fifteen years—the average standard of living will double in Japanese lifetimes.

Achieving Japan's potential growth rate in the long run will not be automatic or easy. Probably the most important structural transformation the economy requires is to shift the growth engine from high saving, high investment, and high exports to domestic consumption-led growth. Japan's saving and investment rates are wastefully high for an economy growing at 2 percent. Japan needs to invest less but more efficiently.

The key to generating sufficient aggregate demand is consumption growth. The Japanese economy is too large to rely significantly on net export growth to be a major source of aggregate demand. Consumption will have to become a significantly larger share of GDP. To

achieve that, wages and household incomes must rise, which they will because labor markets will be tight and the yields on financial assets will improve.

9 Conclusion

To recapitulate, Japan is on a sustained growth path and, if growth continues well, will probably fully absorb remaining slack and achieve full employment growth within two years or so. As that takes place, financial markets will gradually return to normal. However, economic expansion may falter on its current path to sustained growth, though that is not very likely. Downside risks are greater than upside risks.

I worry both about demand disappointments and supply shocks. My greatest near-term concern is that Japan's domestic demand effect of U.S. economic slowdown, which will reduce Japanese exports, will not be offset by a sufficient increase in domestic consumption. Inadequate aggregate demand has been Japan's long-term problem which has not yet been fully resolved. I also worry that the policy definition of price stability will be too low, and that deflation will not really end soon. I suspect that the Abe administration will not persist strongly in implementing economic reforms. And I continue to be wary of the global, and hence domestic, effects of oil price volatility and especially of continued high price levels.

A major challenge for Japanese will be how to alter their mindsets. The postwar economic mindset, and the institutions supporting that mindset, has been buffeted by the economic failures of the past fifteen years as well as by Japan's longer-run economic, political, and social transformations. To compete globally, Japan has to allocate resources more efficiently and effectively, and that requires major mindset changes. Established practices, modes of behavior, and rules of the game (social norms) will have to continue to adjust to today's new realities.

Many issues are yet to be resolved. How far should competitive forces and free market forces go? How, and to what degree, should the weak be protected and sustained? How can such goals be achieved more efficiently? Japan is neither an American Darwinian-type society nor a European welfare-state society. I think its middle-of-the-road, rather egalitarian, commitments will persist.

Japan is certainly not alone in the challenges it faces. It has many strengths that will enable it to do well. Japanese have attained a high educational level; workers are skilled, strongly motivated, and very productive. Its high capital/labor ratio will increase further. Japan's

technological level is outstanding and will continue to improve. Japan is a democracy, with strong rule of law. Compared to most other countries, the degree of corruption is low. It is a stable society; status differentiation is important, but a considerable egalitarian sense constrains inequalities. Japan will continue to be a major world player in the global economy, and certainly at least as successful in dealing with its problems as most other major advanced countries.

ATSUSHI SAITO
SETSUYA SATO

After the IRCJ: A New Capitalism on the Rise in Japan?

After the IRCJ: A New Capitalism on the Rise in Japan?

Atsushi Saito, President & CEO
Setsuya Sato, Senior Director
Industrial Revitalization Corporation of Japan

After a decade-long struggle with the aftermath of the bubble, Japanese business and the economy is finally emerging from the prolonged stagnation. Looking forward, as the society seems ready to move to the next stage under the initiative of the new Prime Minister, it is now important to learn from the lessons of the past, rather than lamenting about the "lost decade" or becoming too complacent.

In this paper, we would like to discuss five topics: (1) Japan's NPL problems and the economy; (2) the IRCJ's achievements and performance; (3) changes in the environment since the IRCJ's establishment; (4) market principles and corporate governance; and (5) a model for new Japanese capitalism in the 21st century.

1. Japan's NPL problems and the economy

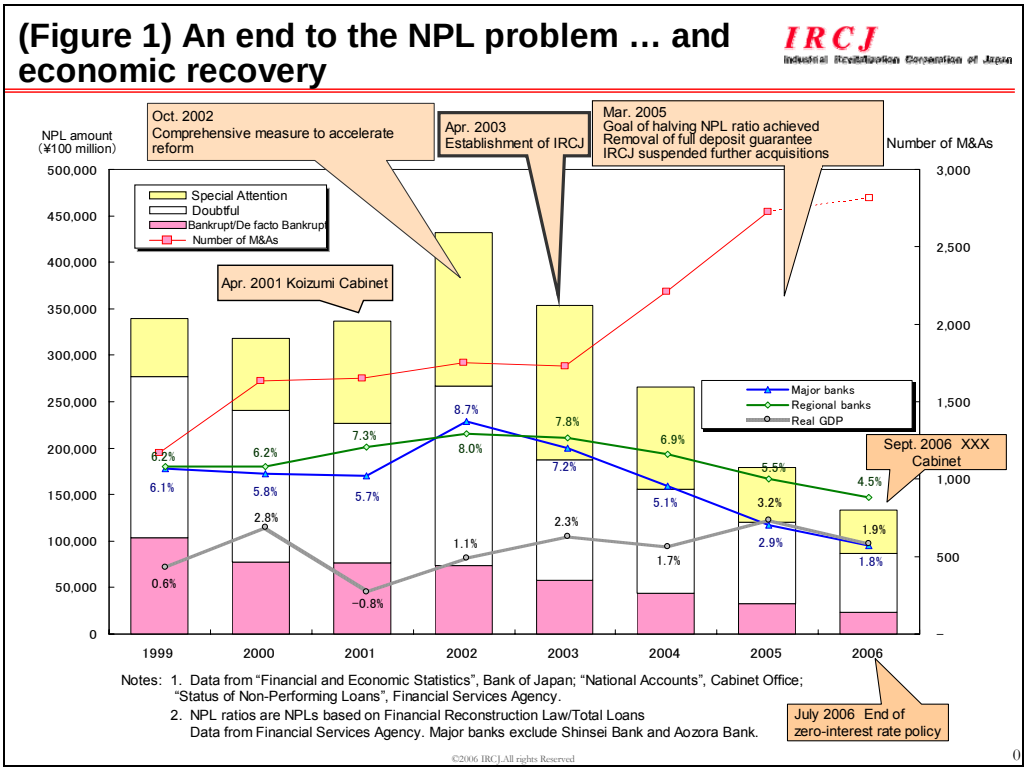
An end to the NPL problem … and economic recovery (Figure 1)

Let us first quickly review the key developments over the past six or so years.

■ Former Prime Minister Junichiro Koizumi took office in April 2001 and announced a comprehensive reform package in October 2002 aimed at revitalizing both the financial and industrial sectors simultaneously. The IRCJ was established as part of the package in April 2003, its task to assist troubled companies, which eventually numbered 41. At the end of March 2005, the goals previously announced by the government of halving the NPL ratio and removing the full deposit guarantee were achieved. Namely, the major banks' NPL ratio came down to 2.9% in March 2005 from its peak of 8.7% in March 2002, and went down further to 1.8% in March 2006. The NPL ratio of regional banks has also declined, but not as much as the major banks, and still remains an issue.

■ The IRCJ also suspended its acquisition of new companies on the same date. In July 2006, the zero interest rate policy was terminated—ushering in a return to normality for Japanese monetary policy. In September 2006, new Prime Minister took office.

■ It is important to note that the number of M&As increased steadily throughout this period.



Reasons Japan overcame deflation … declining breakeven ratios (Figure 2)

■ The key drivers of Japan's economic recovery and improved corporate earnings despite deflation are as follows:

(1) The "three excesses"(excessive debt, excessive production capacity, and excessive labor) have been eliminated;

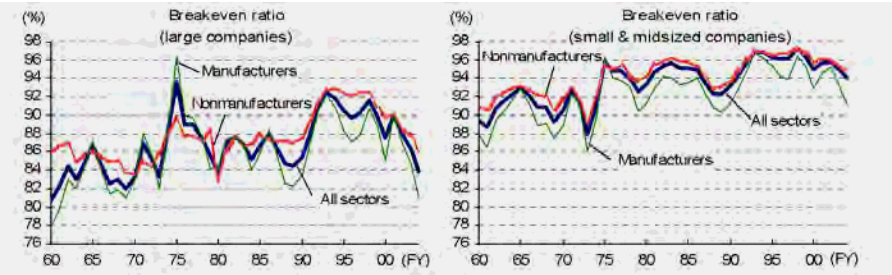
(2) Fixed costs have been either reduced or converted to variable costs (interest expenses, depreciation, employment costs); and

(3) Breakeven ratios have declined, and companies have become increasingly lean.

(Figure 2) Reasons Japan overcame deflation…declining breakeven ratios

IRCJ
Industrial Revitalization Corporation of Japan

- Key drivers of improved corporate earnings despite deflation:
  - Elimination of so-called "three excesses" (excessive debt, excessive production capacity, excessive labor)
  - Reduction of fixed costs/conversion to variable costs (interest expenses, depreciation, employment costs)
  - Declining breakeven ratios, companies becoming increasingly lean



Note: (1) Breakeven ratio (%) ≡ breakeven sales/sales x 100, where breakeven sales ≡ fixed expenses/(1 – (variable expenses/sales)); variable expenses ≡ sales – recurring profits – fixed expenses, and fixed expenses ≡ personnel expenses + depreciation + net non-operating expenses + (0.7 x SG&A expenses). We multiply SG&A expenses by 0.7 for the following reason. In the MOF's "Financial Statement Statistics of Corporations by Industry," personnel expenses and depreciation are presented separately and also included on an apportioned basis in SG&A expenses and costs of sales. Accordingly, if SG&A expenses were added together with the other components of fixed expenses without being adjusted, the personnel expenses and depreciation included in SG&A would be double counted. Considering that personnel expenses and depreciation's share of listed corporations' SG&A expenses has historically been relatively stable at around 30%, we multiplied SG&A expenses by 0.7 to estimate SG&A expenses net of personnel expenses and depreciation. The number 0.7 itself is one determinant of the breakeven ratio's level, but does not influence the ratio's trend. (2) Large corporations are corporations with paid-in capital of at least ¥1bn. SMEs are corporations with paid-in capital of less than ¥1bn.
Source: Nomura, based on the Ministry of Finance's "Financial Statement Statistics of Corporations by Industry"

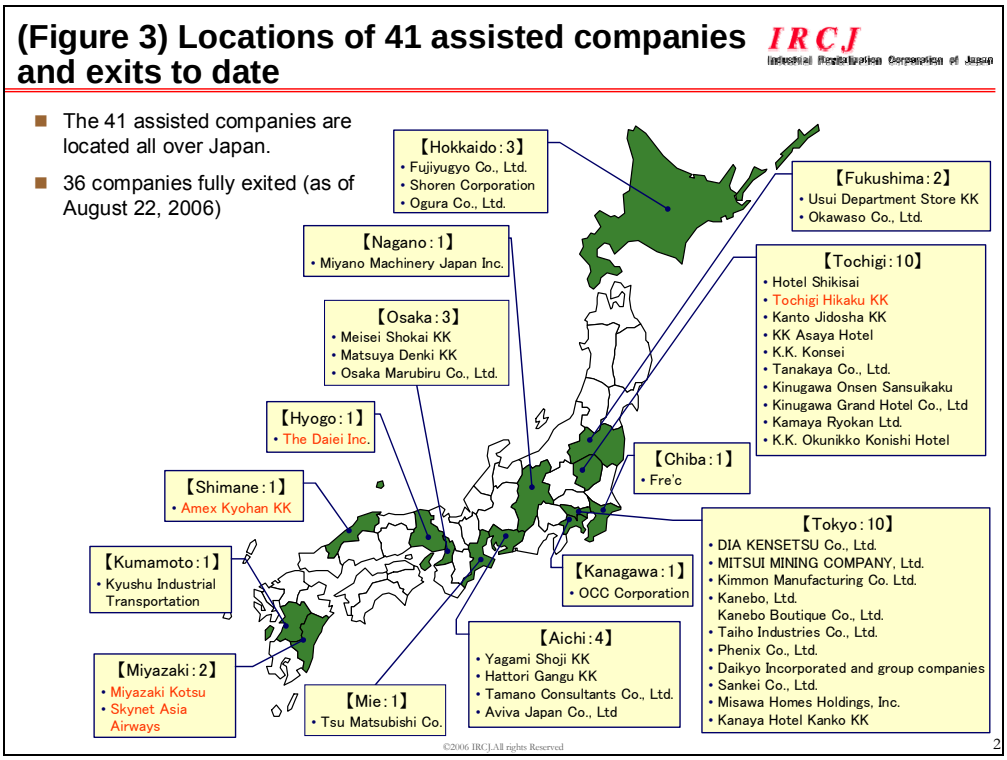
1

2. The IRCJ's achievements and performance

Locations of 41 assisted companies and exits to date (Figure 3)

■ Let us move on to the second topic—the IRCJ's achievements and performance.

- As you can see on the map, the 41 assisted companies are located all over Japan.
- We have fully exited 36 companies to date (as of August 25, 2006).



Breakdown of 41 assisted companies (Figure 4)

■ We have provided assistance for 10% of the total amount of NPLs (or 20% of those NPLs classified as "Special Loans"). The amount of loans borrowed by companies the IRCJ assisted totaled \4 trillion, whereas the total amount of NPLs when the IRCJ was launched was \35.3 trillion (including Special Loans of \16.5 trillion).

■ A breakdown of the "main banks" of the companies the IRCJ assisted is as follows: Megabanks and city banks, 19 cases; Regional banks, 20 cases; Second-tier regional banks, 1 case; others (corporations), 1 case.

■ We assisted companies from a wide variety of industries, including: 13 companies or 30% from the service industry (including 10 hotels and inns); 10 companies or 26% from the manufacturing industry; 7 companies or 17% from the wholesale industry; 5 companies or 12% from the retail industry; 4 companies or 10% from the transport industry, and so forth.

■ Although the IRCJ did not attempt to undertake the revitalization of any "industrial sector" *per se*, which was beyond the IRCJ mandate anyway, the restructuring

models and techniques developed and used by the IRCJ have been widely used by market players—causing a spillover effect.

(Figure 4) Breakdown of 41 assisted companies

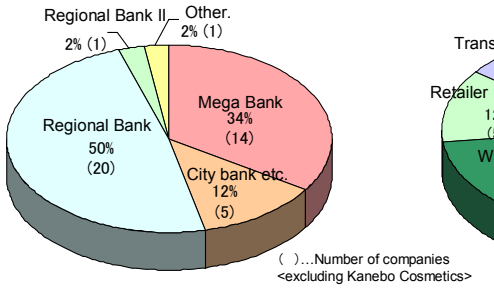
IRCJ
Industrial Revitalization Corporation of Japan

- Assisted equivalent to 10% of total NPLs (25% of "Special loans")
  - The amount of loans borrowed by companies the IRCJ assisted totaled ¥4 trillion, whereas the total amount of NPLs when the IRCJ was launched was ¥35.3 trillion (including Special Loans of ¥16.5 trillion)

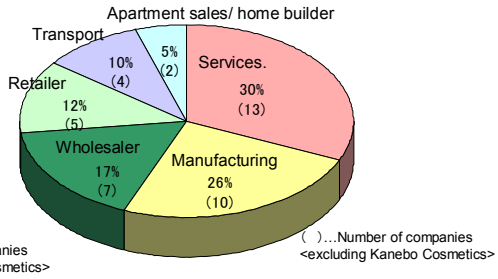
(¥100million)

Special loans (All banks) (March 31, 2003) (A)	Borrowing amount by assisted companies (B)	Amount of financial assistance
165,790	40,255 (B/A 24.3%)	14,312 (C/A 8.6%)

- By main banks



- By industry category



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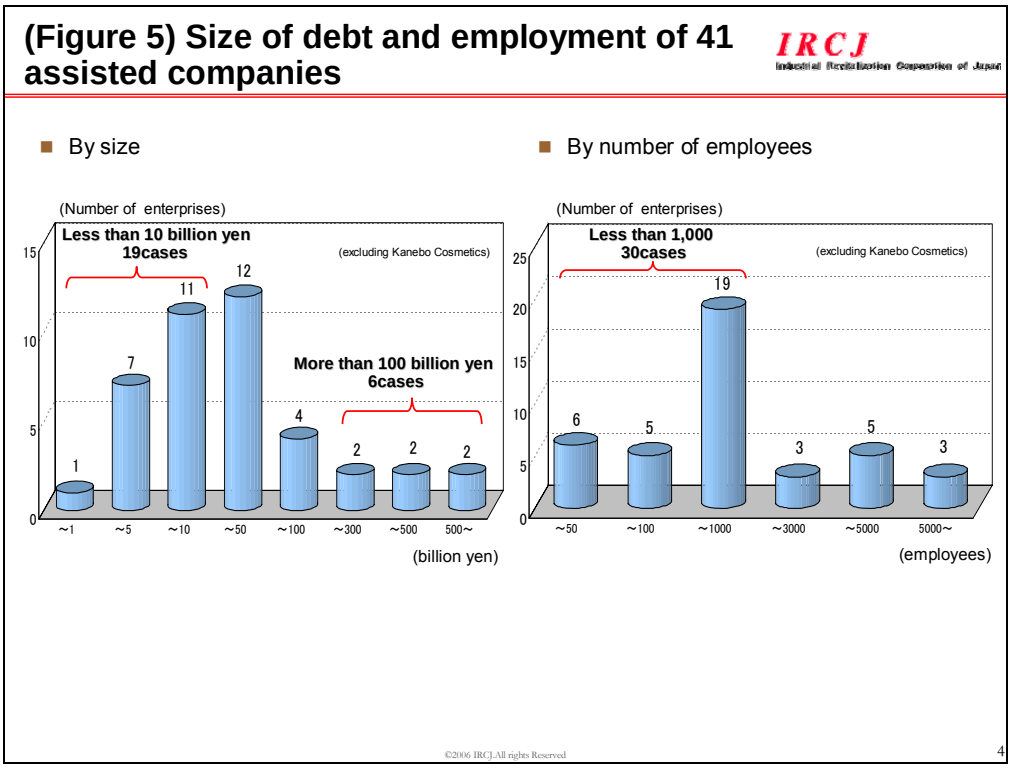
Size of debt and number of employees at the 41 assisted companies (Figure 5)

■ The figures on debt size are as follows:

- Companies with debt of less than \10 billion accounted for 19 cases or nearly 50% of all assisted companies.
- Large companies with debts of more than \100 billion accounted for 6 cases, including Daiei, Kanebo, Daikyo, Mitsui Mining, Misawa Homes, and Dia Kensetsu.

■ The statistics on the number of employees are as follows:

- Companies with less than 1,000 employees accounted for 30 cases or 73%.
- Of the 11 companies with more than 1,000 employees, three of them (Daiei, Kanebo, and Misawa Homes) had more than 5,000 employees.



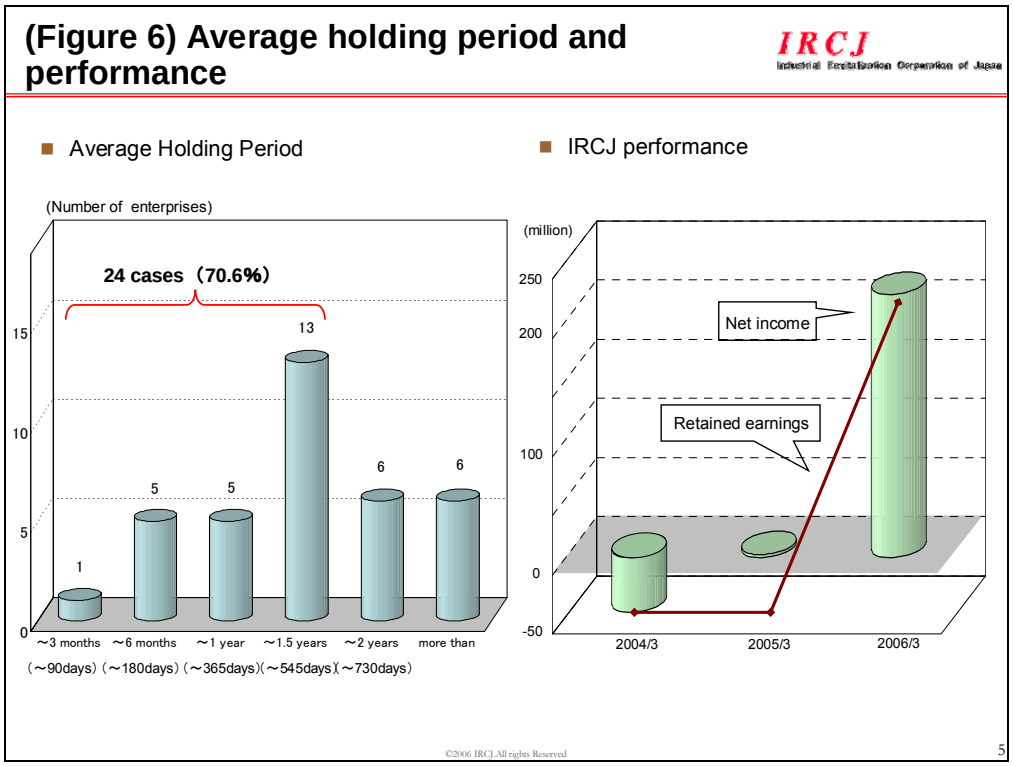
Average holding period and performance (Figure 6)

■ As mentioned earlier, we have fully exited 36 cases to date.

➢ Of these, we exited 24 cases or 70% within one and a half years from the date of investment.

■ As the result of our successful and profitable operations, our net income was about \20 billion ($174 million) and our retained earnings was about \18 billion ($157 million) for FY 2005. Since we continued our profitable exits in FY 2006, it is now probable that we can close our entire operation with a surplus we can return to government coffers. It is more than likely that Japanese taxpayers will not bear any burden relating to the operation of the IRCJ.

■ It should be noted that, globally, it is rare for a government-sponsored asset management agency to be dissolved without losses. For example, in the case of the Resolution Trust Corporation in the U.S., the final cost for U.S. taxpayers for the clean-up activities amounted to an estimated $82.7 billion.

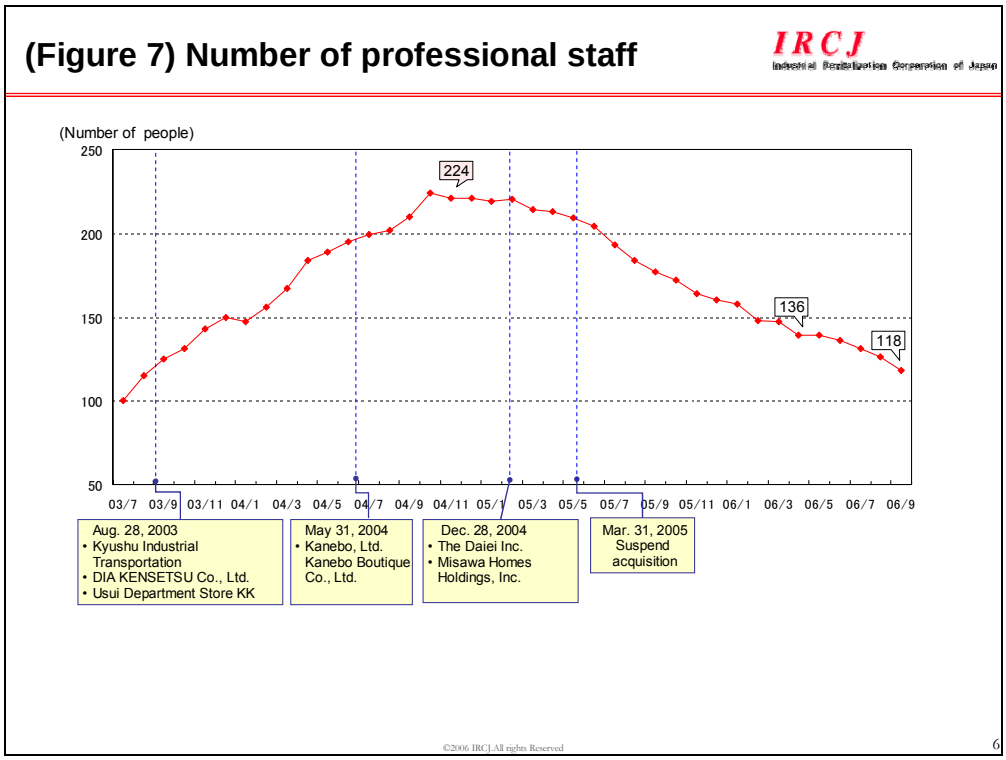


Number of professional staff (Figure 7)

■ As we wind up our operations, increasingly fewer professional staff such as financial accountants, bankruptcy lawyers, business consultants, and so forth, are needed.

- The number of professional staff was 224 at its peak in the fall of 2004 when a huge number of cases were brought to the IRCJ for assistance at the last minute, before we suspended new acquisitions.
- Thereafter, our number of professional staff has consistently declined as we exit the remaining companies, and stands at less than 100 today.

■ Most of the staff who left the IRCJ returned to the private sector, where they are spreading the experience and techniques they acquired at the IRCJ. Some have established their own private equity funds.



3. Changing environment surrounding Japanese corporations

Changing environment surrounding Japanese corporations (Figure 8)

■ Let us now turn to the third topic and briefly review the changes in environment such as changes in corporate strategy, the financial markets, the human resources market, and the product and consumer markets since the IRCJ's establishment.

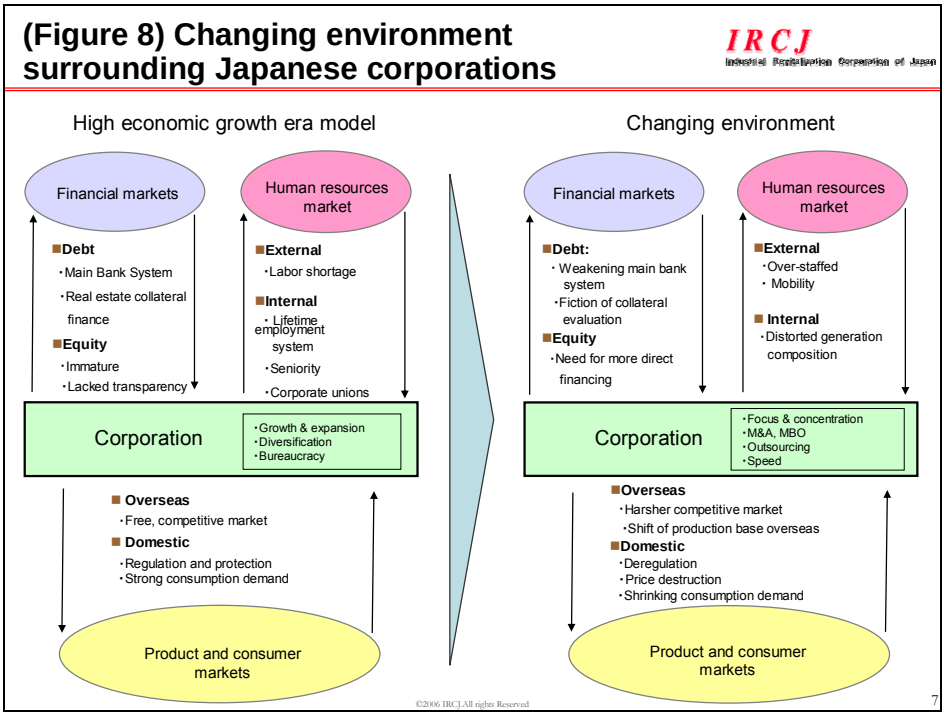
■ We are sure they do not need explaining, but the factors that drove Japan's high economic growth era from the 1950s to the mid 1970s are shown on the left-hand side of the diagram. They are as follows:

- Corporations' strategy was growth and expansion, diversification, and their structure was bureaucratic.
- The "main bank" system provided finance needed for growth—finance that was basically real collateral-based. The Japanese equity markets were still immature and lacked transparency.
- There was a labor shortage in the human resources market. The characteristics of the labor market were lifetime employment, seniority, and corporate unions.

- The product and consumer market was highly regulated and protected, and there was strong consumption demand.

■ These factors have changed dramatically over the past 15 to 20 years and the pace of change has been accelerating. The right-hand side of the diagram lists these changes, which are as follows:

- Corporations' strategy has shifted towards focus and concentration, with M&A and MBOs increasing all the time, and more reliance on outsourcing. Speed has become a key factor.
- The main bank system has weakened and, as a result of rigorous due diligence, corporations' collateral evaluations were revealed to be fictitious. Since the bank-based financing system has proved to be vulnerable to shocks, there are calls for more direct financing through the equity markets. Obviously, revitalizing the banks is not sufficient in itself for resolving all the problems.
- Companies are over-staffed and labor force mobility has increased. The distortion evident in the generation composition of the labor force has become an issue.
- The product and consumer markets are characterized by deregulation, price destruction and shrinking demand. Production bases are shifting overseas, particularly to China.

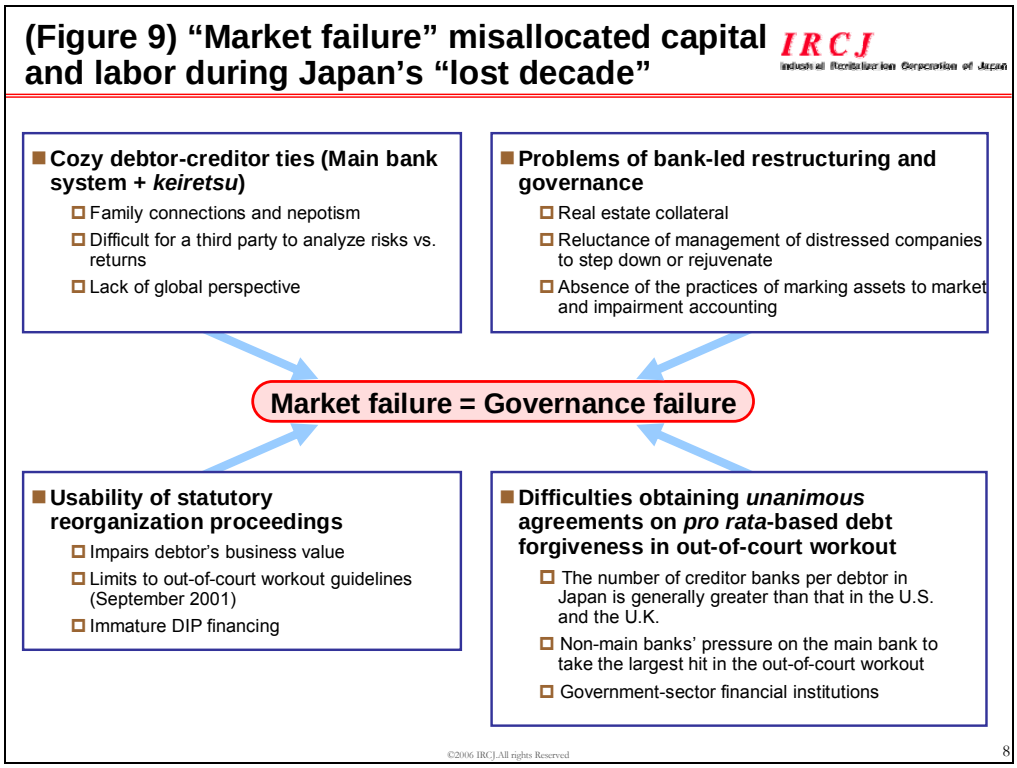


“Market failure” misallocated capital and labor during Japan’s “lost decade” (Figure 9)

■ In hindsight, one could argue that those companies that had to seek IRCJ assistance had ignored or failed to keep apace with these changes I have just described. The underlying factors that kept those companies afloat despite their neglect of these rapid changes are what we could term “market failures”.

- In an economic environment characterized by prolonged inflation, Japan developed a connection-oriented, bureaucratic allocation-oriented economy, instead of market-oriented capitalism that pursued capital efficiency.
- The main bank system and the *keiretsu* system of groups of companies with interlocking business relationships led to the creation of very cozy ties between debtors and creditors, a world based on connections and slipshod accounting.
- The practices of marking assets to market or using impairment accounting were virtually absent and stringent corporate governance was avoided.
- Critical managerial information has long been concealed behind closed doors, making it impossible for a third party to analyze the risks vs. returns appropriately.
- Bank-led governance focused primarily on securing the requisite collateral against the value of the loan and ignored the profitability of the business.
- Lender banks didn’t care much about how the money was used. In other words, they didn’t pay attention to the content or value (NPV) of the business for which the loan was supposed to be used so long as the value of the collateralized asset exceeded the value of the loan, since most collateral was in the form of real estate.
- Banks were mainly concerned with how to avoid debt forgiveness (or negative net worth) through cutting costs and wages, taking advantage of deferred tax assets and so forth. They thus shied away from facing up to—and ultimately resolving—their problems, preferring instead to continue to lend to “zombie companies”in an effort to keep them afloat—which served only to aggravate the situation.

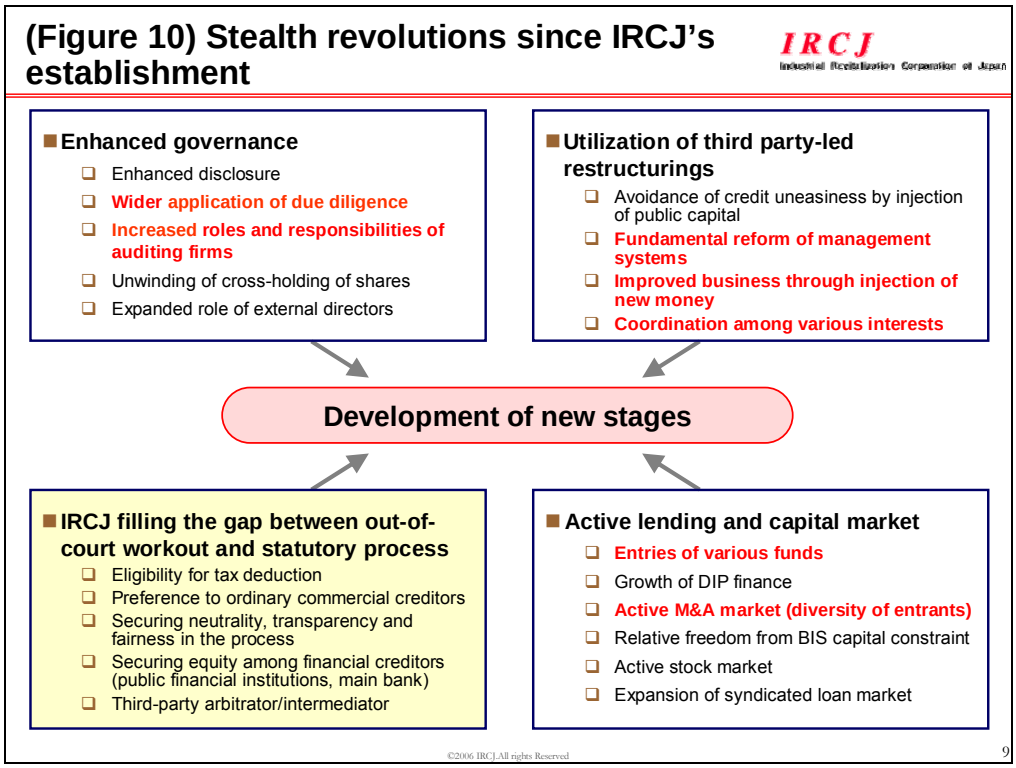
■ These problems are described as “relationship capitalism” by Rajan and Zingales in their famous book, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity*.



Stealth revolutions since IRCJ's establishment (Figure 10)

■ Although they often fall below the radar, there have been various new developments inspired by the IRCJ operations. The IRCJ has revealed various problems that existed at the heart of the Japanese social system and that hindered efficient revitalization of corporations.

- For example, the wider application of due diligence procedures and increased roles and responsibilities of auditing firms will certainly lead to enhanced governance.
- The utilization of third-party-driven restructuring such as that conducted by the IRCJ has led to fundamental reform of management systems, improved business through injection of new money, and promoted coordination among various conflicting interests.
- Various types of funds, both domestic and foreign, have become new entrants to the markets. As we have seen, the M&A market has become increasingly active—and is characterized by its diversity of entrants.



4. Market principle and corporate governance

"Market principles" as a new rational, external discipline

■ Next, we would like to talk about the market principles and corporate governance.

■ In the past decade or so, several weaknesses inherent to the traditional Japanese corporate model have manifested, including:

- An absence of external discipline
- A lack of corporate governance
- Long neglect of aggravating circumstances including corruption and unprofitable operation

■ In light of the increasing discoveries of accounting manipulation, fraud, mismanagement, and so forth, corporate governance based on a stringent capital doctrine is now being recognized as an effective means of controlling and cleaning up the corruption.

■ In this context, the debate over which corporate model—that of the U.S. or that

of Japan—is superior is not very meaningful.

- It is now widely understood that the fiction that “the shareholders own the company” has reached the twilight of its life.
- It is becoming understood that effective governance requires steady efforts to attract and develop shareholders and investors who will govern by prioritizing the importance of the company’s continuous profit growth.
- To ensure effective governance, a company needs shareholders who have a long-term commitment to it and an accumulation of risk money they are prepared to manage patiently, which will be more effective in increasing corporate value over the medium and long term—to maximise the return on risk.
- We’ll elaborate on this point in the next section, and save the next point—the challenges facing Japanese corporations—for a later section.

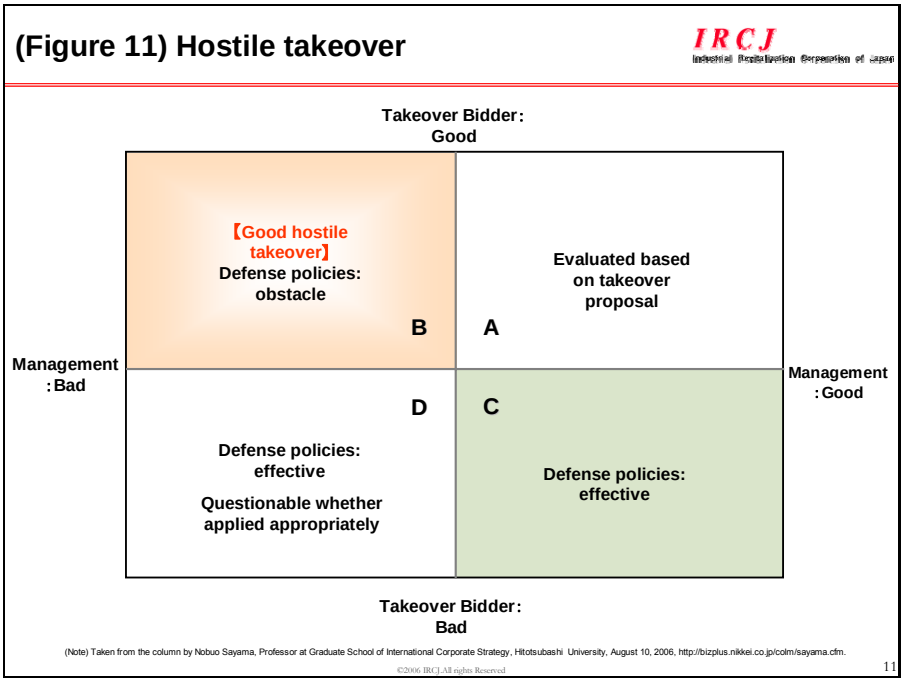
Hostile takeovers (Figure 11)

■ As you are well aware, one effective means of exercising market discipline is through hostile takeovers—once rarely seen in the Japanese M&A market but now increasingly commonplace.

- Oji Paper’s attempt to take over Hokuetsu Paper, men’s clothing retailer Aoki’s attempt to take over another menswear retailer Futata, and so forth, are only a few such examples. Nippon Sheet Glass’s acquisition of Pilkington, Toshiba’s acquisition of Westinghouse and Softbank’s acquisition of Vodafone Japan are examples of increasing cross-boarder, non-hostile takeovers.
- However, sometimes confusing debates took place as to how anti-takeover defense policies should play out.

■ Generally speaking, the issue of whether a takeover is “hostile” or friendly should be separated from the question of whether the takeover is “good” or “bad” for the target company. A hostile takeover is hostile to the incumbent management, but may not necessarily be hostile to the other stakeholders.

■ The four quadrants A, B, C and D in this diagram show a combination of whether the takeover bidder is good or bad and whether the management of the target company is good or bad.



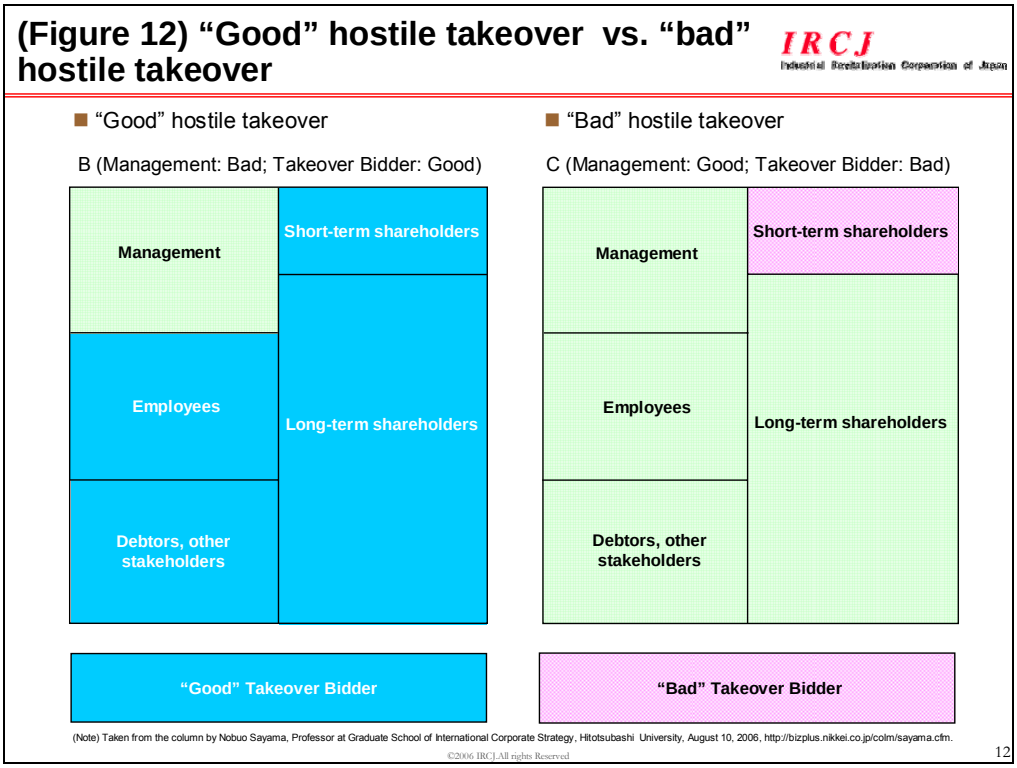
"Good" hostile takeover vs. "bad" hostile takeover (Figure 12)

■ A "good" hostile takeover in Quadrant B benefits all stakeholders—employees, trade partners, customers and so forth—other than the incumbent management opposing the tender offer.

■ If such a takeover succeeds, it will raise the enterprise value of the depressed target company and benefit all stakeholders.

■ A note of caution should be added at this point. For such a takeover bidder to claim that the proposed takeover would be "good", he or she would have to demonstrate what benefits would accrue as the result of the takeover. Otherwise he or she may lose public support and become viewed as a "bad" takeover bidder as shown in Quadrant C.

■ The issue for Japan's revitalization is how to increase the number of "good" takeover bidders.



"Government failure" and the public sector's new role

- Before concluding, let us discuss a little about the role of the public sector.

  - In a capitalist society, it may sometimes be required to soften the brutalism of capitalism by compromising efficiency and economic rationality.

    - Market fundamentalism alone cannot always guarantee people an appropriate standard of living.
    - The public sector should redress "market failure".

- However, government intervention needs to be kept to minimum in terms of both scale and duration.

  - This is because the public sector is generally not governed by the capitalist principles, and thus tends to cause"government failure" that manifests in the form of "relational" capitalism.
  - As we have discussed, the IRCJ's role has been to establish a market-disciplined

corporate governance framework that prioritizes capital efficiency

- ❑ We strongly believe that business failures should be dealt with by the private sector based on strict market principles.
- ❑ The IRCJ's voluntary dissolution next year should be understood in this context.

■ Government's role in the 21st century should be limited to developing a framework to promote an educational environment that nurtures professionalism, deregulation, and tax reform.

5. A model for new Japanese capitalism in the 21st century

A new capitalism on the rise in Japan?

■ We would like to conclude by giving our view on Japan's new capitalism.

■ We have emphasized the need to reconsider governance and improve discipline in the Japanese capital markets in the 21st century.

- ➢ The fundamental requirement of governance is to "exercise ultimate authority over personnel issues for managers who take the responsibility of managing a business through the use of financial data signaling the performance of the company," through both equity governance and debt governance.
- ➢ Passing the baton to the next generation—a generation that can command two languages, the language of business (people, goods, expertise, and profit and loss), and the language of finance (capital and balance sheets)—is crucial. This applies to both those who govern and those who are governed.

■ To this end, improving discipline in the human resources market and increasing the competitiveness of human resources are essential requirements.

- ➢ It is sometimes vital to make use of the survival threat posed by external personnel markets to pursue systems reform, change mindsets and so forth.

- It is also critically important to develop a new Japanese model for human resources who can adapt to the increasingly intangible, service-oriented and knowledge-based economy.

- For that matter, drastic changes are needed to revitalize management resources. The baton must be passed to the next generation.

    - It is hoped that the negative impact of population decline can be mitigated by improving the competitiveness and productivity of each individual Japanese person.

■ Reallocation and replacement functions need to be improved in the capital and human resources markets through increased competition.

- Safety nets need to be redesigned based on a competitive model.
- The roles of the public and private sectors need to be redefined.

    - The public sector should focus on making the rules—or developing the playing field—and concentrate on fulfilling the role of referee, so that
    - The private sector can maximize their animal spirits within the rules of the game.

Toward building a society where losers are given a second chance to seek success (Figure 13)

■ Let us sum up. As we have outlined, the primary reason for Japan's "lost decade" (or lost 15 years) is the absence of a "revitalization" component in the business recycling process, which has thus hindered the optimal allocation of capital and labor.

■ The conventional belief in Japan was that the "survival of the fittest" would widen the income gap and thus raise social costs.

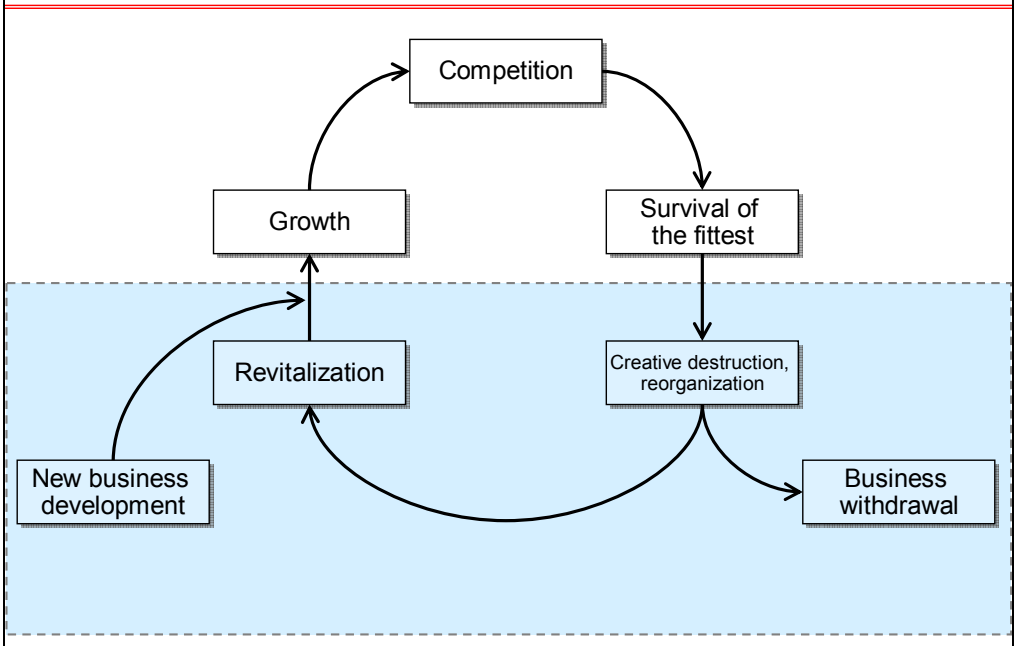
■ In the strongly free market societies of the United States and the United Kingdom, the argument that "losers" should not be propped up has gained strong support. In Japan, however, this kind of argument might be strongly criticized as the "arrogance of the

strong". Consequently, the national government and local governments have extended needless and meaningless subsidies to the weak, helping to drive public finances to the brink of crisis in the process.

■ The IRCJ has boldly strived to break through this legacy of traditional customs, conventions and practices.

■ New Prime Minister is committed to building a society where the losers, i.e., the failed or bankrupt, are given a second chance to seek success. Our job after the dissolution of the IRCJ is to make sure that this happens—by disseminating the knowledge and skills we gained and accumulated at the IRCJ.

(Figure 13) Toward building a society where losers are given a second chance to seek success



14

YOSHIKAZU TAKEDA

How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

Yoshikazu Takeda
Managing Director, Nippon Life Insurance Company

1. Current status of Tokyo and New York as global financial market centers

Both Tokyo and New York markets are recognized as major financial centers comparable to London in terms of market size, such as the amount of stock traded and foreign exchange transactions. However, the level of globalization is much different between the two markets. To compare the amount of foreign stocks traded in these two markets in 2005, $1.8 trillion was traded in NY, which amounts to nearly 10% of domestic stocks traded in the market, but only $2.8 billion in Tokyo, which is less than 0.1% of domestic stocks traded. (See table 1) This table shows that even though Tokyo market is considerably large in its market size, its level of globalization is far lower than New York.

According to a survey conducted among foreign-capitalized financial institutes in Japan, most of respondents answered that, while they consider Japan as the most important financial market in Asia, their Tokyo offices do not function as center for Asian business but cover only business with Japanese companies. This shows that Tokyo has built its status as a financial market center mostly supported by the large economy of Japan, but it is hard to call it a “global” financial market center at this moment.

Rapid economic growth in emerging countries, such as BRICs, may eclipses the importance of Japan as the world economic powerhouse and this in turn translate to the weakened position of Tokyo market as a financial center. From the standpoint of Japanese national economy, as manufacturing capabilities have been migrating to emerging countries where the labor cost is relatively low, it is becoming strategically important for Japan to retain and improve competitiveness of service industries, especially in high value-added financial fields.

Though New York’s level of globalization is much different from Tokyo, New York faces fierce challenges from other global financial market centers, such as London.

Meanwhile, we should also need to take into account the influence of information technology innovation when we discuss the competitiveness of a financial market center. IT innovation has certainly flattered the world, and it eliminated necessity for decision-makers to be

in the proximity of the market where transactions are actually executed. In such a situation, the definition of the financial market center changes. A “market” can mean the place where transactions are electrically booked or where reference places of transaction just happen to be that place. Persons who make actual decisions of transactions or related advices can live in different places far away from the market.

Boston is considered as one of the main cities in asset management business in the U.S. and important investment decision-makers stay in Boston, even though most transactions are executed in “New York market”. In the future, this phenomenon could permeate into various financial sectors, such as investment banking, legal consulting, and accounting services.

Naturally, activities related to investment decision making or financial advice services in the real world generate much more value-added than just providing virtual space for executions of transactions. Therefore, it’s more economically important for countries or cities to be chosen as the center of such high value-added businesses of real world. It’s important to consider possible impact of this kind of detachment between the real places where persons live and virtual spaces where executions take place.

2. Conditions for successful global financial market center

What are the conditions for financial market centers to be successful in global context and to improve their competitiveness? I believe the following four conditions are leading candidates.

(1) Liquidity and depth of financial market

To attract financial transactions, it’s important that financial products are fairly and actively traded and participants can easily measure their fair values. From this standpoint, a financial market backed by a large economy can provide deep liquidity from domestically originated transactions, and such a market has an advantage to become a global financial market center.

(2) Sustainability

An unexpected external shock beyond the level of usual economic volatility could be a threat to market participants in safeguarding asset value and carrying on their operations.

Therefore, it's important to ensure the political stability and sound economic policy with solid historical record.

(3) Dependability based on transparent and adequate regulation

The primary purpose of financial business is to exchange cash flows in order to meet various demands of both fund-raisers and fund-suppliers and to bridge between them, so value of financial business comes from creativity and flexibility. Therefore, a financial market needs to provide the environment where financial industry can operate as little unnecessary constraint as possible, and regulations need to be clearly defined by laws, no-action letters, rules or court precedents. Transparency of regulations should be one of the most important factors to be competitive as a global financial market center.

Also, adequacy of regulation should become more important as competition among markets increases. Too loose regulation results in loss of public confidence in a market, but too strict regulation causes inflated cost and lesser efficiency. It's important to achieve adequate level of regulation by responding flexibly to changes in socioeconomic circumstances, taking account of cost-benefit analysis, international comparison and possible alternative measures. To encourage dialogues between regulators and market participants is required to fulfill this condition.

(4) Quality of social infrastructure and human resources

For the development of a global financial center, it's important to retain high-quality human resources with high educational standard, English literacy, and professional knowledge of law or accounting. Importance of capability to communicate with foreign business partners increases as international transactions grow. And, as many foreigners come to a global financial center, it becomes increasingly important to establish high-quality social and cultural infrastructure for their quality of life.

Above mentioned four conditions are related with one another, and even though certain conditions are relatively undeveloped, it's still possible to achieve a global financial market center status if the levels of other conditions are high enough to compensate it. Singapore market may be a good example. The size of its domestic economy is relatively small and does not provide enough liquidity from its domestic fund pool, but it attracts liquidity from international source by good other conditions.

3. To ensure competitive positions in the future as global financial market centers

(1) Tokyo market

As discussed before, it's important to have regulatory setup in which financial institutions can operate flexibly and innovatively within fair and clear rule framework. However, laws are often subject to interpretation, and financial industry may face unexpected difficulties caused by change of interpretation. Also, innovative nature of financial industry may lead to mismatch where regulation becomes obstacles to new product development. Therefore, it's essential that the language of regulations is continuously updated in order to make up the gap with reality of the market. Even though Japan has been working hard on improvement of regulating system, yet there seem to be many areas to address.

For this purpose, Japan needs to cultivate much more legal capabilities in financial business, and to buildup a set of necessary rules to enhance regulatory transparency. To ensure the adequacy of regulation, it's essential that people with extensive knowledge of financial business engage in regulation-setting. Taking into account the fact that the labor market liquidity in Japan is relatively limited, I expect self-regulations by industry associations will become increasingly important.

Tokyo also has a lot of issues to address in terms of human resources and quality of social infrastructure. We simply do not have sufficient number of English-speakers with financial, legal, and accounting knowledge to support the further development as a global financial center for now.

The strength of Japanese market lies in high transaction liquidity supported by the world second largest economy and in political and economical sustainability. Tokyo market can perform as a fund-raising center for other Asian countries, which both economically and geographically have close relationship with Japan. We should consider to establish a market in Tokyo to trade new securities underlying shares of foreign corporations listed at other Asian markets (like ADR), or new asset-backed-securities which pool various types of risks in Asian markets.

(2) New York Market

New York market seems to satisfy most conditions to ensure the competitive position as a global financial market center, but it is witnessed recently that IPOs of foreign corporations avoid New York market. The Wall Street Journal on August 8, 2006 reported "nine of the world's 10 largest non-U.S. listed in New York in 2000; last year 24 of the largest 25 chose other markets, with London the leading alternative." It is said that one of the major reasons for this movement is to avoid too strict compliance regulation under the Sarbanes-Oxley Act (SOX) regime.

That is an issue of adequacy of regulation. The SOX was enacted in response to major corporate and accounting scandals of Enron and the likes, and it was thought as an adequate response to recover the market confidence in corporate governance in U.S. companies. However, as is shown above, the time may have come to examine the adequacy of the SOX by considering the cost burden of companies, international comparison and possible alternative measures. Dialogue between market participants and regulators is hoped.

(3) Icing on the cake

I believe that we need to take into account the possible detachment of real world from virtual space as a result of IT innovation. This leads to the question of whether people really want to live and work in Tokyo or New York. What Tokyo and New York are ultimately asked for might be steady efforts to improve their attractiveness and comfort as a place to be.

Table 1: Value of Share Trading in 2005

(USD Millions)

Exchange	Domestic	Foreign
NYSE	12,821,944.4	1,234,230.4
NASDAQ	8,605,088.7	591,029.1
Tokyo SE	4,436,804.0	2,821.8
Osaka SE	204,392.4	208.9
London SE	3,185,654.2	2,492,066.8

(World Federation of Exchange Statistics Annual 2005)

TOMOYOSHI URANISHI

How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

How Can Tokyo and New York Ensure Their Competitive Positions in the Future as Global Financial Market Centers?

Tomoyoshi Uranishi
Senior Executive Officer, Tokyo Stock Exchange, Inc.

1. Tokyo Stock Exchange and NY Stock Exchange are expanding.

The trade volume of NYSE has been increasing sharply in the recovery of the USA economy. On the other hand, the stock market of TSE had been stagnated for more than 10 years since the burst of the bubble economy. However, when bad loan issues of Japanese banks are almost settled in the spring of 2003, TSE market has started to recover.

Especially, recently many Japanese emerging companies have been listed in the stock markets. Such a trend supports the popularity of the total market. Japanese emerging markets, Mothers (TSE), JASDAQ, Hercules (OSE) which were hinted by NASDAQ in USA have been very successful and expanding.

I would like to analyze the future of the financial markets including the stock markets and the fundamentals which support the market growth.

2. Fundamentals supporting financial market growth

Fundamentals which support financial market growth are such as follows.

- The size of the economy is larger than a certain level.
- Financial assets in the country have been accumulated to a certain amount.
- IT infrastructures accommodate every investor with tools for global trading.
- Cross-border capital transactions are liberalized totally. Property rights on investments are protected not only for domestic people but also foreigners.
- Fair market rules and traditions are secured not only legally but also spiritually.
- There is a foundation for fostering new industrial technologies.
- There is a market where not only professional investors but also amateur investors can participate. Especially most of the people have a standard financial knowledge.

(1) The size of the economy, financial assets, IT infrastructure

According to international comparative statistics (C.Y.2004), the world GDP total is $40.5 trillion, GDP of USA is $11.7 trillion (29.0%), GDP of Japan is $4.7 trillion (11.5%). Therefore total GDP of USA and Japan is $16.4trillion and the share of the world GDP is more than 40%. Additionally, GDP of German is $2.8trillion (6.8%), GDP of UK is $2.1trillion (5.3%), GDP of France is $2.0trillion (5.1%), GDP of China is $1.7trillion (4.2%). The size of GDP is one of the necessary factors but not a enough condition for the establishment of competitive financial markets.

Secondarily looking at the outstanding of financial assets owned by households, USA is $32.5trillion, Japan is $12.7trillion, UK is $5.7trillion, German is $4.6trillion, France is $3.8trillion. Looking at the ratio of financial assets to GDP, USA is 2.8times, Japan is 2.7times, UK is 2.7times, German is 1.6times, and France is 1.9times. You can understand the accumulation level of financial assets in the households is relatively higher in USA, Japan and UK. 51% of financial assets ($13trillion, 2004.3) owned by Japanese households are cash and deposit compared with 13% by USA households. If the share of cash and deposit owned by Japanese households changes from 51% to 13%, about $5trillion can move from cash and deposit to stocks, mutual funds and bonds.

Japanese IT infrastructure has been developed to a high global level owing to deregulations and the government efforts. The population using internet has increased to more than 70 millions from 10 millions since 1996. More than 70% of the stock trading volume is transacted by individual investors using more than 3 million personal computers.

(2) Liberalization of cross-border capital transactions and property protection

Cross-border capital was totally liberalized in 1997 by revising the foreign exchange control law. Since the legislation, not only companies but also individuals have started to trade global capital transaction freely. And national treatments are given to foreigners to protect their properties. Paralleled to the liberalization, the drastic financial deregulation, so-called Japanese Big Bang, has been progressing. As the result of further competition, the level of the transaction fees has fallen

dramatically. For example, the level of the stock trading fees has been lowered to 1/10 from the past regulated level.

The total level of the financial transaction cost, global and domestic, is very low internationally. So, Japanese financial markets as a whole are easily accessible from global investors.

(3) Fair market rules and market disciplines

It was told the Corporate Governance (CG) of Japanese companies was weak. However, CG of Japanese companies has been strengthened every year from both legislations and corporate efforts. Corporate Social Responsibility (CSR) is becoming the important element as CG for Japanese companies to be respected socially as a profitable and sustainable company.

Japanese corporate staffs are also required to have high ethics standard and conduct standard.The realization of capitalism ethics in both companies and individuals is very important for market capitalism to be prosperous and stable.

Upon the spiritual and organizational foundations, financial markets with fair market rules and market disciplines are being formed and getting trust from global investors.

(4) New industrial technology

Stock markets for emerging companies like Mothers have been taking new venture companies developing new business by using IT or biotechnology or utilizing the chance of various deregulations. It would be impossible for venture companies to be emerging without the foundation of new industrial technologies and without emerging stock markets. After the burst of the Japanese economy, few Japanese banks made loans to venture companies. The only way remaining for venture companies to raise money is the stock markets. Emerging stock markets like Mothers are one of the engines to push the Japanese economy to recover and made the world economy more vigorous.

(5) Individual investors

Looking at the distribution of stock holders, 27% of total stocks are owned by foreign investors, 26% are owned by domestic institutional investors, 19% are owned by domestic individual investors. The share of stocks owned by large banks decreased from 15% to 5% in ten years. On the other hand, the share of stocks owned by foreign investors increased from 12% to 27% in ten years. The share of stocks owned by domestic individual investors was 19% constantly for 10 years.

Looking at the share of trading volume, you can see another view. The share of trading volume through brokers by foreign investors is about 50%, the share of trade by domestic individual investors is about 40%. Foreign investors and individual investors are main players in Tokyo market. Especially most of the trades in emerging stock markets are made by individual investors. Individual investors are engines to supply much liquidity into the markets. Active participation of individual investors is essential for forming the markets with high liquidity.

3. Prospects for the future

Total capitalization value of stocks listed in the world stock markets (C.Y2005) is around $31trillion. As the break down of distribution, NYSE is $13.3trillion (43.0%), TSE is $4.6trillion (14.8%), NASDAQ is $3.7trillion (11.6%), LSE is $3.1trillion (9.9%) and Euronext is $2.7trillion (8.7%). The total share of Japan and USA is around 70%. This is the share of cash markets. The share of derivatives markets is quite different from that of cash markets.

To keep the current ranking of TSE, No2 of the world market, TSE has to make big efforts in two points, as follows.

(1) Enhance the capacity and speed of the trading system

TSE has started to make preparation for developing the next generation trading system until 2009. The target of the new system is not only to enhance the capacity corresponding to sharp increase of the trading volume, but also to make the transaction speed the highest in the world, corresponding to computer programming trades or algorithmic trades. Recently the method of orders has been changing dramatically. Investors try to reduce market impacts by slicing the large amount order into small orders, try to execute orders for large baskets of stocks simultaneously

and try to make complicated arbitrage trades by using computer programs. Users of such program trading have been expanding from large institutional investors to Hedge funds and individual investors.

TSE has to catch up with the new trend of the trades.

(2) Variety of financial instruments listed in the market

In the normal Diet session of this year, Securities Exchange Law was totally revised into Financial Instruments and Exchange Law. In the context of the new law, the legal name of Stock Exchange is changed to Financial Instrument Exchange. It does not mean only the change of the name, but the Exchange can deal with not only the traditional securities but also comprehensive financial products. Substantially the restrictions over the financial products which can be listed in Stock Exchanges are removed by the new legislation. TSE can build any new Exchange business model by its effort.

Japanese economy has been stagnating for more than 10 years because of the bad loan problems of Japanese banks. One of the big reasons for the bad loan problems is that the Japanese financial system depends too much upon the indirect financial system, namely banking system. The role of the banking system in the Japanese financial system is still large. However, banks should adopt the market functions to evaluate their portfolio or to manage their credit or market risks as much as possible.

Both financial and non financial institutions should restructure their portfolios timely according to the change of economic situations to achieve the most appropriate portfolios. However, if there are no markets for them, it is very difficult for banks or companies to assess the value of their assets and to trade their assets smoothly. The markets for liquidated assets among big investment banks might be useful to achieve the optimum portfolios and diverse the various risks. And more open markets like Exchanges should be more useful to achieve such purposes.

Not to repeat again the Great depression in 1929 or the Burst of the Japanese bubble economy in 1990’s, we should build the liquid markets for most of the financial products to assess the true value of the assets and to trade them smoothly.

Under the new Financial Instruments and Exchange Law, Stock Exchanges can contribute to build such markets actively.

TSE has been enhancing the competitiveness for existing financial products listed in the market. And toward the future, TSE will contribute to Japanese and world financial markets aggressively, through expanding the variety of listed financial products including financial derivatives.

The intense cooperation between TSE and NYSE will make the world financial markets more effective and active in the future. (The opinions in the sentence are not the views of TSE, but my own views.)

APPENDIX III

SPONSOR PROFILES

LEAD SPONSOR

With $10.9 trillion in assets under custody and $1.5 trillion under management (as of June 30, 2006), State Street Corporation (NYSE: STT) is the world's leading specialist in providing institutional investors with investment servicing, investment management and investment research and trading. We combine an unwavering customer focus with in-depth experience and leading-edge technology to offer an unrivaled breadth of products and services to the global investment community.

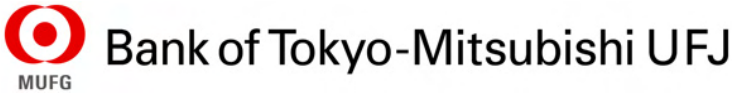
State Street's customers are among the most sophisticated investors in the world: investment managers, pension plan sponsors, collective investment fund managers, banks, multinational corporations and non-profit organizations. As a specialist provider, we work closely with our customers to develop a thorough understanding of their needs. This consultative approach enables us to deliver a comprehensive array of customized solutions that help global investors achieve their business objectives, across all phases of the investment process.

SPONSORS

For 50 years, Aflac products have given policyholders the opportunity to direct cash where it is needed most when a life-interrupting medical event causes financial challenges. Aflac is the number one provider of guaranteed-renewable insurance in the United States and the number one insurance company in terms of individual insurance policies in force in Japan. Aflac's insurance products provide protection to more than 40 million people worldwide. In January 2006, Aflac was included in Fortune magazine's list of the 100 Best Companies to Work For in America for the eighth consecutive year. Aflac has also been included in both Forbes magazine's Platinum 400 List of America's Best Big Companies and in Fortune magazine's listing of America's Most Admired Companies for five consecutive years. Aflac Incorporated is a Fortune 500 company listed on the New York Stock Exchange.

American International Group, Inc. (AIG), world leaders in insurance and financial services, is the leading international insurance organization with operations in more than 130 countries and jurisdictions. AIG companies serve commercial, institutional and individual customers through the most extensive worldwide property-casualty and life insurance networks of any insurer. In addition, AIG companies are leading providers of retirement services, financial services and asset management around the world.

AIG traces its roots in Japan to property-casualty operations that were established in 1946. Over the course of the past 60 years, AIG's businesses in Japan have grown substantially. Today, AIG Japan consists of more than 20 member companies including five major insurers; AIU Insurance, American Home Assurance, ALICO Japan, AIG Star Life and AIG Edison Life.



The Bank of Tokyo-Mitsubishi UFJ, Ltd. (BTMU) was formed in January 2006 through the merger of The Bank of Tokyo-Mitsubishi, Ltd. and UFJ Bank Limited. BTMU offers an extensive scope of commercial and investment banking products and services to its domestic and overseas customers. It also provides trust banking, securities, credit card, consumer finance and many more fields of financial services in close cooperation with group companies. The bank has the largest overseas network of any Japanese bank, comprising office and subsidiaries, including Union Bank of California, in more than 40 countries.

Bingham McCutchen Murase is an international law firm with more than 950 lawyers worldwide, focused on serving clients in complex financial transactions, high-stakes litigation and a full range of corporate matters. The firm has over 40 years of experience in Japanese, U.S. and European cross-border matters and provides strategic legal, business and governmental advice crucial for success in business operations.

Attorneys in our U.S., London, and Tokyo offices advise and represent major U.S. and European companies in Japan and Asia, as well as nearly 500 Japanese-affiliated companies. The firm provides clients with the strategic insight crucial for navigating the unique cultural framework of the region. Our firm offers teams of professionals with broad experience in cross-border matters, including M&A, project finance, financial transactions, joint ventures, complex litigation, intellectual property, governmental relations and regulatory matters as well as major cross-border insolvency and corporate restructuring matters.

Capital Partners

Capital Partners Securities is a small but dynamic and smart independent Japanese securities firm. In May 2003, CPS took over an American-owned securities company specializing in conventional traditional equities brokerage business. Since then, CPS has undertaken major changes in its corporate strategy by establishing a business model based on foreign investment funds and investment banking, then steering its management policy to two major businesses, international investment trusts and investment banking business.

By taking advantage of its extensive global network and international alliances, CPS has successfully introduced a series of foreign financial products such as the Vietnam Dragon Fund and Quadriga Superfund to Japanese investors. These strategic products, in conjunction with traditional investments, have been designed to offer long-term asset management for our clients' portfolios, and introduces Japanese individual investors to a series of international excellent financial products such as Vietnam Dragon Fund and Quadriga Super Fund for their long-term portfolio building. CPS's Investment Banking Division completed a number of medium-sized domestic and cross-border M&A deals and, in order to provide the highest quality advisory service to our clients, joined the Merger Alliance Group, becoming the only representative member from Japan.

Cerberus and its affiliated funds comprise one of the largest groups of funds globally with over US$20 billion of equity capital under management. Cerberus specializes in providing both financial resources and operational expertise to help transform undervalued companies into industry leaders for long-term success and value creation. Cerberus holds controlling or significant minority interests in over 50 companies globally. These companies collectively employ over 250,000 people, conduct business in over 140 countries, and generate annual revenue in excess of US$45 billion. Cerberus is headquartered in New York City with offices in Chicago, Los Angeles, Atlanta, London, Baarn, Frankfurt, Tokyo, Osaka and Taipei.

As part of its global investment platform, Cerberus is one of the largest investors in Japan. Since commencement of activities in 1998, Cerberus has completed approximately US$10 billion of investments in Japan, representing Cerberus' second most active market after the United States. Cerberus' extensive experience in owning and operating businesses includes financial institutions (Aozora Bank), transportation and leisure businesses (Kokusai Kogyo and Seibu/Kokudo) and real estate development and management businesses (Showa Jisho).

Citigroup, the leading global financial services company has some 200 million customer accounts and does business in more than 100 countries, providing consumers, corporations, governments and institutions with a broad range of financial products and services, including consumer banking and credit, corporate and investment banking, securities brokerage and wealth management.

Citigroup in Japan

Since Citibank opened its first Japanese branch in Yokohama in 1902, Citigroup companies in Japan have grown to become some of the country's most recognized financial services companies. As of February 2006, Citigroup has nearly 7,400 employees nationwide, in entities conducting its corporate, consumer and investment banking businesses as well as its credit cards, consumer finance and brokerage operations

DAIDO LIFE INSURANCE COMPANY

Daido Life is a leading provider of life insurance in the SME (small to medium sized enterprises) market and is the market leader with 23.1% share in terms of individual term life insurance based on policy amount in force in Japan.

Daido Life's basic policy on investment is to sustain a healthy asset portfolio and liability-driven ALM in accordance with the characteristics of the products it offers. Based on this policy, the Company carries out strict risk management for each asset category.

Since fiscal year 1999, Daido Life has invested positively in alternative investments within the scope of appropriate risk control with the objective of improving the investment performance over the medium term. Among these investments are private equity and hedge funds (mostly fund of funds). The Company plans to increase alternative investments in the portfolio with the goal of building a well diversified portfolio capable of generating stable returns.

Fidelity International Limited (FIL) was established nearly 40 years ago and operates in markets outside the Americas. The company and its subsidiaries currently manage more than $200b for major institutions and individual investors globally. Our US affiliate, Fidelity Management and Research (FMR), was founded in Boston in 1946 and is one of America's largest mutual fund companies.

Fidelity opened its first overseas office in Tokyo in 1969 and operates throughout the world. In Asia Pacific, Fidelity has offices in Japan, Hong Kong, Taiwan, Australia, Korea, India (Delhi & Mumbai), Singapore, and China. Over 70 research professionals and fund managers based in these offices identify investment opportunities in this diverse and rapidly growing market. With access to over 600 total Fidelity investment professionals globally, FIL and FMR together covers 95% of the world's stockmarkets by capitalization, giving us a view of the world markets that few other investment managers are able to match.

GE is Imagination at Work -- a diversified technology, media and financial services company focused on solving some of the world's toughest problems. With products and services ranging from aircraft engines, power generation, water processing and security technology to medical imaging, business and consumer financing, media content and advanced materials, GE serves customers in more than 100 countries and employs more than 300,000 people worldwide. GE operates in Japan over 100 years and employs more than 8,000 people.

The company traces its beginnings to Thomas A. Edison, who established Edison Electric Light Company in 1878. In 1892, a merger of Edison General Electric Company and Thomson-Houston Electric Company created General Electric Company. GE is the only company listed in the Dow Jones Industrial Index today that was also included in the original index in 1896.
For more information, visit the company's Web site at www.ge.com.

Genworth Financial, Inc. (NYSE: GNW) is a leading, U.S.-based insurance holding company, with growing international scope, serving the lifestyle protection, retirement income, investment and mortgage insurance needs of more than 15 million customers in 24 countries. The company has mortgage insurance operations in the U.S., Canada, Australia, New Zealand, Japan, Mexico and nine countries in Europe.

Genworth maintains leadership positions in key products that are expected to benefit from significant demographic, governmental and market trends globally. The company distributes its products and services through an extensive and diversified distribution network that includes financial intermediaries, independent producers and dedicated sales specialists around the world.

The company, has more than 6,900 employees worldwide, total assets of more than U.S. $105 billion, and generated revenues of more than U.S. $10.5 billion in 2005.

For more information, visit www.genworth.com.

JPMorgan is the wholesale investment banking arm of JPMorgan Chase & Co. (NYSE: JPM) a leading global financial services firm with assets of $1.3 trillion and operations in more than 50 countries. The firm is a leader in investment banking, financial services for consumers and businesses, financial transaction processing, asset and wealth management, and private equity. Under the JPMorgan and Chase brands, the firm serves millions of consumers and many of the world's most prominent corporate, institutional and government clients.

In Asia Pacific, JPMorgan has over 7,000 employees in 15 countries with an unparalleled client base and leadership across the full spectrum of financial services. The firm has a strong regional footprint with its Asia Pacific headquarters in Hong Kong and offices in Tokyo, Sydney, Beijing, Singapore and other major financial centers in the region.

In Japan, the firm conducts businesses such as investment banking, treasury & securities services, and investment management with a client base that includes public bodies, finanoperty and Litigation. Based on the firm's expertise and primary focus on international business transactions, the firm regularly assists overseas clients conducting business in Japan, as well as guiding Japanese clients with investments and businesses abroad.

Kamano Sogo Law Offices

Kamano Sogo Law Offices offers a full range of legal services in international and domestic business transactions. Practice areas are: International, Corporate, Commercial, Banking, Trust, Securities, Finance, Leases, Anti-Monopoly, Mergers and Acquisitions, Foreign Investments, Intellectual Property and Litigation. Based on the firm's expertise and primary focus on international business transactions, the firm regularly assists overseas clients conducting business in Japan, as well as guiding Japanese clients with investments and businesses abroad.

Mr. Hiroyuki Kamano, the firm's founding partner, and other members of the firm have various international experience which enables them to provide clients with a comprehensive legal representation from a global perspective. All of the members of the firm are committed to providing clients with legal representation based on dedication, experience, continuing legal education and active involvement in legal and business developments.

KPMG AZSA&Co. is one of Japan's largest audit corporations, fielding a team of approximately 3,000 people in 47 offices across the country. KPMG AZSA&Co. offers clients a variety of high quality professional services tailored to the emerging needs of today's business environment, including audit, related attestation services and advisory services such as preparation for initial public offerings and financial advisory services.

KPMG AZSA&Co. is a member firm of KPMG, which is the global network of professional services firms. With nearly 94,000 people world wide, KPMG member firms provide audit, tax and advisory services from 714 cities in 148 countries.

Linklaters

Linklaters specialises in advising the world's leading companies, financial institutions and governments on their most challenging transactions and assignments. With offices in major business and financial centres, we deliver an outstanding service to our clients anywhere in the world.

A collaborative approach is central to everything we do. However complex, urgent or challenging a transaction may be, we are driven to help our clients succeed. We are a single, unified firm with lawyers in 22 countries, geared to provide a superior level of service wherever you need to do business. Our consistent processes and global systems ensure you are supported by a firm that is thinking, planning and moving in one direction: your direction.

Additional information can be found at www.linklaters.com.

Medley Capital Management is a $1 billion direct credit lending fund. The fund specializes in corporate and asset lending to growth companies that are making positive contributions to environmental, transportation, finance and other sectors. This is the second fund for all partners in this strategy and focuses on mid-sized growth lending with a return profile in the mid-teens.

Mitsubishi Corporation

Mitsubishi Corporation (MC) is Japan's largest general trading company (sogo shosha) with over 200 bases of operations in approximately 80 countries worldwide. Together with its over 500 group companies, MC employs a multinational workforce of approximately 48,000 people. MC has long been engaged in business with customers around the world in virtually every industry, including energy, metals, machinery, chemicals, food and general merchandise.

MC seeks to contribute to the enrichment of society through business firmly rooted in principles of fairness and integrity. Although our activities encompass everything from trading to business investment, the essence of what we do at MC can best be described as focusing on the needs and seeds of customers and society, conceiving business models, and reliably providing functions and services to propel these businesses forward.
Through consistent and dedicated efforts, MC is committed to further strengthening the high level of trust earned from our customers over the years.

Morgan Stanley

Founded in 1935, Morgan Stanley is a global financial services firm and a market leader in securities, investment management and credit services. With more than 600 offices in 28 countries, Morgan Stanley connects people, ideas and capital to help clients achieve their financial aspirations.

Morgan Stanley has a significant presence in Asia with regional headquarters in Tokyo and Hong Kong. The Firm also has offices in Beijing, Shanghai, Taipei, Seoul, Singapore, Bangkok, Mumbai, New Delhi, Sydney and Melbourne.

Our long-term, relationship oriented approach has led to 35 years of capital markets innovation and growth in Japan. From a two-person office in 1970, today the Firm has more than 1,300 people in Tokyo and is a leading provider of investment banking, sales & trading, research, securitization, real estate and investment management services.

NAGASHIMA OHNO & TSUNEMATSU

長島·大野·常松 法律事務所

Nagashima Ohno & Tsunematsu, established in 2000, is widely known as a leading law firm in Japan and a foremost provider of international and commercial legal services. We represent domestic and foreign companies and organizations involved in every major industry sector and legal service area in Japan. We have successfully structured and negotiated many of Japan's largest and most significant corporate and finance transactions, and have deep litigation strength spanning key commercial areas, including intellectual property and taxation. As of October 1, 2006, we have 232 lawyers (inclusive of 12 foreign-licensed lawyers) capable of providing our clients with practical solutions to meet their business needs.

For more information, please visit: www.noandt.com

Nikko Asset Management Co., Ltd. has over 45 years of history and received the Lipper Award for Best Fund Group in Japan in 2005. Since new management embarked on major corporate reform in 2003, the firm has gained world-class financial investors like Warburg Pincus and the Government of Singapore Investment Corporation (GIC), and a mostly new and highly motivated workforce. Under its new leadership, Nikko AM* has created a new culture and now offers customers a diverse range of asset classes, including traditional and alternative investments, while enjoying its fastest growth ever.

Nikko AM provides in-house funds, investing mainly in Japanese equities, fixed income, and REITs, as well as China A-shares and Indian equities, and, through its sub-advisory platform, "World Series," access to top-performing global asset managers.

Nikko AM has assets under management totaling ¥10.3 trillion ($87.7 billion) and employs over 500 people in Tokyo, New York, London and Singapore.**

For further information, please visit: http://www.nikkoam.com/english/

* "Nikko AM" stands for Nikko Asset Management Co., Ltd. and its overseas subsidiaries.
** Nikko AM's assets under management as of June 30, 2006 (includes advised assets).

NOMURA

The Nomura Group is a global financial services group that provides financial services for individual, institutional, corporate and government clients.

The Group offers financial and advisory solutions through its global headquarters in Tokyo, 139 branches in Japan, and an international network, doing business in 29 countries: with regional headquarters in New York, London and Hong Kong. In the U.S., Nomura Holding America Inc. offers investment banking, securities brokerage and investment advisory services through its U.S. broker-dealer, Nomura Securities International, Inc., which is a member of NASD, NYSE and SIPC.

Founded in Osaka, Japan in 1925, by Tokushichi Nomura, the Group employs more than 15,000 people worldwide. The Group's business activities include investment consultation and brokerage services for retail investors in Japan and, on a global basis, brokerage and trading, underwriting, investment banking, merchant banking and asset management.

For additional information on the Nomura Group, please visit our web site at www.nomura.com.

The Norinchukin Bank
農林中央金庫

The Norinchukin Bank (the "Bank") was established in 1923 as a quasi-governmental financial institution. Privatized in 1959, the bank is one of Japan's largest and most distinguished banks.

The bank is the central bank for Japan agricultural, forestry and fishery cooperative systems. Based on constant funds procurement from member cooperatives, the bank carries out efficient and flexible asset management by investing in various financial products. This is carried out on a global scale. The profits from these activities are then continuously passed on to its members.

The bank has branches in the world's major financial centers, including New York, London and Singapore. Coupled with its Head Office in Tokyo, this network enables 24-hour coverage of the global financial markets.

Prudential Financial companies, with approximately $568 billion in total assets under management as of June 30, 2006, serve individual and institutional customers worldwide. In Japan, Prudential Financial has two life insurance operations, The Prudential Life Insurance Company, Ltd (POJ) and The Gibraltar Life Insurance Company, Ltd (Gibraltar Life).

POJ focuses on need-based selling services by Life Planners, who are insurance professionals. POJ has achieved 18 years of consecutive growth in policies in force. Gibraltar Life serves the broad middle-income market through Life Advisors. Gibraltar Life's strength is in its close longtime relationships with associations such as Kyoko (Teachers' Association) and Shoko (Small Business Owner's Association).

Prudential Financial has several other operations in Japan with Prudential Investment Management (Japan), Limited and Pricoa Relocation Asia Pte. Ltd being of significance. PIMJ manages fixed income assets and is responsible for strengthening the company's institutional asset management business while Pricoa Relocation Asia Pte. Ltd provides comprehensive mobility management and relocation services.

RAMIUS CAPITAL GROUP, LLC

Ramius Capital Group, LLC is a privately owned investment management Firm that pursues low-volatility absolute returns that are also “non-market-directional” in nature. The Firm’s expertise lies in the allocation and management of a series of arbitrage and hedged strategies that seek to provide, depending on the Fund, net annualized returns of 5 – 10%* above the “risk-free” rate of 91-day U.S. Treasury Bills over a complete market cycle. Returns have exhibited minimal correlation when compared to the historical return pattern of traditional asset classes such as equities and bonds.

Ramius Capital’s investment strategies have been designed to address the institutional and high net worth individual’s need to preserve and grow allocated capital on an absolute basis. The Firm’s philosophy is one of long-term wealth enhancement rather than one that purports to achieve rapid wealth creation.

Portfolios are usually managed with minimal leverage, thereby making specific return targets more dependent on portfolio manager skills and the particular strategies selected. Core investment strategies employed are often arbitrage-based and designed to capture market inefficiencies. The historical returns of several of these strategies have been mean-reverting in nature and independent of market direction. Ramius Capital’s real estate and mortgage activities also provide proprietary investment opportunities for the Firm’s clients.

Rating and Investment Information, Inc. (R&I) is among the largest and the most recognized rating agency in Asia. It headquarters in Tokyo, and it is highly respected as an independent source of financial information among many broker-dealers and institutional investors throughout Japan and the U.S.

R&I provides a variety of credit rating services for publicly issued instruments, structured finance products, senior long-term financial obligations of incorporated schools and hospitals and creditworthiness of borrowers of syndicated loans.

R&I ratings are proved consistent with its default cases empirically. R&I annually updates and discloses default ratios for each rating symbol by using historical data for more than 25 years.

R&I delivers its rating information through various media such as Nikkei newspapers as well as electronic media including Bloomberg and Reuters.

R&I has been engaged in the US SEC in an effort to receive a "Nationally Recognized Statistical Rating Organization (NRSRO)" designation.

RS Asset Management Japan Co., Ltd. (RSAM) is a Tokyo-based premier asset management boutique focused on the active investment in Japanese and U.S. equities as well as currency. The firm has advised Japanese investors on assets of approximately $2.5 billion in traditional and alternative investment strategies that include equity and currency hedges. Founded in January 1998 as a subsidiary of RS Investments, RSAM, with a staff of 28 professionals, is today an employee-owned Japanese company that primarily serves institutional clients in the life insurance, property and casualty insurance, banking, and quasi-governmental sectors as well as corporate pension programs and university endowments.

One of the few fully-licensed independent boutiques in Japan

- Securities Investment Trust Management Business License: Prime Minister's Certification No. 17
- Discretionary Investment Management Business License: Financial Reconstruction Committee No. 20
- Investment Advisor Business License: Kanto Local Finance Bureau No. 774

Strong business relationships with top quality asset management boutiques in US

- US Equity: RS Investments and Eastbourne Capital Management in San Francisco
- US Venture Capital: Horsley Bridge Partners and Crosslink Capital in San Francisco
- Currency: FX Concepts in New York

SIDLEY AUSTIN BROWN & WOOD LLP
NISHIKAWA & PARTNERS

Established in 1866, Sidley is one of the world's largest law firms. With more than 1,500 lawyers practising in 13 offices on three continents the firm offers a comprehensive, multi-jurisdictional legal service.

In 2002, Sidley formed a joint enterprise with Nishikawa & Partners. Led by Tomoo Nishikawa, a prominent former government policy maker who was actively involved in Diet and central government matters, we offer clients the unique services of a highly-regarded Japanese team of 13 bengoshi supported by the breadth of experience and quality of a global firm. We have expertise in and focus on areas such as Lobbying/Regulatory Advice, International IP Litigation and HR for Foreign Companies. We also have unique expertise in Pharmaceutical and Insurance industries. In the financing areas we focus on Securitization, Structured Financing and Real Estate Financing.

SMBC SUMITOMO MITSUI BANKING CORPORATION

Strong domestic business base, speed in implementing strategies, and sector-leading group companies are Sumitomo Mitsui Banking Corporation's strengths. We leverage these strengths to provide comprehensive financial services to our customers. Operating under the umbrella of Sumitomo Mitsui Financial Group, a holding company, SMBC and other member companies, such as Sumitomo Mitsui Card Company, Ltd., work as one to create new value for our customers.

We provide global services not just to our domestic customers but also to overseas Japanese and non-Japanese companies, sovereigns and government agencies. Building on our strong business platform in Japan, we are proactively developing business in Europe, the Americas, and East Asia, tailoring our products and services to meet local needs.

We will continue to develop and provide leading-edge products and service that answer our customers' increasingly diversified and sophisticated needs, wherever they may be, in order to remain their bank of choice.

The Sumitomo Trust & Banking Co., Ltd. (STB) is a trust bank established in 1925. STB's management model is an indispensable financial institution providing asset management and custody services based on commercial banking. This model guides the operations of STB's five business groups, and enables the company to actively carry out our unique strategies.

Since our principal concern, which was the repayment of borrowed public funds, has been resolved, STB has moved from a defensive to an offensive management strategy, both in Japan and overseas. We currently have more than 5,000 employees working in 59 domestic branches and 8 overseas offices. This forward-looking management strategy will be founded on investment activities utilizing our competitive edge in trust business to strive to further advance the company's business model and increase STB's corporate value.

Tokyo Stock Exchange, Inc. (TSE) is a leading global exchange and maintains the largest securities market in the Asia-Pacific region. TSE prides itself on its strengths as a leader and as a partner, and is committed to working together with other major exchanges around the world to shape the global financial market of the future. Over the years, TSE has greatly diversified its product range and its derivatives market is now home to both bond and equity-based products.

TSE makes the utmost effort to maintain abundant liquidity and a high level of integrity, and to provide market participants both domestic and global with attractive investment opportunities.

WHITE & CASE

Operating 36 offices in 24 countries, White & Case is distinguished by the depth and scope of our global legal services. Wherever our clients do business, our entire global resources are engaged to help solve the most challenging business and legal issues promptly and efficiently. We move quickly, effectively and with expert knowledge of global and local legal environments to mitigate problems, resolve complexities and close deals simultaneously across multiple borders.

Our Tokyo office has been a leading law firm in Japan for the past fifteen years. Our foreign and Japan-qualified lawyers work seamlessly together to deliver integrated foreign and Japanese legal and tax advice to domestic and international clients. White & Case has consistently been rated as a leading firm in Japan in Capital Markets, Banking, Corporate, Asset and Project Finance, Mergers and Acquisitions, Tax, Dispute Resolution, Regulatory and Intellectual Property. We have advised clients on some of the most innovative and challenging transactions in the Japanese market during the past twenty years.