SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:

AN AGENDA FOR JAPAN AND THE UNITED STATES
ARMONK, NEW YORK • OCTOBER 23-25, 2009

AGENDA

FRIDAY, OCTOBER 23

5:30-6:15 *Doral Guests – Bus to the Weill Center departs approximately every 15 minutes*

6:00-6:30 Cocktail Reception – Main Lobby of the Weill Center

6:30-6:40 **GREETINGS** – Conference Room H, second floor
Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School
Tribute to Tasuku Takagaki
Takashiro Furuhata, Executive Director, International House of Japan

6:40-7:40 **KEYNOTE ADDRESS** – Conference Room H
Bill Rhodes, Senior Vice Chairman, Citi; Senior Vice Chairman, Citibank
Shigesuke Kashiwagi, President and Chief Executive Officer, Nomura Holding America, Inc.

7:45-9:15 Dinner – Main Dining Room, first floor

9:15-11:00 After-Dinner Cocktails – Main Lobby

9:15 *Doral Guests – Bus to the Doral; meet in Main Lobby*

10:00 *Doral Guests – Bus to the Doral; meet in Main Lobby*

11:00 *Doral Guests – Last bus to the Doral; meet in Main Lobby*

SATURDAY, OCTOBER 24

7:00-8:00 *Doral Guests – Bus to the Weill Center departs approximately every 15 minutes*

7:30-8:15 Breakfast – Main Dining Room
Panelists, Reporters, and Facilitators – Breakfast Meeting in Main Dining Room

8:15-8:25 **WELCOME & OPENING REMARKS** – Conference Room H
Hal Scott, Nomura Professor and Director, Program on International Financial Systems (PIFS), Harvard Law School

8:25-8:45 **PANEL SESSION** – Conference Room H

Topic 1: The Future of Banking and Securities Regulation

Japan Panelist: Nobuchika Mori, Deputy Commissioner, International Affairs and Supervision, Financial Services Agency, Government of Japan

U.S. Panelist: Anil Kashyap, Professor of Economics and Finance, University of Chicago

8:50-10:15 **SMALL GROUP SESSIONS**

Group	Room	Facilitator - Japan	Facilitator - U.S.	Reporter
1	*Conference Room H*	*Takatoshi Ito*	*Stefan Gavell*	*William Grimes*
2	*Conference Room J*	*Taisuke Sasanuma*	*John Allison*	*Arthur Mitchell*
3	*Conference Room F*	*Shuji Yanase*	*Jonathan Malamud*	*Andrew Conrad*
4	*Conference Room E*	*Naoko Nakamae*	*Yukio Yoshimura*	*Akihiro Wani*
5	*Dining Room 2*	*Akira Ariyoshi*	*Christopher LaFleur*	*Peter McKillop*
6	*Conference Room A*	*Ryusaburo Harasawa*	*Shigemitsu Sugisaki*	*Christopher Wells*
7	*Conference Room B*	*Hiroshi Ota*	*Satoru Murase*	*Laurence Bates*

10:15-10:25 Refreshment Break

10:25-10:45 **PANEL SESSION** – Conference Room H

Topic 2: Crisis Management and Resolution: What is the Role of the Central Bank

Japan Panelist: Mitsuhiro Fukao, Professor of Economics, Keio University

U.S. Panelist: Matthew Higgins, Vice President, Federal Reserve Bank of New York

10:50-12:20 **SMALL GROUP SESSIONS**

Group	Room	Facilitator - Japan	Facilitator - U.S.	Reporter
1	*Conference Room H*	*Naoki Tabata*	*Alicia Ogawa*	*Christopher Wells*
2	*Conference Room J*	*Takashi Oyama*	*Thomas Cargill*	*Akihiro Wani*
3	*Conference Room F*	*Tadashi Iwashita*	*Paul Sheard*	*Peter McKillop*
4	*Conference Room E*	*Yoshio Okubo*	*Anthony Miller*	*William Grimes*
5	*Dining Room 2*	*Hiroshi Watanabe*	*Joe Peek*	*Laurence Bates*
6	*Conference Room A*	*Naoyuki Yoshino*	*Victoria Melendez*	*Arthur Mitchell*
7	*Conference Room B*	*Estuko Katsu*	*Robin Radin*	*Andrew Conrad*

12:25-1:30 Lunch – Main Dining Room

KEYNOTE ADDRESS

Takafumi Sato, Former Commissioner, Financial Services Agency, Japan

1:30-3:00 **PANEL SESSION – PLENARY DISCUSSION ONLY** – Conference Room H

Topic 3: How Should the U.S. Respond to the Financial Crisis: Lessons from Japan

Japan Panelist: Hideaki Fukazawa, President and Managing Partner, Tokio Marine Capital Co., Ltd.

Japan Panelist: Akihiro Wani, Partner, Linklaters Tokyo

U.S. Panelist: David Hale, Chairman, David Hale Global Economics

U.S. Panelist: Thierry Porté, Operating Partner, J.C. Flowers & Co.; Chairman, U.S.-Japan Conference on Educational and Cultural Interchange (CULCON)

3:00-5:45 Free Time

3:00-6:00 Reporters Meeting – Conference Room F

3:00 *Doral Guests – Bus to the Doral; meet in Main Lobby*

3:15-4:45 Wine Tasting – Great Room, Conference Center 1

4:45 *Bus to the Doral*

5:30-6:30 *Doral Guests – Bus to the Weill Center departs approximately every 15 minutes*

6:15- 6:45 Cocktail Reception – Main Lobby

6:45-7:45 **KEYNOTE ADDRESS** – Conference Room H
Rintaro Tamaki, Vice Minister of Finance for International Affairs, Ministry of Finance Japan
Neal S. Wolin, Deputy Secretary, U.S. Department of the Treasury

7:45-9:15 Dinner – Main Dining Room

9:15-11:00 After-Dinner Cocktails – Main Lobby

9:15 *Doral Guests – Bus to the Doral; meet in Main Lobby*

10:00 *Doral Guests – Bus to the Doral; meet in Main Lobby*

11:00 *Doral Guests – Last bus to the Doral; meet in Main Lobby*

SUNDAY, OCTOBER 25

ALL PARTICIPANTS: PLEASE BE SURE TO CHECK OUT OF YOUR ROOM PRIOR TO THE OPENING OF THE SYMPOSIUM (NO LATER THAN 8:15 A.M.). STORE ALL LUGGAGE AT THE WEILL CENTER.

6:45-7:30 *Doral Guests – Bus to the Weill Center departs approximately every 15 minutes*

7:30-8:15 Breakfast – Main Dining Room
Chairs and Reporters – Breakfast Meeting in Main Dining Room

8:15-9:15 **PRESENTATION & DISCUSSION** – Conference Room H
Topic 1: The Future of Banking and Securities Regulation
Japan Chair: Takatoshi Ito, Professor, Graduate School of Economics, University of Tokyo
U.S. Chair: Douglas L. Peterson, Chairman, Representative Director, President, and Chief Executive Officer, Citigroup Japan Holdings Corp.

9:20-10:20 **PRESENTATION & DISCUSSION** – Conference Room H
Topic 2: Crisis Management and Resolution: What is the Role of the Central Bank
Japan Chair: Akinari Horii, Assistant Governor, Bank of Japan
U.S. Chair: Robert Alan Feldman, Managing Director, Morgan Stanley Japan Securities Co., Ltd.

10:20-10:30 Refreshment Break

10:30-11:30 **PRESENTATION & DISCUSSION** – Conference Room H
Topic 3: How Should the U.S. Respond to the Financial Crisis: Lessons from Japan
Japan Chair: Yoshio Okubo, Senior Managing Director, Japan Securities Dealers Association
U.S. Chair: Masaaki Kanno, Managing Director, Chief Economist, JPMorgan Securities Japan Co., Ltd.

11:30-1:00 Closing Lunch – Main Dining Room

1:15 Reserved shuttle buses depart for Manhattan – Main Lobby

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

ARMONK, NEW YORK • OCTOBER 23-25, 2009

SYMPOSIUM REPORT

PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL
INTERNATIONAL HOUSE OF JAPAN



SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY
AN AGENDA FOR JAPAN AND THE UNITED STATES
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SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR JAPAN AND THE UNITED STATES
ARMONK, NEW YORK • OCTOBER 23-25, 2009

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7:45-9:15 Dinner

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Topic 1: The Future of Banking and Securities Regulation
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7	*Hiroshi Ota*	*Satoru Murase*	*Laurence Bates*

10:15-10:25 Refreshment Break

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2	*Takashi Oyama*	*Thomas Cargill*	*Akihiro Wani*
3	*Tadashi Iwashita*	*Paul Sheard*	*Peter McKillop*
4	*Yoshio Okubo*	*Anthony Miller*	*William Grimes*
5	*Hiroshi Watanabe*	*Joe Peek*	*Laurence Bates*
6	*Naoyuki Yoshino*	*Victoria Melendez*	*Arthur Mitchell*
7	*Estuko Katsu*	*Robin Radin*	*Andrew Conrad*

12:25-1:30 Lunch

KEYNOTE ADDRESS

Takafumi Sato, Former Commissioner, Financial Services Agency, Japan

1:30-3:00 **PANEL SESSION – PLENARY DISCUSSION ONLY**

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Neal S. Wolin, Deputy Secretary, U.S. Department of the Treasury

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SUNDAY, OCTOBER 25

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Japan Chair: Takatoshi Ito, Professor, Graduate School of Economics, University of Tokyo
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U.S. Chair: Robert Alan Feldman, Managing Director, Morgan Stanley Japan Securities Co., Ltd.

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Japan Chair: Yoshio Okubo, Senior Managing Director, Japan Securities Dealers Association
U.S. Chair: Masaaki Kanno, Managing Director, Chief Economist, JPMorgan Securities Japan Co., Ltd.

11:30-1:00 Closing Lunch

Japan Participants:

Shuhei Aoki	General Manager for the Americas, Bank of Japan
Akira Ariyoshi	Director, Regional Office for Asia and the Pacific, International Monetary Fund
Yutaka Endo	Deputy President, Mizuho Securities Co., Ltd.
Mitsuhiro Fukao	Professor of Economics, Keio University
Hideaki Fukazawa	President and Managing Partner, Tokio Marine Capital Co., Ltd.
Hajime Fukuzawa	General Manager, Mizuho Corporate Bank Ltd.
Takashiro Furuhata	Executive Director, International House of Japan
Masaaki Goto	Chairman and Chief Executive Officer, Daiwa America Corporation
Ryusaburo Harasawa	Advisor, Bank of Tokyo-Mitsubishi UFJ Ltd.
Masao Hasegawa	Executive Officer and General Manager, The Bank of Tokyo-Mitsubishi UFJ Ltd.
Takayoshi Hatayama	Advisor, Abeam Consulting Ltd.
Akinari Horii	Assistant Governor, Bank of Japan
Takatoshi Ito	Professor, Graduate School of Economics, University of Tokyo
Tadashi Iwashita	Chairman, Lone Star Japan Acquisitions Ltd.
Masaaki Kaji	Chief Representative, Development Bank of Japan, Inc.
Mikio Kajikawa	Minister of Finance, Embassy of Japan
Shigesuke Kashiwagi	President and Chief Executive Officer, Nomura Holding America, Inc.
Etsuko Katsu	Vice President International, Professor, Meiji University
Kozo Koide	Chief Economist, DIAM Co., Ltd.
Tomoya Masanao	Executive Vice President, Head of Portfolio Management Japan, PIMCO Japan Ltd.
Hajime Matsuura	U.S. Correspondent, The Nikkei
Hiroshi Minoura	Managing Director and Head of the Americas, Sumitomo Mitsui Banking Corporation
Nobuchika Mori	Deputy Commissioner, International Affairs and Supervision, Financial Services Agency, Government of Japan
Naoko Nakamae	Finance and Business Correspondent, The Economist
Roberto Nishikawa	Chief Executive Officer, Itaú Securities
Shinichi Nishimiya	Ambassador and Consul General, Consulate General of Japan in New York
Yoshio Okubo	Senior Managing Director, Japan Securities Dealers Association
Hiroshi Ota	Independent Director, Kasikorn Bank, Thailand
Takashi Oyama	Advisor for Global Strategy, Norinchukin Research Institute
Yoneo Sakai	Chief Executive Officer, HSBC Securities (Japan) Limited
Taisuke Sasanuma	Representative Partner, Advantage Partners LLP
Takafumi Sato	Former Commissioner, Financial Services Agency, Japan
Joseph R. Schmuckler	Senior Executive Officer, Mitsubishi UFJ Securities Co., Ltd.
Yuta Seki	Senior Analyst, Chief Representative, Nomura Institute of Capital Markets Research
Paul Sheard	Global Chief Economist, Global Head of Economic Research, Nomura Securities International, Inc.
Akio Shinju	General Manager, Investment Planning Department, Daido Life Insurance Company

Yasuhisa Shiozaki	LDP Member of the House of Representatives, Former Chief Cabinet Secretary
Takeo Sumino	Chief Operating Officer, Nomura Holding America, Inc.
Naoki Tabata	Executive Senior Advisor, RHJ International Japan
Ken Takayama	Chief Financial Officer, Director, Rakuten, Inc.
Yoichi Takita	Deputy Chief Editorial Writer, The Nikkei
Rintaro Tamaki	Vice Minister of Finance for International Affairs, Ministry of Finance Japan
Eiichi Tanabe	Treasurer, Senior Vice President, Mitsubishi Corporation
Keiji Tanaka	Executive Officer, Regional Executive for the Americas; General Manager, New York Branch, Sumitomo Trust & Banking Co., Ltd.
Tomoyoshi Uranishi	Senior Executive Officer, Tokyo Stock Exchange, Inc.
Akihiro Wani	Partner, Linklaters Tokyo
Hiroshi Watanabe	President and Chief Executive Officer, Japan Bank for International Cooperation
Tsutomu Watanabe	Professor, Research Center for Price Dynamics, Hitotsubashi University
Osamu Yamamoto	Partner, Unison Capital, Inc.
Shuji Yanase	Of Counsel, Nagashima Ohno & Tsunematsu
Yoichiro Yokoyama	Director General, Treasury Department, Development Bank of Japan, Inc.
Naoyuki Yoshino	Professor, Department of Economics, Keio University

U.S. Participants:

John A. Allison	Chairman and Chief Executive Officer, Unio Holdings
Emily Altman	Private Investor
Kenji Amino	Partner, Ernst & Young Shinnihon Tax
David L. Asher	Managing Partner, Anshin Capital Advisors
Laurence W. Bates	General Counsel, GE Japan
Thomas F. Cargill	Professor of Economics, University of Nevada, Reno
Andrew Conrad	Senior Vice President and Counsel, Aflac International, Inc.
Kenneth W. Dam	Max Pam Professor Emeritus of American and Foreign Law and Senior Lecturer, University of Chicago Law School
Robert Dohner	Deputy Assistant Secretary for Asia, U.S. Department of the Treasury
Royanne K. Doi	Vice President and Counsel, Prudential Holdings of Japan, Inc.
Timothy E. Feige	Co-President, Prudential International Insurance
Robert Alan Feldman	Managing Director, Morgan Stanley Japan Securities Co., Ltd.
Stefan Gavell	Executive Vice President and Head of Regulatory and Industry Affairs, State Street Corporation
William W. Grimes	Associate Professor of International Relations and Director of the Center for the Study of Asia, Boston University
David Hale	Chairman, David Hale Global Economics
Lyric Hughes Hale	President, David Hale Global Economics
Matthew Higgins	Vice President, Federal Reserve Bank of New York

Takeo Hoshi	Professor, School of International Relations and Pacific Studies, University of California, San Diego
Douglas L. Hymas	President and Chief Executive Officer, ING Mutual Funds Management Company (Japan) Ltd.
Chad Iverson	Vice President, Capital International KK
Merit E. Janow	Professor and Director, Program on International Finance and Economic Policy, Columbia University
William F. Jarvis	Managing Director, Commonfund Institute
John Jeffrey	Partner, Deloitte LLP
Richard Jerram	Chief Economist, Macquarie Securities
Masaaki Kanno	Managing Director, Chief Economist, Japan, JPMorgan Securities Japan Co., Ltd.
Yasuo Kanzaki	Special Advisor, Citigroup Global Markets Japan, Inc.
Robert K. Kaproth	Financial Attaché, U.S. Embassy, Tokyo
Anil Kashyap	Professor of Economics and Finance, University of Chicago
Susumu Kato	Chief Economist, Managing Director, Calyon Credit Agricole CIB and CLSA
Richard Katz	Editor, The Oriental Economist Report
Brian W. Kelly	Chief Executive Officer, Asian Century Quest
Jyoti Kohli	Senior Supervisory Financial Analyst, Board of Governors of the Federal Reserve System
Dino Kos	Managing Director, Portales Partners LLC
Yasushi Kusaka	Director, Business Development, Ernst & Young Shinnihon Tax
Christopher J. LaFleur	Vice Chairman, JPMorgan Securities Japan Co., Ltd.
Laura Lane	Senior Vice President, International Government Affairs, Citi
Andrew Liu	Managing Director, Elliott Advisors Asia Limited
Sarah Lubman	Director, Brunswick Group
Jonathan S. Malamud	Vice President and International Counsel, Prudential Financial, Inc.
Dan McCardell	Deputy Director, Program on International Financial Systems, Harvard Law School
Peter McKillop	Director of Global Communications, Kohlberg Kravis Roberts & Co.
Victoria Melendez	Managing Director, Rockefeller & Co.
Curtis J. Milhaupt	Fuyo Professor of Japanese Law; Professor of Comparative Corporate Law; Director, Center for Japanese Legal Studies, Columbia Law School
Anthony M. Miller	Chief Executive Officer, Pacific Alliance Japan Limited
Arthur M. Mitchell III	Senior Counselor, White & Case LLP
Satoru Murase	Partner, Bingham McCutchen Murase LLP
Naoko Nemoto	Managing Director, Financial Institutions Ratings, Standard & Poor's
Allan O'Bryant	President and Chief Executive Officer, Yunzei Capital Advisors
Alicia Ogawa	Senior Advisor to the Center on Japanese Economy and Business, Columbia University Business School; Adjunct Professor, School of International and Public Affairs, Columbia University
Yuri Okane	Senior Policy Analyst, Tudor Investment Corporation
Hugh T. Patrick	R.D. Calkins Professor of International Business Emeritus and Director, Center on Japanese Economy and Business, Columbia Business School
Joe Peek	Professor, Gatton College of Business and Economics, University of Kentucky

Douglas L. Peterson	Chairman, Representative Director, President, and Chief Executive Officer, Citigroup Japan Holdings Corp.
Thierry Porté	Operating Partner, J.C. Flowers & Co.; Chairman, U.S.-Japan Conference on Educational and Cultural Interchange (CULCON)
Robin Radin	Co-Founder, Japan-U.S. Symposium
Bill Rhodes	Senior Vice Chairman, Citi; Senior Vice Chairman, Citibank
T. Timothy Ryan, Jr.	President and Chief Executive Officer, Securities Industry and Financial Markets Association (SIFMA)
Stanley M. Sawai	Partner, KPMG AZSA & Co.
Jonathan D. Schuman	Managing Director, Head of Institutional Business Division, Head of Product and Business Development Division, AIG Investments Japan Co., Ltd.
Hal S. Scott	Nomura Professor and Director, Program on International Financial Systems, Harvard Law School
Henny Sender	International Financial Correspondent, Financial Times
Catherine Simmons	Vice President, Government, Regulatory, and Industry Affairs, Asia Pacific, State Street Bank and Trust Company
Allan D. Smith	General Counsel, AIG Companies, Japan and Korea
Paul Speltz	Chairman and Chief Executive Officer, Global Strategic Associates LLC
Shigemitsu Sugisaki	Vice Chairman, Goldman Sachs Japan Co., Ltd.
Adrian van Rixtel	Head of International Financial Analysis, Bank of Spain
Christopher P. Wells	Partner, White & Case LLP
Eric Wetlaufer	Group Chief Investments Officer, Fidelity
Bill Wilder	President and Chief Investment Officer, Nikko Asset Management Co., Ltd.
Andrew Winden	Partner, Morrison & Foerster LLP
Neal S. Wolin	Deputy Secretary, U.S. Department of the Treasury
Yukio Yoshimura	Executive Officer, Head of Government Affairs, Citigroup Japan Holdings Corp.

SYMPOSIUM REPORT

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

ARMONK, NEW YORK • OCTOBER 23-25, 2009

2009 SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR JAPAN AND THE UNITED STATES

The twelfth Japan-U.S. Symposium was held in Armonk, New York from October 23-25, 2009. Sessions discussed the future of banking and securities regulation, the role of central banks in crisis management and resolution, and lessons from Japan for how the U.S. should respond to the financial crisis. While recognizing that financial conditions had improved since the previous Symposium, participants voiced concerns about whether current U.S. financial and economic policy proposals adequately incorporated the lessons of either the current crisis or of Japan's earlier financial challenges. Several aspects of Japan's regulatory system, including systemic risk regulation, were held up as potential models for the U.S., although there was considerable skepticism about the ability of the U.S. political system to create a rational financial regulatory system.

SESSION I
THE FUTURE OF BANKING AND SECURITIES REGULATION

Among the most pressing questions for participants were the issues of how the banking and securities industries should be regulated going forward, how they would actually be regulated, and what effects the regulatory changes would likely have. While there was vigorous debate on many aspects of regulation, one clear concern that arose was the need for a means by which failure of systemically important financial institutions could be managed without disrupting the system.

Essential Elements of Reform

Participants agreed on several general elements that they saw as essential to effective reform, although they expressed concern that not all of them would be heeded or adequately addressed.

A major theme was market discipline. One key element on which participants agreed was that regulations must aim not only at market stability, but also at ensuring competition. Some participants emphasized that without competition, innovation would be stifled and that there would be insufficient incentives for efficiency or productivity gains. Others cautioned that innovation should not be seen as a goal in and of itself. Many were also concerned that any efforts to reduce the competition, innovation, and material rewards of the banking sector would run the risk of shifting greater risk to less regulated parts of the financial system, with the net effect of increasing systemic risk. Meanwhile, some participants felt that attitudes toward financial innovation, dynamism, and stability varied considerably by country, and suggested that in contrast to Japan's overall preference for stability over innovation, the U.S. financial system had traditionally favored innovation and dynamism.

For many participants, the main pathway to improved market discipline would be to improve transparency, consistency, and accuracy of information regarding financial institutions' balance sheets. Participants agreed that in normal times, accurate accounting would mean marking to market. There were, however, differences of opinion regarding how to best represent the fair value of illiquid assets in the midst of a crisis. Some participants felt that marking to market under such circumstances would risk bankrupting viable financial institutions, as they may be forced to sell assets at "fire-sale" prices. Most participants appeared to disagree, on several grounds. A widely-shared assessment was that, even if mark-to-market did not provide the most accurate price at any given time, allowing flexibility would lead to inconsistency of standards (especially when it conveniently served the purposes of loss-making institutions), which would actually make the information conveyed in balance sheets less trusted. It was also noted that market prices for asset-backed securities of various sorts that were considered "fire sale" early in the crisis had proved to be more accurate than marking to model. Finally, a number of participants suggested that if market discipline were the goal, market prices should be the basis of accounting for fair value. One lingering doubt expressed by some participants was the tendency of mark-to-market to reinforce procyclicality, but most participants appeared to feel that procyclicality issues should be handled separately from pricing.

Many participants were very troubled at what they saw as asymmetries between financial institutions' private gains and the public burden when they got into trouble. They

felt that this was politically and economically untenable, and argued that unless means could be found to ensure that stakeholders would be punished sufficiently for financial institutions' mistakes, a heavy-handed regulatory response would be inevitable. For these participants, the central requirement of market discipline was that stakeholders—including debt-holders and counterparties as well as shareholders—must know that they would lose their investments or positions in the event of an insolvency even if the institution is large.

One implication of this argument was that the problem of "too big to fail" needed to be eliminated. To achieve this goal, many participants agreed that there would need to be orderly means of managing the failure of a systemically important financial institution. They felt that in the absence of clear and effective resolution procedures for financial conglomerates, there was little alternative between using public money to subsidize stakeholders (as in AIG) and risking a cascade of payments disturbances or bankruptcies (as in Lehman). To avoid both moral hazard and calamity, they argued, there would need to be a way of dealing with multinational financial conglomerates.

International cooperation was seen as being indispensable for both market discipline and effective resolution of systemically important institutions. With regard to the issue of resolution of failed institutions, it was noted that virtually all systemically important institutions had a significant cross-border element, and that different jurisdictions often treated bankruptcies in fundamentally different ways. Greater international uniformity of regulation was also seen as important in reducing the willingness or ability of financial institutions to engage in excessive risk-taking. While some worried that efforts to enforce uniformity would tend to stifle innovation, it was generally recognized that opportunities for regulatory arbitrage should be closed off.

Participants also discussed leverage ratios and capital adequacy, two issues that have become a focus of the global debate over financial re-regulation. Capital adequacy is discussed at greater length below.

Finally, there was some discussion of whether it would be beneficial to extend the model of stress tests. Several participants argued that the U.S. stress tests had been important both in forcing financial institutions to realistically confront the quality of their assets and in reassuring markets that the financial system was solvent. They contrasted this with the European stress tests, in which methods and results were not released. Other participants were more cynical about the stress tests, arguing that worst-case scenarios had been manipulated to get the right result. Nonetheless, even some of these participants saw potential in a model by which regulators would impose some level of external rigor on internal assessments that financial institutions should be doing anyway as part of their internal risk management.

Capital Requirements

Reflecting the broader policy debate, one of the major topics for discussion at the Symposium was the role of capital requirements in making financial institutions more resilient in the face of downturns or business losses. For some participants, the need for a more substantial capital cushion was uncontroversial. They pointed out that financial institutions with healthier capital bases had been more able to weather the crisis than their competitors, and noted that the market crisis had made the availability of liquidity highly contingent on apparent solvency.

Others were more skeptical, however, questioning how increased capital requirements would affect financial institutions' risk preferences, opportunities for regulatory arbitrage, and market expectations. A number of participants worried that increasing capital requirements would lead financial institutions to take on more risk in order to maintain return on equity, thus paradoxically reducing the stability of the system. Alternatively, it was argued that raising capital requirements in the banking sector would create incentives for investors to move their money to less-regulated sectors such as private equity and hedge funds, where high rates of leverage and low levels of transparency might allow for the creation of a new financial crisis. Pointing to the experience of the current crisis as evidence, some participants also felt that increasing required capital would not necessarily address the need for financial institutions to have substantial capital cushions anyway, since in a crisis markets would likely judge them by how much cushion they had in excess of regulatory capital.

For some participants, debates about specific levels of capital adequacy missed the point. They argued instead that capital requirements should be tailored to the specific needs of financial institutions, based on their individual characteristics (e.g. term structure of liabilities) and the potential impacts on broader financial markets if they were to fail (e.g. requiring higher capital ratios for systemically important financial institutions). Another proposal was to require systemically important financial institutions to maintain part of their regulatory capital in the form of convertible debt, which would allow for rapid expansion of equity in the event of either individual or systemic crises. While recognizing that tailoring capital to individual financial institutions' characteristics had in fact been one of the major goals of Basel II, most participants appeared to feel that Basel II had been ineffective if not counterproductive in the current crisis. There was, however, little discussion of how specifically to revise the Basel standards.

There did appear to be a consensus among participants on two principles: that the procyclical effects of capital requirements should be reduced and that systemically important financial institutions should have higher capital requirements to address moral hazard problems. However, there was much less consensus on how—or even whether—these principles could be put into practice.

Finally, there appeared to be considerable support for the argument that, however capital requirements should be increased or otherwise reconfigured, they could only be understood as part of a larger regulatory solution. Thus, without significant changes in regulation and market practices, better-designed capital controls alone would not be a magic bullet for long-term stability, and in fact might create new problems.

Systemically Important Financial Institutions

The issue of how to deal with systemically important financial institutions ran through much of the discussion of how to make the global financial system more stable. Few participants appeared willing to accept proposals to return to a clear delineation between highly-regulated commercial banks and other types of financial institutions, or to have regulators more aggressively limit size in an effort to eliminate the issue of "too big to fail." They felt that the benefits for some financial conglomerates of scale and scope were considerable and also noted that traditional measures of "too big to fail" did not provide insight into which financial institutions had proved to be systemically important in the actual crisis. Thus, discussion focused instead on the questions of how to reduce the risks to the system created by large and complex financial institutions and how to manage failures when they occur.

In order to address the question of how to deal with systemically important financial institutions, participants agreed that it would be essential to identify which institutions actually were "systemically important." There was no clear consensus as to how to do so, however. While the idea of "too big to fail" has contributed to a traditional emphasis on size and concentration, many participants felt that in a globalized financial system few if any financial institutions would qualify as systemically important based solely on the size of their balance sheets. Additional factors that were suggested as indicators of systemic importance included scope of operations, complexity, interconnectedness, and leverage. However, while participants gave various examples from the current crisis that drew on each of these concepts, it was generally acknowledged that much more research and analysis would be required to come up with robust concrete guidelines.

Acknowledging that rigorous definitions did not yet exist, participants focused much of their attention on the challenges posed by major multinational financial conglomerates. While it was recognized that such a focus might leave out key financial institutions in specific market niches that might have broader effects, most participants felt that multinational financial conglomerates clearly had systemic importance and that moreover the complexity of the task of resolving failures of these financial institutions called for special attention. Meanwhile, many participants felt that internal management of risk was at least as important as regulatory reforms.

"Too Big to Manage"

Participants were sensitive to the difficulties of managing large multinational financial conglomerates, and many insisted that if such institutions were to be allowed by regulators or markets to continue to exist, better risk management would be required. In other words, participants expressed a concern that some financial conglomerates had become not only too big to fail, but also too big or too "messy" to manage. Three major problems were cited: monitoring, managing internal conflicts of interest, and making rational trade-offs among many varied sources of risk. Discussions of internal management focused on the latter two.

Participants identified two main types of internal conflicts of interest. The first, which reflected much of the public debate, focused on the incentives created by compensation schemes for individuals—in other words, that the interests of traders and executives were not aligned with those of shareholders. Many participants agreed that prevailing compensation practices created incentives for traders to take large risks in the hopes of making a big score, without having symmetrical costs associated with having those bets go sour. Others were skeptical, however. Although they appreciated the logic of the compensation argument, they pointed out that empirical analysis had not shown compensation practices to be systematically related to success or failure of financial institutions either in the past or in the current crisis. Some also pointed to specific examples, such as Lehman, in which the very high personal exposure of top executives appeared not to have made them behave more prudently. The other internal conflict of interest story was between divisions. In particular, participants expressed the view that executives needed to figure out how to pay better heed to risk managers when their views were in opposition to money-making divisions.

Participants also recognized the difficulties of effective risk analysis. While the current crisis had generally shown the dangers of overreliance on historical data and models based upon them, they felt that financial conglomerates had a much more significant challenge. Some argued that, in the face of the impossibility of keeping track of all the

risks within large and diversified structures, most financial institutions—often with the support or even guidance of regulators—had fallen back on a reliance on certain standardized, quantitative metrics (from the Basel standards and value-at-risk to credit ratings to measures of risk hedging) that appeared to be generalizable across divisions, without understanding their inherent limitations. The sheer complexity and mathematical sophistication of the metrics, they argued, had blinded market participants to weaknesses in the quality of the data or assumptions on which they were based. While no solutions were offered, many participants expressed the belief that leaders had deflected their own responsibility for understanding and managing risks onto models that they did not understand and that did not leave space for judgment and discretion.

"Too Big to Regulate"

In addition to the widely recognized issue of "too big to fail," some participants noted that increasingly, systemically important financial institutions are also "too big to regulate." Here, the issue was seen less as size than as functional and organizational complexity. In the U.S., participants felt that the problems were compounded by the defects of the U.S. regulatory system.

There was some discussion of the Volcker-King proposal to eliminate the problem by reinstituting the clear separation between commercial banking and other functions and by preventing financial institutions from becoming too big to fail. There was a general consensus that this would be impractical, however, given the significant blurring of lines among various financial functions. Some also pointed to positive synergies created through integrated financial institutions. Moreover, few participants were willing to accept that the elimination of Glass-Steagall had been an important cause of the financial crisis.

Thus, they saw the key issues as going back to the basics of financial supervision and they called for improvement of prudential rules and inspection regimes. In this regard, concerns were raised about whether regulatory bodies would have the human resources to keep pace with the sophistication, change, and complexity of financial conglomerates.

At the least, most participants agreed that the functional complexity of financial conglomerates called for an integrated approach to regulation and supervision. Otherwise, they felt, piecemeal supervision would lead to significant supervisory gaps. Moreover, issues in one section of the financial conglomerate that were not seen as particularly dangerous by the relevant functional supervisory agency might create serious problems when combined with practices in other units supervised by other agencies. While not all participants were convinced of the need for a unitary regulator *per se*—partly on the assumption that even within a single regulator there was likely to be significant stovepiping—they agreed on the need for institutionalized mechanisms of communication and cooperation among supervisors of financial conglomerates.

The same basic rationale was also seen to apply across borders, even for relatively simple multinational financial institutions. (Functional complexity was of course seen as worsening the problem, however.) Except in limited cases, such as within the European Union where country regulators are bound by MiFID, significant differences were understood to separate the regulatory environments and supervisory practices under which financial institutions operate. As discussed below, this problem becomes particularly acute in the event of a failure of a financial conglomerate.

There were some differences of opinion regarding how the problem should be handled. Some participants called for regulatory convergence based on clear and binding agreements over principles and practices of regulation and supervision. In this scenario, there would need to be sanctions on jurisdictions that did not adhere to agreed global standards as well as on financial institutions that sought to avoid strict regulation by doing substantial business in those jurisdictions. Other participants were leery of strict standardization of regulation, fearing that it would stifle innovation. Most of these participants agreed on the utility of having common accounting rules and general regulatory principles, but felt that there were benefits in allowing national regulators to compete among themselves to create the most attractive financial markets.

There was a strong consensus, however, about the need for ongoing cooperation and communication among national regulators, both in institutionalized forums like the Basel Committee and IOSCO, and at the level of supervising the activities of financial multinationals through colleges of regulators. Nonetheless, some participants remained pessimistic about the potential of international colleges of regulators to surmount the problems of fragmented supervision.

Finally, participants agreed that the U.S. constituted an especially challenging case, with its multiplicity of state and federal regulators. They agreed that the fragmented system offered excessive opportunities for venue shopping and regulatory arbitrage, as well as capture of agencies by the financial institutions they regulate and supervise. They also noted that venue shopping could lead to problems of mismatched capabilities and missions, citing for example the supervision of AIG by the Office of Thrift Supervision or the prudential supervision of Lehman by the SEC. Thus, many participants agreed that significant consolidation of regulatory and supervisory agencies should be a major element of U.S. regulatory reform, as it had in Japan. However, few believed that this was politically likely, due to the inertia of entrenched sectionalism of agencies as well as long-term links between financial institutions and their regulators. Thus, they were forced to fall back on the concept of partial consolidation and the creation of colleges of regulators in order to achieve at least some level of *de facto* regulatory integration. The expansion of Fed prudential supervision over most major financial institutions was also seen as useful in reducing regulatory gaps. Finally, some participants drew hope from the development of effective cooperation between the BOJ and FSA in Japan, suggesting that it might be a model for U.S. regulators as well.

Resolution of Failed Systemically Important Financial Institutions

In discussions of systemically important financial institutions, two principles appeared to be generally accepted among the majority of participants who agreed that it would be impractical to force the break-up of financial conglomerates. One was that such institutions should be “charged” more (in the form of either higher capital requirements or an actual insurance fund) than financial institutions whose failure would be unlikely to have broad systemic effects.

The other was that there needed to be some means by which failures of systemically important financial institutions could be managed, at both the domestic and international levels. Discussion of this issue drew on two main principles: that it was essential that systemically important financial institutions be allowed to fail in order to reduce moral hazard, and that provisions be made to allow the continued management of financial conglomerates in the event of such a failure.

The discussion drew on both Japanese and U.S. examples. For example, it was noted that until 1998, there was no Japanese law in place that would allow for the takeover of a bank that was not technically insolvent; only when such a law was enacted was the government able to address the problem of failing major banks by taking over NCB and LTCB. Supervisors were then able to evaluate the banks' assets, remove particularly problematic loans to sell off, then restructure and sell the banks, all while keeping the banks in operation and forcing severe losses on shareholders. Several participants argued that this had been a seminal moment in the resolution of the Japanese crisis. In Japan, no losses were imposed on debt holders.

In the U.S., in contrast, participants agreed that the lack of a resolution mechanism for non-FDIC-insured financial institutions had made crisis management much more difficult and *ad hoc*. Some argued that if there had been such a provision, the failure of Lehman may not have been so disruptive and that the problems of AIG might have been managed through an orderly process rather than by the emergency investment of public funds by the Fed.

While the FDIC has the ability to take over a bank that it deems insolvent and keep it running while it finds a buyer or sells off assets, financial conglomerates were seen to pose a more complicated problem, whether or not they include commercial banks among their subsidiaries. For example, it was argued that under current law, for a financial conglomerate in which the holding company centralizes key business functions for the group (e.g. IT services), the bankruptcy of the holding company would void contracts between it and its subsidiaries and thus be highly disruptive to their functioning.

While handling the failure of a systematically important financial institution in a single country was seen as enormously challenging, participants were even more worried about the implications of a major cross-border failure. They noted that countries had varying rules and expectations regarding the disposal of assets of different units of a bankrupt firm. In this sense, Lehman Brothers was seen as a cautionary tale. They noted that more than a year after its failure, ownership of many of the firms' assets remains in dispute, at least partly due to cross-border complications.

While there was a clear consensus on the importance of a resolution mechanism for systemically important financial institutions, there was debate as to how it should work. At the level of principle, participants discussed the question of who should lose money in a financial institution failure in order to avoid moral hazard. While most participants rejected the idea that only shareholders should lose money and agreed that debt-holders should also take a loss, there was no clear agreement about counterparties. One line of argument was that, unless there was a credible expectation that everyone providing credit to a firm (i.e. including debt-holders and counterparties) was putting their money at risk, market discipline would not be enforced. Others, drawing on the Lehman case, worried that enforcing losses for counterparties in a major financial institution failure would mean severe systemic impacts. Some participants noted that Japan has recognized this danger in its current law regarding state takeover of banks—for smaller banks, all stakeholders' money not covered by deposit insurance (i.e. deposits up to ¥10 million per depositor) is at risk, while for systemically important financial institutions, debt-holders are made whole. While the fear was widely shared that forcing losses on counterparties would spark a crisis, a few participants countered that there was no clear empirical evidence that enforcing losses for all creditors would have systemic effects at

this point—and that if that were the case, it would be better to reduce such exposure than to guarantee losses..

There was also some discussion about how best to address the challenge of resolution of systemically important financial institutions on a practical level. While participants appeared to agree on the need for a clear legal basis and set of procedures to allow governments to swiftly take over failing financial conglomerates at home, the cross-border aspects were seen as much more difficult to handle. Some participants expressed hope that the problem could be effectively addressed by requiring financial multinationals to create "living wills" that would create a plan for dissolution and clarify the links among the various units of the company. Others felt that living wills would at best be a useful adjunct in addressing the unwinding of a financial multinational. They emphasized instead the importance of having clear procedures and international colleges of regulators for financial multinationals.

Looking Forward & Looking Back

In the midst of the vigorous discussions over how banking and securities regulation should be reformed, some participants expressed doubts as to whether any of the regulatory fixes being contemplated would have prevented the current crisis. Going beyond the specific questions already noted regarding capital adequacy and compensation, they argued that investors and financial institutions would always be able to circumvent rules that they found inconvenient. For these participants, the key to making the financial system less prone to crisis was market discipline and better monetary policy.

Looking forward, some participants asked whether the proposals would have the effects that proponents intended. One concern was that regulators were in effect fighting the last war; as many participants agreed, the next crisis might well arise in an area that was unaffected—or even not yet in existence—in the current one. Participants also discussed the potential for unintended consequences of proposed regulatory fixes, worrying that they may actually serve to create the next crisis rather than prevent it.

SESSION II
CRISIS MANAGEMENT AND RESOLUTION: WHAT IS THE ROLE OF THE CENTRAL BANK?

Session II turned to the role of central banks. While the title of the session suggested mostly a focus on how central banks should act once crises arise, there was also considerable discussion about their role in crisis prevention. In this regard, participants debated whether central banks should try to prevent bubbles, either through monetary policy or by acting as systemic risk regulators.

Central Banking in Crises

A starting point of the discussion was an assessment of the performance of central banks' role in crisis management in the current crisis. Participants gave high marks to the world's major central banks for their roles in stabilizing domestic financial systems, ensuring liquidity, and providing monetary stimulus to ailing economies. At the international level, they agreed that central banks had acted cooperatively to ensure international liquidity and to coordinate their monetary policies.

In praising the crisis management performance of central banks, participants not only expressed appreciation for the major central banks (and in particular, the Fed under Chairman Bernanke). They also agreed that central banks should necessarily be the main actors in a financial crisis, due to their role as lenders of last resort, their technical expertise and deep relationships with private financial actors, and the speed and creativeness with which independent central banks are able to act. The last point was seen by many participants as especially important—as they noted, central banks including the Fed had helped to stabilize financial markets by providing unprecedentedly large amounts of funds extremely quickly, often making up entire new lending facilities and *de facto* supervisory responsibilities as they went along.

Long-Term Effect of Emergency Measures

Nonetheless, a number of participants were profoundly concerned by the longer-term effects of some of the emergency measures that had been undertaken. There were also many who felt that whatever were the strengths of the Fed and other central banks in crisis management, those central banks had also been instrumental in creating the crisis and thus deserved blame as well as praise.

One set of concerns centered around the expansion—and deterioration—of central banks' balance sheets as a result of new liquidity facilities (e.g. TALF, TSLF) and quantitative easing measures. Participants wrestled especially with the implications of the vastly expanded Fed balance sheet, asking for example whether the Fed was in danger of becoming the "lender of only resort." On the macro level, some voiced concerns about the possible resurgence of inflation that they believed could result from such a vast injection of credit into the economy. Others were less concerned. They argued that with low capacity utilization, weak recovery, and a still fragile financial system, the risks of price inflation were low. They saw the situation as providing space for central banks to unwind excess liquidity as economic circumstances begin to improve, and noted with approval the efforts of the Fed to begin to close down unnecessary liquidity facilities and to test measures for reabsorbing liquidity. Several participants pointed to Japan's extended experience of deflation despite significant quantitative easing measures to demonstrate that inflation was not a necessary

consequence of the current actions of the Fed and other central banks. Most participants also agreed that in any event, the potential damage of a miscalculation in favor of inflation was less severe than the consequences of premature tightening.

However, many of the participants who continued to support extraordinary monetary measures expressed some anxiety about the longer-term implications of those policies, however. These anxieties took several forms. For example, some participants saw the possibility of the return of 1970s-style stagflation as the likely price for having avoided financial meltdown. Other participants expressed a more immediate concern: that despite the lack of price inflation, central banks' actions may be creating serious asset price inflation (i.e. bubbles) in several markets. In support of this point of view, these participants pointed to the price spikes in gold and other commodities, as well as what they saw as a bubble in government bonds. (Not all participants considered it to be meaningful to take about a T-bond or JGB "bubble," since these securities are not really assets. But many did agree with the assessment that a sudden drop in their value could have a serious negative impact on financial institutions' balance sheets.) Some also referred to the development of a new "dollar carry trade."

A third concern was more political than technical in nature. There was a strong consensus among participants that the goal of extraordinary liquidity measures should be systemic stability rather than "normalcy." In other words, they were concerned that central banks would be tempted—or pressured—to continue extraordinary measures until the economy was growing healthily again rather than discontinuing them once they were no longer needed to keep the financial system functioning. If that were to happen, it was agreed, inflationary pressures would likely take hold as well as moral hazard. While most participants expressed confidence that central bankers understood the situation, many worried that their freedom of action would be constrained by severe political pressures to support the economy as a whole, and not just "Wall Street." Some participants even warned that the Fed was in danger of losing its autonomy, as some U.S. legislators and commentators had begun to advocate.

A number of participants also worried more broadly that "the genie was out of the bottle." In other words, while the implementation of unprecedented policy tools had been essential to managing the current crisis, financial institutions and politicians now knew that these tools were available in the event of an emergency. Some participants worried that it would be difficult to confine their use only to emergencies and foresaw the likelihood of political pressure to use extraordinary measures in ordinary times. Another version of the same story was that policymakers and financial actors are likely to have different opinions from central bankers and economists about what constitutes a crisis, and therefore whether extraordinary measures should be implemented at any given time. And some participants suggested that the known availability of such measures might embolden some financial institutions to take bigger risks, thus contributing to the likelihood of future crises.

A final set of concerns revolved around the quality of central banks' balance sheets, particularly that of the Fed. Several participants expressed concern about the level of risk that the Fed was assuming, noting that it had abandoned traditional standards for collateral and was taking on assets that they saw as clearly problematic, such as Fannie Mae and Freddie Mac debt. Many participants felt that if public funds were to be put at risk in this way it would be more appropriate to do so openly through an appropriations process—in other words, they saw these actions as fiscal policy by monetary authorities,

which they considered to be inappropriate. Several pointed approvingly to Japan, where the BOJ had secured an explicit guarantee from the government that it would be reimbursed for losses before it purchased equities from banks as part of the process of unwinding their cross-shareholdings.

Some participants also expressed concern that the deterioration of the Fed balance sheet would have broader impacts on its credibility in the market. They suggested that this would likely lead to ongoing dollar weakness, and potentially even the loss of the dollar's status as the world's main reserve currency. While there was not a great deal of discussion about this possibility, most participants did not seem to consider loss of reserve status to be a serious risk.

Regulating Systemic Risk

In addition to crisis management, participants also discussed at some length the more forward-looking issue of systemic risk regulation. Discussions addressed several key issues, including how to define the mission of a systemic risk regulator, what policy capabilities the mission would require, and whether central banks should be in charge of regulating systemic risk.

There was some ambiguity about what systemic risk regulation—or even systemic risk—actually meant, reflecting the newness and lack of consensus of the public debate. In principle, systemic risk was seen to be risk factors that could create possible chain reaction of failures of important financial institutions or that could threaten all financial institutions, regardless of how effectively they managed their own individual risk. This definition was seen to provide very little effective guidance, however, although participants pointed to a variety of factors that in retrospect could be seen as warning signs for the current crisis, including the vast amounts of OTC derivatives that depended on confidence in the solvency and liquidity of counterparties, the increasing debt of households in the U.S. and other economies such as the UK, correlation risk posed by CDS and bond insurance markets, and the housing bubble. A number of participants were skeptical of whether it was possible to detect systemic risk before it had actually manifested itself in a crisis, calling into question the benefits of creating a systemic risk regulator.

Another practical issue was that, while most participants appeared to agree that a primary role of a systemic risk regulator would be financial market surveillance, there was no consensus over what tools a systemic risk regulator would need to have beyond the ability to gather and analyze market data. Some participants suggested that a systemic risk regulator would need to have significant enforcement capabilities of its own to carry out its mission. Others felt that combining financial institution supervision with systemic risk regulation would make system-level monitoring impractical. Rather, they felt that the systemic risk regulator should work with regulators and supervisors to fashion a coordinated response. At the least, participants agreed that effective regulation of systemic risk would require the ability to collect a great deal of information regarding debt and capital structure. Several participants argued that systemic risk regulators should be able to force financial institutions to raise capital (perhaps on a countercyclical basis) or to convert convertible debt as necessary. They suggested that the Japanese FSA's regime of early warning and prompt corrective action letters was a good model.

Another fundamental question was whether systemic risk regulation should be left to central banks. Advocates of this approach made several arguments in its favor. (Indeed,

a number of participants argued that central banks were already responsible for monitoring and reducing systemic risks, although that responsibility was not formally stated as such.) A key argument in favor of delegating systemic risk regulation to central banks was that monetary policy tools would be essential to dealing with systemic risks. Participants pointed out that many potential systemic risks were ultimately issues of liquidity; also, it was noted that one practical way of dissuading financial institutions from engaging in risky behaviors would be to restrict access to lending facilities. For banks, this would be an extension of existing prudential supervision responsibilities. But by restricting the use of certain types of assets as collateral, the central bank could also indirectly affect financial institutions that it does not directly oversee.

Another argument in favor of central banks as systemic risk regulators had to do with monitoring capabilities. Participants noted that central banks already have extensive systems and personnel dedicated to monitoring financial markets and economic conditions, and some suggested that it would be impractical to try to replicate that in another agency. Looking at the U.S. situation, a number of participants also expressed the opinion that the Federal Reserve system would be better able than any existing government agency to attract excellent personnel (due both to compensation levels and internal culture), and that its tradition of supporting high-quality economic research would be an important asset in creating models and techniques for identifying systemic risk factors.

Not all participants were enthusiastic about making central banks responsible for systemic risk regulation, however. One major concern was about how that responsibility might conflict with its monetary policy objectives. If central banks were to be forced to choose between financial stability and price stability, they argued, then the long-term goal of price stability was likely to be sacrificed to the short-term needs of the financial institutions.

Other participants focused their criticisms more on specific central banks, especially the Fed. Several argued that the Fed was already in *de facto* charge of monitoring systemic risk and that it had done a very poor job of it, having missed the warning signs of the current crisis. Some of the critical participants were more positive about the job that Chairman Bernanke had done, but felt that in the Greenspan period the Fed had been very irresponsible in addressing systemic risk. Thus, they expressed deep reservations about entrusting the responsibility to the institution.

Finally, even some advocates of giving systemic risk regulation responsibilities to the Fed expressed their opinion that it would be politically problematic, for one of two reasons. Some pointed to the deep political unpopularity of the Fed, and argued that it would be a lost cause to advocate giving it broad new powers. Others felt that putting the Fed in the position of such far-reaching authority would strengthen the political appeal of proposals to reduce its independence. They worried that Congressional intervention in monetary policy would result, with potentially severe negative economic consequences.

Preventing Bubbles

Many participants understood the key factor in reducing systemic risk as preventing the formation of bubbles. Discussion of how to prevent bubbles broke down into two broad categories: the role of monetary policy and the role of regulation.

Monetary Policy and Asset Bubbles

Most participants agreed that one of the main causes of financial bubbles was the availability of easy money, and that the housing bubble had been no exception. This led to considerable discussion of the role of central banks in preventing, creating, and bursting bubbles.

Participants noted that a consensus had formed among central bankers over the past two decades that monetary policy should not target asset prices. The rationale was that asset prices are volatile and forward-looking, and that there is no way to determine whether asset prices are rising to unsustainable levels, except in retrospect. Many participants at the Symposium called this consensus into question. They identified asset price inflation as a monetary phenomenon and thus a legitimate concern for central banks; moreover, looking at the damage done by the bursting of the U.S. housing bubble, they suggested that it would be irresponsible to focus only on prices of goods and services. Some also insisted that it had been quite clear that asset price inflation was a major problem in a number of markets, especially housing, but that the easy availability of cheap credit and incentives not to lag benchmarks had clouded many investors' judgment.

Even those participants who agreed with that analysis conceded the practical difficulties of detecting incipient bubbles and choking them off. They recognized that this would call for a redefinition of price stability and agreed that there was no clear rule by which to combine asset and goods prices in a simple algorithm. Several participants were very uncomfortable with the idea of incorporating asset prices into monetary policymaking, arguing that it would necessarily require monetary policy makers to target preferred asset price levels. Others countered that the relevant guide was actually speed of asset price changes rather than price levels. Even if it were not possible to fit the data into a precise formula, they argued, it would be appropriate to take asset prices into account when they rose much more rapidly than prices for goods and services over an extended period of time. This suggested a need for central banks to be allowed to exercise discretion rather than adhere to clear rules such as inflation targeting.

A number of participants were deeply uncomfortable with the idea of expanding central bank discretion. They argued that decades of data had shown that discretionary monetary policy tended to be less consistent and less credible than rule-driven policy. In response to this critique, some participants tried to come up with alternative means of incorporating asset prices into the overall idea of price stability, although no consensus was reached. For example, some participants suggested using the growth of total credit in the economy as an alternative target to price, while others pointed out the difficulties of money supply targeting in situations in which it had been tried.

Role of Regulatory Policies

There was also considerable discussion on regulatory policies that might inhibit the formation of bubbles. Some participants even argued that if appropriate regulatory policies had been in place in Japan in the late 1980s or in the U.S. in the 2000s, their bubbles may not have occurred, even though monetary policy was excessively loose. Rather, the excess liquidity would have led to price inflation, and so the central banks would have acted more quickly to reverse easy money. Not all participants agreed with that assessment, however.

Regulation also was seen as being important to the level of other forms of systemic risk. Participants pointed to accounting and risk management practices as having contributed to excessive risk-taking among financial institutions. While not going deeply into accounting issues, participants agreed on the importance of the principle of keeping risks on the balance sheet. This was seen as important both for internal risk management but also for enabling market discipline.

A number of participants suggested that another means by which excessive risk-taking could have been avoided would have been by imposing maximum leverage ratios on non-bank financial institutions as well as banks. While some participants countered that leverage ratios were too blunt an instrument to be useful across the board, others noted that the BOJ and FSA keep careful track of financial institutions' leverage ratios and provide guidance when they consider them too high. Another criticism not only of leverage ratios but also capital adequacy standards and other regulations was that they tended to exclude many relevant financial institutions. Participants questioned which financial institutions should be covered by leverage limits, but offered few concrete answers.

Finally, most participants agreed that one of the key lessons of the crisis was the need to reduce counterparty risk. Many argued that this would require that most derivatives trading be done through clearinghouses, but not all participants agreed that the loss in flexibility was worth the reduced risk. Another suggestion was for enhanced collateral requirements for securities that were not centrally cleared.

SESSION III
HOW SHOULD THE U.S. RESPOND TO THE FINANCIAL CRISIS: LESSONS FROM JAPAN

An overriding theme of the 2009 Symposium was the need for the U.S. to learn from Japan's experiences in dealing with financial crisis. Participants agreed that Japan had a variety of both positive and negative lessons to teach, although there were disagreements on many of the specifics.

"Amend, Extend, Pretend" vs. "Inspect, Inject, Eject"

A lesson that many participants drew from the Japanese financial crisis was that in order to deal with the problem of bad assets on a massive scale, governments needed to follow the prescription of "inspect, inject, eject." (In other words, to carry out credible inspections that would make clear the extent of impaired assets and require appropriate pricing; to inject capital in weakened but viable financial institutions; and to sell off bad assets as quickly as possible in order to improve balance sheets.) They noted that financial institutions—and sometimes regulators—tend to prefer forbearance, hoping that as asset prices and economic activity recovers in the aftermath of a crisis, so will their balance sheets. But these participants argued that forbearance instead had the effect of making it difficult for such financial institutions to expand their loans or investments; widespread forbearance led inevitably to weak lending growth and weak economic growth.

Participants pointed to several key events in Japan that they considered to have been particularly important in ending forbearance and putting Japanese banks back on the road to recovery. These included the passage of the first FSA law in 1997 and its establishment in 1998, the passage of laws allowing nationalization of banks and the subsequent nationalization of LTCB and NCB later that year, recapitalizations in 1998 and 1999, the Takenaka Plan for NPLs in 2002, and the effective nationalization of Resona Bank in 2003. While participants noted that the process had been quite drawn out, they felt that in that period Japanese authorities put in place all of the regulatory pieces for revival of the banking system. They expressed the hope that the U.S. would incorporate all those elements in its own policy process and that it would do so in a more compressed time period than had Japan, although some worried that the U.S. process might also prove to be lengthy and perhaps slowed by mistakes and backtracking.

In this regard, there were some differences of opinion regarding how far the U.S. had progressed in the direction of "inspect, inject, eject." While many participants argued that U.S. regulators had been strict about forcing honest recognition of bad assets, others disagreed. They said that the U.S. was still in the midst of "amend, extend, pretend" (in other words, forbearance and concealment of losses). They pointed out that financial institutions' estimates of their losses had risen significantly since early in the crisis. Some also criticized the Treasury's stress tests, arguing that the tests had been designed with a final result in mind rather than rigorous economic analysis. Moreover, several aspects of the worst case scenario had actually proved to be too optimistic. For these participants, the rapid U.S. response had only really addressed the need for capital injection; however, they compared the U.S. capital injections under the TARP to the initial Japanese capital injections in 1998, which had come with no conditions and had not properly differentiated healthy banks from unhealthy ones.

Monetary and Fiscal Policy

Many participants stressed that in addition to regulatory responses, policy makers should focus on economic recovery as their top priority. As a number of participants noted, Japanese banks' write-offs of NPLs were unable to keep pace with the appearance of new NPLs until export markets picked up and deflation abated (both at least partly due to unsterilized currency intervention). Thus, they argued that the need for macroeconomic policies to support demand and prevent deflation should be seen as central lessons of the Japanese crisis.

Most participants felt that U.S. authorities had effectively learned the monetary policy lessons of Japan's long stagnation. They pointed out that the BOJ had gotten behind the curve in lowering interest rates in the 1990s, eventually forcing it to reduce overnight interest rates to zero. When even zero interest rates proved to be ineffective in stimulating new lending due to the presence of deflation, Japanese central bankers had been forced into quantitative easing measures and continuation of zero percent short-term rates. Participants noted that the Fed had sought to avoid a fall into deflation by cutting interest rates aggressively before the full extent of the negative effects of the crisis had become visible, and then had moved into quantitative easing measures even before lowering overnight rates all the way to zero.

While most participants lauded U.S. monetary policy makers for preventing a deflationary spiral and keeping liquidity in the banking system, there were some critical voices. Several participants were concerned about the deterioration of quality of the Fed balance sheet, and argued that the Fed should have learned from the BOJ's good example of requiring fiscal backing for purchases of risky assets. A number of participants suggested that the measures were creating new asset bubbles in Treasuries and commodities markets that would lead to future problems. (Others countered, however, that the same concerns had been expressed in Japan, especially by officials of the BOJ, and Japan had experienced anything but inflation.) A few participants argued that Japan's resort to zero interest rates had actually had a very negative effect on its banking system, and urged U.S. authorities not to follow what they saw as the wrong lesson.

In terms of fiscal policy as well, participants observed that the U.S. had made an effort to learn from Japan's experience. The key lesson, many argued, was the disastrous decision in 1997 to reverse fiscal stimulus due to fears of mounting government debt. Most—albeit not all—participants approved of the Obama administration's efforts at fiscal stimulus, even if they did not all agree on the shape or size of the package. But several participants expressed concern that the fiscal stimulus would soon run its course and that it would be politically impossible put through a new one. Thus, they worried that the U.S. might be headed for a repeat of Japan's experience in 1997—or less seriously, perhaps in 2002. Other participants were more worried about the sustainability of U.S. budget deficits, echoing the concerns of Japanese fiscal conservatives dating back to the mid-1990s. These participants were particularly troubled by what they saw as the long-term impacts of current policies, as they saw a large component of increased fiscal deficits to be structural in nature rather than cyclical.

Regulatory Restructuring

Many participants suggested that Japan offered a valuable model for regulatory restructuring. They saw the 1997 decision to create a unified financial regulator separate from the Ministry of Finance as having been an enormously important milestone, for

several reasons. The establishment of the Financial Services Agency (and its predecessor, the Financial Supervisory Agency) had the effect of cutting some of the established ties between financial institutions and the bank regulators and inspectors. It also severed MOF's internal linkage between budget-making and financial regulation, which had been seen as promoting forbearance as a strategy for dealing with troubled banks. In addition, it allowed the expansion of numbers of inspectors, who could be recruited from outside MOF based on specific needs for expertise. Finally, it preserved the idea of keeping financial supervision under one roof.

Not all of those lessons were seen as relevant for the U.S., but participants expressed the wish that sectionalism and regulatory capture could be reduced through significant consolidation of regulatory and supervisory agencies. Few if any expected that a unitary regulator would result, however, and many were pessimistic about the prospects for less ambitious consolidation as well.

A number of participants also felt that U.S. regulators could learn from some FSA practices. One important procedural innovation noted was the ongoing use of early warning systems and prompt corrective action notices. Several participants argued that these measures had contributed to caution on the part of the Japanese banking system going into the crisis. They pointed, for example, to FSA administrative guidance to reduce real estate lending in 2006 as an effective and proper use of regulatory discretion. Some participants noted that a key component of the FSA's early warning system was essentially stress-testing on a quarterly basis, albeit without publicizing the individual results. They suggested that this would be a practical way for U.S. regulators to try to monitor and contain systemic risk as well.

Finally, many participants gave positive evaluations of cooperation between the FSA and BOJ as it pertained to systemic risk regulation. They felt that having separate agencies solved the problem of internal conflicts of interest that some participants had feared would arise if systemic risk regulation were made the responsibility of the central bank. At the same time, they felt that the FSA and BOJ had developed an effective means of nearly constant communication.

PRESENTATION OF FINAL PLENARY SESSION



2009 Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States



SESSION I

The Future of Banking and Securities Regulation

Essential Element of Reform

- Competition
- How to create effective market discipline
  - Transparency
  - Fair value accounting: market-based price discovery
- Resolution procedures for systemically important financial institutions
- Leverage ratios
- International cooperation
  - Resolution of multinational financial conglomerates
  - Regulatory arbitrage

Capital Requirements

- Systemically important financial institutions
  - How to define? (Size, scope, complexity, leverage?)
  - Should have higher capital requirements
- Prevention of asset-liability mismatch
  - Should this be a regulatory responsibility?
- Creating counter-cyclicality
- Dangers of piecemeal reform
  - Capital adequacy alone is not sufficient
  - Dangers of requiring more capital without imposing better risk management

Risk Management

- "Too Big (or Messy) to Manage"
  - How to manage complexity and internal conflicts of interest?
  - Hazards of overreliance on metrics and standards (VAR, Basel, etc.)
- "Too Big to Regulate"
  - Functional complexity
  - Problems of multinational coordination
  - Regulatory fragmentation (U.S.) & regulatory arbitrage
- Regulatory responses
  - Re-segmentation?
  - Going back to basics
    - Prudential rules
    - Inspection regimes

Resolution of Failed Systemically Important Financial Institutions

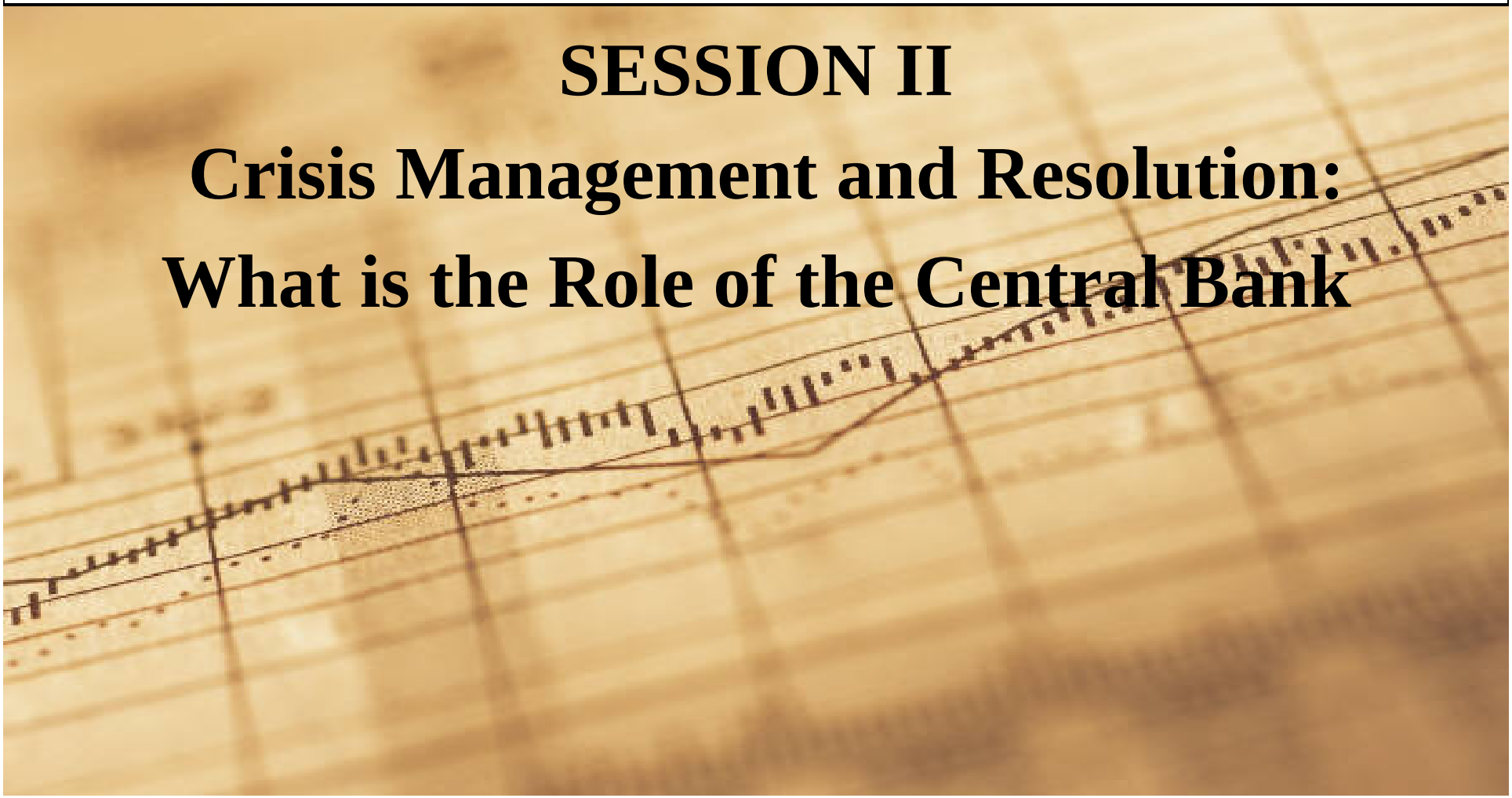
- Necessary to prevent contagion
  - Provisions for continued management of financial institution
- Cross-border resolution issues
  - No current uniform standards
  - Lehman Brothers as a cautionary tale
- Avoiding moral hazard
  - Who needs to lose money?
    - Just shareholders?
    - How about debtholders and counterparties?
  - Role of living wills

Politics

- Principles
  - Which aspects of finance are public goods?
  - Differing bases of regulation
    - U.S.: emphasis on growth and innovation
    - Japan: safety over innovation
- U.S. regulatory fragmentation
  - Can U.S. fix regulatory fragmentation? No!
  - If not, we need effective means of coordination
  - Fitting regulatory ability to regulatory needs (functional approach)

Looking Forward & Looking Back

- Are we fighting the last war?
- Would any of the proposed policies have prevented the crisis?
- If proposals are adopted, what will be the unintended consequences?



SESSION II

Crisis Management and Resolution: What is the Role of the Central Bank

Central Banking in Crises

- No one else can act in emergency
  - Successes as lender of last resort in current crisis
  - Effective international cooperation
- Non-traditional policies
  - Liquidity facilities
  - Quantitative easing measures
  - Balance sheets
    - How much risk?
    - Who should carry it—Fed or Treasury?
    - Japanese experience

Long-Term Effect of Emergency Measures

- How bad is the Fed's balance sheet?
  - Should we fear price inflation?
  - Are we creating another bubble?
- Unwinding excess liquidity
  - Is there a viable exit strategy?
  - Goals: systemic stability vs. normalcy
- Genie is out of the bottle
  - Will there be pressure to use extraordinary measures in ordinary times?
- Will dollar overhang threaten reserve currency status?

Regulating Systemic Risk

- Roles of systemic risk regulation
  - Surveillance and detection of systemic risks
    - Can we even predict systemic risk?
    - Systemic risk vs. financial institution risk
  - Policy capabilities
    - Enforcement
    - Monetary policy
- Should the central bank be the systemic risk regulator?
  - Conflicting objectives (price stability vs. financial stability)
  - Capabilities
    - Tools (does the Fed need more tools?)
    - Human resources
  - Political considerations
    - Unpopularity of Fed
    - Threats to independence

Preventing Bubbles

- Monetary policy and asset bubbles
  - Asset price inflation is a monetary phenomenon
- Detecting bubbles
  - What is price stability?
    - Should we target asset prices?
    - How about speed of change?
  - Growth of credit as alternative target
- Role of regulatory policies
  - Accounting & risk management
    - Keeping risks on balance sheets
    - Improving assessment of VAR
  - Leverage ratios
  - Reducing counterparty risk (collateral requirements, clearinghouses)
  - Which financial institutions should be covered?

Coordination Issues

- International coordination
  - Crisis management coordination: success of central banks
  - Structural reforms
    - Uniform standards to prevent regulatory arbitrage
    - Where should coordination be centered? G-20, FSB, Basel?
- Internal coordination
  - Japan: effective cooperation of FSA & BOJ
  - U.S.: can the college of regulators work?



SESSION III

How Should the U.S. Respond to the Financial Crisis: Lessons from Japan

Session 3

- Are we in 1996, 1998, or 2002?
- Can we build a bridge from “Amend, Extend, Pretend” to “Inspect, Inject, Eject?”
- Will it take the U.S. 10 years to fix the financial system?
- What can we learn from Japan about managing deflation?

KEYNOTE ADDRESSES

BILL RHODES

KEYNOTE ADDRESS

KEYNOTE SPEECH

Bill Rhodes, Senior Vice Chairman, Citi; Senior Vice Chairman, Citibank

Good evening. It is a pleasure to be addressing such a distinguished group here today. Unfortunately Vikram is unable to join us this evening but asked me to emphasize the great importance that he and all of us at Citi place on our franchise in Japan, having opened our first branch there in 1902. Notwithstanding the recent change in profile due to the sale of Nikko, Citi is very much committed to the ongoing development and growth of the Japanese business, with a focus on Citibank Japan and the wholesale securities business of Citigroup Global Markets Japan. Indeed as we all know, there are few markets that are as strategically important as Japan, due to its size, sophistication and willingness to adopt new technologies and innovation. I am also joined here tonight by Doug Peterson, our Country Officer for Japan and by Alan Macdonald, Vice Chairman of Citibank who makes frequent visits to Japan as well.

Speaking personally, I've been involved with Japan and Asia for a good part of my career. In April this year, I had the opportunity to introduce Governor Shirakawa at the Japan Society where he gave an excellent speech on the lessons to be learned from Japan's experiences during the financial crisis of the 1990s. I saw Governor Shirakawa again in June when I attended the International Monetary Conference held in Kyoto, where we had participation from all the major Japanese banks, along with a number of central bank heads and regulators from around the world. Just a few weeks ago, I chaired a panel at the Annual Meeting of the Institute of International Finance at the IMF/World Bank meetings in Istanbul which was attended by more than 1,000 people. The panel included my old friend Toyoo Gyohten, who was recently named Minister of Finance Fujii's special foreign-exchange adviser and the well-known economist, Nouriel Roubini. Comments were made during each of these sessions that are relevant to the three themes of this symposium: the future of banking and securities regulation, crisis management and resolution (including the role of the Central Bank) and finally, how the U.S should respond to the Financial Crisis. I will touch on all these points.

I would like to start however, with a brief look at the origins of this crisis. Three years ago, at the InterAmerican Development Bank meeting in Brazil, and then at the IMF/World Bank meetings in Singapore, I began issuing warnings about the gigantic financial bubble that had been created and the danger that this presented to the world economy.

In March 2007, as the bubble continued to grow I felt compelled to write an Op Ed for the Financial Times titled "A Market Correction is Coming, this time for Real." As you can imagine it was not greeted very positively by the markets and was criticized by most for being overly negative.

At that time, I had noted that a tremendous bubble had been created, with extraordinary levels of liquidity due to the Federal Reserve's expansionary monetary policies early in the decade and the US administration's substantial fiscal stimulus.

This led to a build up in leverage which was further exacerbated by the Yen carry trade, the reach for yield, the low or non-existent spreads, the lack of differentiation among borrowers and documentation-light loans. At the same time, the pockets of excess were becoming harder to ignore especially in the housing and mortgage sectors, particularly in the sub-prime area in the US.

In contrast with various reports prevalent then, I also said that decoupling was a myth – the reality was that securitization and the proliferation and global distribution of financial instruments meant that economies were more inter-dependent than ever. Unfortunately, my point was proven to be the case and the collapse of Lehman Brothers, and the shockwaves it produced around the world, was a clear indication of this interconnectedness. Freezing of financial markets worldwide, with liquidity and credit virtually drying up, led to a collapse of global demand, production and trade, with devastating impact on jobs and living standards of so many people in so many countries. I have worked in banking for over 50 years and this has been the worst crisis I have seen.

As a result of major policy initiatives implemented by the governments and central banks, as well as all-out efforts by the private sector, we're starting to see some long awaited signs of recovery, particularly in Asia. For example, China has just reported GDP growth of 8.9% for the 3rd quarter (on an annualized basis) while Singapore, which led the region into recession, is showing strong 3rd quarter economic expansion of almost 15% (on an annualized basis), following a 2nd quarter increase of 22%. Certainly this pace will need to moderate and indeed there remain key questions around the global recovery's speed and sustainability. Here, opinions are very clearly divided and all kinds of alphabetic letters are injected into the discussion – V-shaped, U-shaped and W-shaped.

Regardless of the shape however, we must recognize that much of the global economy remains in a fragile condition. Rarely before have policy-makers had to confront so many challenges on the economic and financial front as they do today. While there are encouraging signs, we must recognize that difficult times still lie ahead. Generally speaking, economies with stronger fundamentals are weathering the global storm, but those with outsized current account deficits, excessive reliance on foreign funding and lax macroeconomic policies are facing a long and difficult adjustment.

For over a decade the US Consumer, which is 70% of the US economy, carried the world on its back and the US economy acted as the locomotive for growth. The events of the last 18 months have changed all of this as we know, and in spite of growth in this quarter and next, 2010 in the US looks problematic as inventory replenishment is completed and the stimulus package phases out. Housing is still looking for a bottom. Unemployment will remain high for some time, commercial real estate will be a challenge and the US Consumer will not return to past buying patterns any time soon.

Looking at Japan, although the banks have largely weathered the recent storm, thanks in part to the FSA's cautious stance on capital requirements, Japan's economy still faces a number of significant obstacles as you are all well aware, such as the significant public debt challenge and the deflationary pressures that have re-emerged, which could lead to further weakness in domestic demand. Additionally, there are signs that the economy's traditional strength in key export industries—e.g., autos and consumer electronics—are being severely challenged by competitors elsewhere in Asia, especially China and Korea.

So, as we move beyond immediate crisis management and begin to think about longer term actions, what remains to be done?

First, there is the urgent need to address increasingly protectionist measures and countermeasures. Indeed, in the weeks following April's G20 meeting, 17 of the

participating countries adopted measures that could be perceived as protectionist in nature.

We need to recall that during the economic problems of the 1930's, fear spawned the "beggar thy neighbor" trade protectionist approaches. Not only did these approaches fail to secure economic recovery but actually further cemented in the great depression and simultaneously created extraordinary tensions in international relations.

Second, restoration of trade levels must be a priority. The World Bank and the regional development banks like the Asia Development Bank, in partnership with the export credit agencies need to offer expanded lines for trade financing. Diminished global demand is not the sole constraint on world trade – lack of financing is hampering 'the global engine' as well.

Urgent and concrete action is needed as well to conclude a number of pending trade agreements, including the Doha Development Round. Successful conclusion of this agreement will serve to restore confidence and to reinforce the stability and predictability of the global trading system. It would also complement the many national stimulus packages that have been put into place globally. But as I wrote in an Op Ed in July, the seats for top officials at the Doha Round table remain empty.

Third, beyond trade protectionism, there are risks of financial isolationism and fragmentation. Policies developed with a country-focus that largely disregard the dependency of major industrial nations on financial flows from surplus nations, will be counter-productive. Policies that ignore the importance of capital flows between the mature and the emerging market economies will similarly be harmful. We simply cannot cut out international capital flows as without the ability to transfer capital, trade flows are further depressed and limit global growth and recovery.

Additionally, there is ever-increasing risk associated with measures taken by national or regional authorities that strengthen "home bias," seek to insulate pools of liquidity for use by the domestic economy, or have other negative effects on global financial intermediation and regulatory consistency. The ongoing G-20 efforts must include concrete measures to reverse this dynamic.

Fourth, there remains the urgent need to achieve convergence of international accounting standards and regulatory norms in order to ensure a level playing field as well as to prevent regulatory and accounting "arbitrage". Although mandated at previous G20 meetings, work currently remains in progress to review fair-value and accrual accounting for financial institutions, and should be concluded as quickly as possible.

As reform efforts proceed, we are seeing multiple official proposals on capital, leverage, underwriting, liquidity and compensation, which are designed to secure the system's soundness and stability. This is very important, but so too is the need to ensure that regulated financial institutions have the ability to develop new products while providing the credit flows necessary for economic growth across the world.

We need sound and smart regulation that is implemented on a continual basis, to ensure that risks are managed appropriately yet innovation is not stifled. As Governor Shirakawa said in his speech at the Japan Society, regulatory overreaction could undermine economic efficiency, putting downward pressure on productivity growth. And

with Japan's new government, I hope for continued support for open and competitive financial markets and transparency in financial regulations.

Looking ahead to the end of the year, into 2010, the nature of any upturn in the U.S. is likely to be somewhat weak, even in the face of substantial policy support and lean inventories. Most forecasts for the United States indicate growth of between 3% and 4% for the remaining two quarters of this year. Looking beyond that, the landscape is less certain. We must ask then, where will growth come from to replace the US Consumer?

The answer is that we cannot look for a single solution – not to Japan nor to Western Europe. The Chinese consumer is providing a boost, with retail sales up 15.5% over the past 12 months, but shifting from an export-dominated to a more balanced, consumer-led economy will take time; several other major emerging market economies are providing leadership and strength to the global economy, but not sufficiently so as to ensure substantial global growth as 2010 unfolds. Global demand strength will need to come from a wide variety of sources, with all countries – both mature and emerging – contributing their share to the recovery.

Here to, I am thinking of the proposed creation of an East Asian Economic Community. Insofar as it could provide leverage and support to consumer demand within the region, could be an important path forward for export-dependent Japan, Korea and China. Indeed, on Monday night I returned from Korea where I spent almost an hour with President Lee who indicated his interest in such a relationship.

Careful thought must also be given to how the major economies of the world will unwind the massive stimulus packages and Central bank liquidity programs that are now in place. The maintenance of massive levels of public spending to boost the economy, while adding additional central banking liquidity, are policy decisions ill-suited to the creation of durable non-inflationary global growth. Here we must recall the lessons of the 70's, where continued macroeconomic policy accommodation in the face of sharply strengthening domestic demand and intensifying price pressures eventually led to runaway inflation. Ultimately Paul Volcker was brought in to slay this dragon of inflation in the U.S., which eventually required interest rates in excess of 20%. But lest we begin the unwinding process too quickly, we must also remember the lessons of 1937 in the U.S. which taught that prematurely pulling back fiscal and monetary stimulus will only serve to push the economy back into crisis.

Although there are signs of hope and a growing sense of confidence, neither should be mistaken for increased economic strength. Here I would like to echo another point made by Governor Shirakawa. Policy actions taken in the past twenty months are no substitute for the necessary unwinding of economic imbalances accumulated in the preceding booms. One of the lessons that the Governor cited from Japan's so-called 'lost decade' is that sustainable recovery didn't resume until it eliminated excess debt, excess capacity and excess labor – a lesson that we need to study for the US economy in the current crisis.

To conclude then, as the recession ends in many markets globally, I fear that the world will grow complacent and weaken in its resolve to address the systemic weaknesses and global imbalances that played such a central role in the global financial crisis. The reality is that there are still urgent matters at hand that cannot and should not be ignored.

Thank you for your attention.

TAKAFUMI SATO

KEYNOTE ADDRESS

KEYNOTE SPEECH

Dr. Takafumi Sato, Former Commissioner, Financial Services Agency

Japan's Response to the Global Financial Crisis and Outlook for Global Financial Regulation

Introduction

It is my great pleasure to be invited to this Symposium again to speak before distinguished experts in the financial field from Japan and the United States.

When I delivered a speech in Hakone, Japan, almost exactly a year ago, the world was deep in the aftermath of the collapse of a US investment bank, Lehman Brothers. The financial world has gone through a historic period since then, and there have been a number of significant policy developments. The scale of the current crisis has often been characterized as "once-in-a-century" or "the most severe since the Great Depression." Since the impact of the market turmoil has been serious globally, it is not without reason that the current difficulties are labeled in this manner.

Yet my feeling is rather that the current stress is just a "second-in-a-decade" event. This is because I happen to have served Japan's financial regulatory authority for more than ten years and experienced both the current global financial crisis and Japan's last banking crisis in the late 1990s. I had the privilege of dealing with a big financial crisis, not only once but twice. "What a lucky person I am!" I sometimes feel like this somewhat cynically.

In today's speech, I would first like to use this perspective to explain the effects of the current global crisis on Japan's financial sector and explore the possible reasons why the country's financial system has been less affected than the United States and Europe this time. I will also describe the Japanese authorities' response to the current stress. In the second part of this speech, I would like to discuss the broad directions of the global reform of financial regulation, and make brief comments with regard to the manner in which the regulators should advance their reform agenda.

Global financial crisis and Japan's stabilization measures

Comparing the current stress in Japan with the last crisis

There are divergent views as to how the effects of the current financial stress in Japan can be compared with the country's last banking crisis in the 1990s in terms of their nature and magnitude. These divergent views probably reflect the fact that the current stress differs significantly from the crisis we faced in the 1990s. I think the following four can be pointed out as the main sources of the difference:

First, the market turbulence in Japan this time was triggered by an exogenous shock. The current financial stress in Japan stems mainly from the collapse of the housing and securitization markets in the United States, among others. In contrast, the crisis in the 1990s was the result of an endogenous shock, where Japanese financial firms had been deeply involved in the creation of the bubble in the domestic property market.

Second, Japan's regulatory framework and financial safety net have now been improved significantly. In the early 1990s, we had in place neither sufficiently effective frameworks for disclosure and provisioning, nor sufficiently robust schemes for deposit protection

and bank resolution. The lack of these frameworks provided incentives for banks to postpone the disposal of their non-performing loans, and for the authorities to avoid bank resolution in fear of its side effects. Based on the bitter experience that the lack of a reliable framework prolonged financial distress and the economic slump, we have improved disclosure requirements, clarified the rules on write-downs and provisioning, put in place a prompt corrective action scheme, and established an early warning system that enables the supervisors to conduct intense monitoring of banks before they become undercapitalized. The deposit insurance and bank resolution schemes have also been strengthened, and a robust framework to deal with systemic risk has been put in place.

Third, the impact of the market turmoil in one country spilled over quickly to other countries this time, including Japan. Since securitized products are traded on the markets, the current crisis takes on a strong cross-border character. Thus risks were scattered to a wide range of investors through the use of what is called the "originate-to-distribute" business model, and the losses were dispersed globally. The global turmoil also hit Japan's financial sector through a sharp decline of share prices worldwide. In comparison, the effect of Japan's banking crisis in the 1990s was largely contained within the border.

The fourth point of difference is that the current market turmoil resulted in what is likely to become the deepest global recession since the Second World War. In the late 1990s, the world economy sustained positive growth as a whole even in spite of Japan's banking crisis, the Asian crisis, and the turbulence of the global markets that followed. However, in the World Economic Outlook published earlier this month, the International Monetary Fund forecasts the World's real GDP growth for 2009 as minus 1.1 percent. The global recession has led to a serious weakening of Japan's real economy through severe contraction of external demand. Japan's GDP recorded a negative growth of 12.4 percent on an annualized basis in the first quarter of 2009, and is projected to record an annual growth of minus 5.4 percent in 2009. The current global recession thus revealed vividly that Japan's economy is heavily dependent on the export sector.

Why was Japan's financial system less severely hit this time?

As I have just explained, Japan was not immune from the current global financial crisis. The financial system was severely affected by high volatility of the financial markets, and the deterioration of the real economy impacted banks' profitability in the form of increased credit costs.

Nevertheless, one can fairly say that Japan's financial system itself remains relatively sound compared with those in the United States and Europe. This recognition derives from the fact that the losses Japan's financial banking sector incurred from complex securitized products have been limited; as of end-June 2009, the cumulative realized losses since April 2007 are about 25 billion US dollars, and the valuation losses are about 5 billion dollars. These figures are one digit smaller than those of the American and European financial sectors. The exposure of Japan's financial sector to opaque, toxic assets is also significantly smaller.

Then, why was Japan's financial system less severely affected in the current crisis? There are a few anecdotes that indicate some possible reasons for this relative soundness.

First, it is alleged that the soundness is simply a result of the fact that Japan's financial firms were not strongly innovation-oriented.

Second, it is probably because of a historical coincidence that the firms were giving priority to improving their financial soundness rather than enhancing their profitability in the last several years. When the "originate-to-distribute" business model became widespread, it happened that Japan's financial firms were at the final stage of resolving the non-performing loan problems.

Third and finally, some observers point out that the risk management practices of Japan's financial firms were improving in the course of the period I just mentioned. Firms became more cautious than before about investing in financial products with uncertainty on their underlying assets or associated risks. Early implementation of the Basel II framework in Japan has also contributed to ensuring these practices.

I think there is some truth in every anecdote but, being a former financial regulator, I am naturally most attracted to the third possible reason.

Stabilization measures taken in Japan

Let me now move on to describe the short-term stabilization measures taken in Japan in response to the current market turmoil. It seems that the features of these measures differ considerably between Japan on the one hand, and the U.S. and Europe on the other.

The U.S. and European authorities have taken a number of extraordinary actions to stabilize the financial system. They include large-scale capital injection with public funds, temporary bank nationalization, and bank debt guarantees by governments, as well as massive liquidity provisioning by central banks. Meanwhile, few of these extreme actions have been taken in Japan in response to the current turmoil.

This difference reflects the fact that the shock Japan has suffered in the current turmoil is exogenous. Therefore, most of the short-term policies in Japan are aimed at preventing the exogenous shock from turning into a serious system-wide problem. More specifically, the measures we took can be classified into three types.

The first type is the measures to preserve the soundness of the financial sector. For instance, we conducted stress tests with financial firms on a regular basis to make sure that the financial sector maintains its soundness as a whole.
We also did our best to identify as soon as possible the potential spillover effects of overseas events, such as the collapse of Lehman Brothers and the public intervention into AIG (American International Group).
Based on these efforts, we expressed concerns to the financial firms that could be impacted significantly, and urged them to take remedial actions as necessary.

The second type of measures is aimed at maintaining the functioning of the financial markets. For example, we banned naked short selling of shares and enhanced disclosure on short selling. The objectives of these measures were not to keep a specific level of share prices, but to avoid extreme price volatility and to support the pricing function of the markets.

Also, in response to the market turmoil that followed the Lehman's collapse, we, the Financial Services Agency (FSA), coordinated with the Bank of Japan and relevant

government agencies with respect to government or central bank purchases of qualified commercial paper and bonds in an effort to provide liquidity.

The third type of measures is focused on sustaining bank lending in order to support activities in the real economy. They include: providing the capital injection scheme, which can be used by banks on their own business judgment to maintain a sufficient capital base and sustain their lending; and intensive supervisory review of banks' lending practices to ensure that their financial intermediary functions work properly.

"Re-design" of the regulatory framework

Now, let me move on to the second part of the speech to look at recent developments in financial regulation taking place globally.

Six key concepts of regulatory reform

In parallel with short-term measures, the world's financial regulators are advancing medium-term reforms to strengthen financial regulation. Discussions are underway globally, led by the Group of Twenty (G20), the Financial Stability Board (FSB), the Basel Committee on Banking Supervision and others. An international consensus seems to be emerging gradually, as indicated in the recent policy documents such as the G20 Leaders' Statement in Pittsburgh four weeks ago.

Reading these documents carefully, I think the following six points may be highlighted as the key concepts that indicate the broad directions of likely changes in financial regulation.

The first concept is enhancing risk management at financial firms.

A long period of benign macroeconomic conditions created complacency among market participants, which gave rise to an erosion of sound practices. The risk management systems of financial firms failed to capture the risks associated with their business models. On the regulatory side, the Basel II framework was certainly an improvement from Basel I in terms of risk sensitivity, but even this new capital regime did not pay sufficient attention to the complexities of risks regarding structured finance. In the first place, Basel II had not been implemented in major jurisdictions before 2007, with the notable exception of Japan.

In view of the current market turmoil, financial firms should strengthen risk capture and build a sufficient level of capital that is proportionate to the risks their business models entail. To this end, the Basel Committee is set to introduce the enhanced capital framework for trading book, securitization, and off-balance activities. The Committee is also working on enhancing the quality of bank capital in an internationally harmonized manner.

The second concept is addressing misaligned incentives in business models.

Lack of transparency and conflicts of interest in the "originate-to -distribute" business model led to moral hazard in the securitization market. It took the form of poor underwriting standards by originators, insufficient risk information provided by arrangers or distributors, poor performance of credit rating agencies, and poor due diligence and blind reliance on credit ratings by investors. If the originators, arrangers, or distributors thought they could take off the associated risks immediately by selling the assets they bought, it is not surprising that they omitted due diligence in the securitization chain.

Among the measures to address these problems, the Pittsburgh G20 Statement declared that "[s]ecuritization sponsors and originators should retain a part of the risk of the underlying assets." In fact, it was the Japan FSA who first made such a proposal as early as autumn 2007. When I floated this idea at a meeting of the FSF Working Group in early 2008, another member of the Group expressed doubt about the effectiveness of such a measure. I have therefore been encouraged by the global wisdom expressed by the G20 Leaders in endorsing this idea.

Another example of misaligned incentives is financial firms' compensation schemes. Compensation practices at financial firms gave excessive incentives that favored maximization of short-term profitability, and did not recognize explicitly the huge risks that could be materialized much later. As an effort to promote more risk-adjusted compensation schemes, the Financial Stability Forum (FSF), the FSB's predecessor body, issued the Principles for Sound Compensation Practices last April. This was followed by the Implementation Standards issued by the FSB in September.

The third concept is enhancing integrity and transparency of the markets.

Increasingly complex, opaque financial products were widely traded among market participants, including off-balance-sheet entities, without adequate appreciation of risks, without transmission of accurate information, and without sufficient disclosure of assets held by financial institutions. As a result, tremendous uncertainty was built up in the market as to toxic exposures and future losses which, in turn, increased the level of counterparty risk.

To prevent the recurrence of such a situation, the recommended measures are aimed at ensuring the integrity and transparency of the markets. They include improving the transparency of securitized products, strengthened disclosure by financial institutions, enhanced quality of accounting standards, regulatory framework for credit rating agencies, and more rigorous due diligence.

The fourth concept is broadening the regulatory scope with a view to systemic risk.

The current turmoil has highlighted the fact that the behavior of non-bank financial firms can have a significant impact on overall financial stability. Traditionally, the regulatory framework to deal with systemic risk has been mainly focused on the commercial banking sector. However, the current turmoil was triggered and deepened typically by troubles at large investment banks and a global insurance group. Large commercial banks had also expanded the scope of their business, for example, by using SIVs (structured investment vehicles) or ABCP (asset-backed commercial paper) conduits and by providing them with liquidity support. Furthermore, previously unregulated firms and markets are exerting increasing influence over the global financial system.

In view of these developments, the G20 leaders declared in London last April that the scope of regulation and supervision would be broadened to cover all systemically important products, markets, and institutions, including hedge funds. In Pittsburgh, they subsequently agreed to promote standardization of OTC derivatives, trading of such products on exchanges or electronic trading platforms, and clearing of the transactions by central counterparties.

The fifth concept is strengthening international cooperation among regulators.

Prior to the current market turmoil, risks had been scattered through the markets to a wide range of investors around the globe. Reflecting this increasingly cross-border character of financial transactions, the measures to tackle the current problem need to be internationally consistent.

In addition, the international impact of the recent collapse of large, complex financial institutions has demonstrated that global systemic risk posed by such institutions needs to be dealt with by close cooperation among regulators. To this end, the world's major regulators have established supervisory colleges for each of the global financial firms, and have also agreed to the FSF Principles for Cross-Border Cooperation on Crisis Management.

The sixth concept is macroprudential perspectives for supervision.

Historically low interest rates, the favorable macroeconomic environment, and global imbalances contributed to breeding the current turmoil. They made financial firms eager to search for higher returns, which led to excessive leverage and reckless behavior.

As financial transactions become increasingly market-based, serious risks latent in the markets have become common risk factors to many financial firms, which would materialize themselves once an individual firm runs into trouble. The effect could spread to the entire financial system through increased counterparty risk and behavioral changes at financial firms, with market liquidity dried up and the pricing function of the markets impaired. This in turn would threaten the soundness of other financial firms.
Indeed, the current crisis has demonstrated that macroeconomic and market developments are as important as idiosyncratic risk at individual firms. It is therefore essential that regulators strive to identify such common risk factors and make use of the analysis in supervision. To this end, traditional microprudential supervision that focuses on the soundness of individual financial firms will not be sufficient. Regulators will need to analyze more thoroughly the effect of macroeconomic or market developments on the soundness of the financial system and behavior of financial firms.

In addition, the macroeconomic impact of the financial system or financial regulation should also be analyzed. Addressing procyclicality of the capital adequacy requirements can be seen as one of the macroprudential approaches in this broader sense. In order to address this problem, discussions are underway at the Basel Committee on how to design the rules for countercyclical capital buffers.

Right balance between crisis management and reform

So far, I have characterized the broad directions of the "re-design" of financial regulation. As the global financial markets seem to be bottoming out, the focus of the policy response has now shifted from short-term stabilization measures to medium-term regulatory reforms, with a view to avoiding the recurrence of the same kind of crises.

At the same time, however, the right balance needs to be struck in implementing short-term and medium-term measures. On the one hand, crisis management measures should not remain in place over a prolonged period as some of them include exceptional actions with large-scale public support. On the other hand, too hasty exit from these measures and implementation of medium-term reforms could rather impede market normalization and economic recovery.

In this connection, the Pittsburgh G20 Statement is right in making it clear that the existing extraordinary policy support will be withdrawn “when the time is right,” while the rules to improve bank capital “will be phased in as financial conditions improve and economic recovery is assured.” Given the facts that further de-leveraging will be needed in the U.S. and Europe and the financial markets are still heavily dependent on public support, one cannot be too optimistic about the outlook of the world economy.

Furthermore, it is essential that regulatory strengthening should be aligned with the root causes of the current crisis. From this standpoint, I remain concerned about recent discussions at international fora because the proposed measures seem to be strongly biased to increasing the level of bank capital. Without addressing the problems of insufficient risk capture, procyclicality, and lack of market integrity and transparency, simply raising the level of capital could end up merely seeding the next crisis. In the absence of the incentives for strengthening risk management, financial firms could be induced to undertake much riskier businesses to meet the demand for higher returns from investors who supply additional capital.

An important aim of the regulatory reform should be to incentivize financial firms, with a view to ensuring that the financial intermediary function of the financial system as a whole can work properly, and the system can fulfill its fundamental role of supporting the real economy. To this end, the tendency of bank management and shareholders to take excessive risks to maximize short-term profits needs to be controlled effectively. Without correcting these misaligned incentives, higher bank capital would just encourage circumvention or regulatory arbitrage. Efforts in areas other than banking regulation may be required to strengthen discipline in bank management and investors’ behavior. These areas would include the market infrastructure to ensure the integrity and transparency of the markets, such as accounting, public disclosure, and credit ratings.

Financial regulators should be reminded that tightening regulation is not a goal in itself: it is rather a means to ensure that the financial system plays its indispensable role of supporting the broader economy.

Thank you.

NEAL S. WOLIN

KEYNOTE ADDRESS

KEYNOTE SPEECH

Neal S. Wolin, Deputy Secretary, U.S. Department of the Treasury

Good evening. It's a pleasure to be here tonight and to share the podium with Vice Minister Tamaki.

As many of you know, Mr. Tamaki spent a few years during the early part of this decade working at the Japanese Embassy in Washington. Today, as then, we have the deepest respect for his expertise and insights on international economic policy.

I want to thank the Harvard Law School and the International House of Japan for organizing this conference. I want to offer a special thanks to Hal Scott for his valuable leadership as Director of the law school's Program on International Financial Systems.

This symposium first convened in the midst of the Japanese Financial Crisis of the late 1990s. Over the past eleven years, U.S. and Japanese leaders gathering for this symposium have addressed many of the most important and challenging issues facing our nations' economies.

Last year, one might say this symposium returned to its roots, convening again in the midst of a financial crisis—a crisis not limited to any one region or continent, however, but truly global in scope.

At that time—October, 2008—global credit markets had frozen. Global trade was collapsing. As Secretary Geithner has said, we were standing on the edge of the abyss. There were few who would have predicted with confidence that we would see the signs of recovery and growth one year later that we do today.

One of the reasons that we have successfully stepped back from the abyss, I think, is that we had the benefit of learning from past experiences—including, to a meaningful extent, from Japan's experiences in the 1990s.

As Dr. Takafumi Sato, Commissioner of Japan's Financial Services Agency, said at this symposium last year, Japan's experience taught the importance of recognizing financial losses early and acting swiftly to restore the health of financial institutions' balance sheets. I would add that Japan's experience also helped to teach that, to be most effective, fiscal stimulus measures must be not only large but also sustained and targeted.

The U.S. and Japan have each acted upon those lessons domestically in response to this recent crisis. But even more importantly, the U.S. and Japan—as well as others—together played a leading role in building the consensus for coordinated international action.

Looking beyond the financial crisis today, I believe that one of the most significant and positive outcomes of the recent crisis is a broad recognition of the importance—and also the power—of close international coordination. And that's what I'd like to focus on this evening, in two contexts: First, in the context of rebuilding and reforming the international

financial system; and second, in the context of the need for a more sustainable and balanced model for global economic growth.

In both of these areas, there are tremendous opportunities for the United States and Japan to continue to play leading roles—and to continue the unique partnership between our two nations.

When the G-20 nations gathered in London in April, we agreed collectively to a coordinated recovery program—to spur growth, to stabilize the financial system, to restore the flow of credit, to mobilize financial resources for emerging market economies, and to keep our markets open for trade and investment.

In the United States, the Obama Administration and Congress had already enacted a sweeping economic recovery package. And we implemented a Financial Stability Plan designed to subject our banks to transparent stress tests and recapitalize our financial system; to repair the institutions and markets that provide credit to American families and businesses; and to stabilize the spiraling housing crisis.

Japan, for its part, responded with a variety of fiscal, monetary and financial policy measures. After three separate stimulus packages in 2008, Japan announced a fourth in April, which is now being revised and redirected by the Hatoyama Government.

The Bank of Japan promoted stability by directly purchasing commercial paper and accepting it as eligible collateral. Both the government and regulatory authorities increased the public funds available for bank recapitalization.

Other nations implemented similar stimulus and stabilization efforts. And when the G-20 leaders gathered again, just a month ago in Pittsburgh, it was clear that the actions taken by each nation and those taken in common were of a scale never before seen in such a short period of time.

We still face substantial risks and we still have much work to do to solidify and sustain the recovery. In that context, it's time to begin laying the foundation for the post-crisis 21st century economy, and to turn our attention to the longer-term challenge of building a safer, more stable financial system for the future.

As we do so, we must approach the reform effort with the same sense of interdependence and common purpose with which we approached the rescue.

As you know, the Obama Administration has proposed to Congress the most sweeping set of regulatory reforms since the New Deal.

These reforms would close the regulatory gaps and loopholes that helped produce the recent crisis—by, among other things, strengthening supervision for the largest, most interconnected firms, as well as for key payment and settlement systems; regulating the over-the-counter derivatives markets; establishing a new agency dedicated to protecting consumers' interests.

We are pursuing these reforms aggressively, and Congress has already made strong progress toward enactment of a comprehensive package. But even as we push for

reform at home, it is critical that our efforts here are matched by corresponding efforts around the world.

There is a clear international consensus in favor of reform. Many G-20 nations have already made their own efforts domestically. And at Pittsburgh, G-20 leaders adopted timetables for action in four key areas: capital, compensation, over-the-counter derivatives and cross-border resolution.

With respect to capital, we believe that the financial crisis demonstrated all too clearly that capital and liquidity requirements were inadequate—across the board, and especially for the largest firms. G-20 Leaders agreed to develop rules by the end of 2010 to improve the quantity and quality of bank capital and to discourage excessive leverage.

There will, of course, be plenty of work ahead to flesh out the precise nature of the rules. We believe, however, that capital fulfills its loss-absorbing function most effectively if it is permanent and deeply-subordinated—and that, accordingly, common equity should constitute a larger majority of banking firms' regulatory capital during good economic times.

With respect to compensation, we are pleased that the G-20 nations endorsed standards to better align compensation with long-term value and risk management, and that national supervisors and governments are in the process of implementing reforms to promote sound practices in their home jurisdictions.

Just this week, the Federal Reserve and the Treasury Special Master made announcements that will help advance the G-20 principles here in the United States.
With respect to cross-border bank resolution, the G-20 Leaders have agreed to establish crisis management groups for the major cross-border firms and to strengthen their nations' domestic frameworks for resolution of financial firms.

These actions—coupled with the imposition of higher prudential standards for the largest, most interconnected firms—are critical in a world where large financial firms are truly global in reach.

Finally, with respect to over-the-counter derivatives, the Leaders agreed to advance the work already done by many G20 members by agreeing that, by the end of 2012, all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, as appropriate, and should be cleared through central counterparties.

We look forward, in all of these areas, to working closely with Japan. There can be no doubt that, if Japan and the United States work hand in hand, with a sense of common purpose, we can accomplish a tremendous amount.

I'd like to turn now to what is probably the more challenging issue of building a sustainable and balanced model for global economic growth.

In the lead-up to this crisis, some of the world's largest economies relied upon the American consumer as the primary engine of growth. These nations relied too heavily on exports, running large external surpluses, building up large foreign exchange reserves, and leaving themselves vulnerable to the collapse in demand that followed the financial crisis.

And Americans made it easy. For far too long, we bought too much and saved too little—running up large external deficits and substantial international debt.
The imbalanced growth model of recent years is not just undesirable, it's unsustainable.

Between the end of 2007 and mid-2009, U.S. household wealth fell by $12 trillion, or 19 percent. Household savings rates have rebounded, and we expect them to rise further. The U.S. fiscal deficit will fall as the economy recovers and our stimulus spending declines.

The combination of increased saving and a falling deficit means that the United States and U.S. consumers can no longer be the driving force of global expansion.

As we seek to build a stronger, more resilient global financial system, it is vital that we work together to rebalance the global economy and build a new model of economic growth.

There is, of course, a consensus on the need for such change. In Pittsburgh, the G-20 leaders adopted a Framework for Strong, Sustainable, and Balanced Growth that avoids the pitfalls of the past. Among other things, the Framework calls for:

Higher levels of savings in countries like the United States—and policies to increase domestic demand in today's external surplus countries;

For a new process of mutual assessment to evaluate whether G20 policies are consistent with a more sustainable and balanced pattern of global growth;

And for the adoption of macro-prudential regulatory policies to help prevent destabilizing credit and asset price cycles.

The challenge of rebalancing the global economy to assure strong, sustained, and balanced growth will be a central theme in the upcoming APEC Finance Ministers and Leaders meetings in Singapore. APEC is particularly important given its huge weight in the world economy and the large scope for rebalancing in this region.

Achieving strong, sustainable and balanced growth will not be easy, however. And to have meaning, the words of the G-20 Framework must be matched by actions—actions at least as bold as the actions taken in response to the immediate pressures of the financial crisis.

In the United States, we have made a start. We are working to reform our health care system, to improve the quality of education, to rebuild our infrastructure, and to improve energy efficiency. These reforms are essential to boosting the productive capacity of our economy.

At the same time, we are determined to reduce our deficit significantly over the long-term. Our recently completed Mid-Session Budget Review projects the US deficit falling to about 4.1 percent of GDP by 2015. The Administration is committed to further cuts in the deficit to a long-term sustainable level.

We look to our partners, including Japan, to pursue complementary strategies.

We welcome the Hatoyama government's commitment to moving the Japanese economy away from export-dependence and toward greater reliance on domestic demand.

For Japan, the challenge is to ensure long-term growth with a labor force that is declining, by assuring strong productivity growth and by channeling capital and labor to those sectors where productivity is highest.

Several policies listed in the DPJ manifesto—including support for families with children, expanded daycare, and reforms to the pension system—will be beneficial. And reforms to boost competition and increase investment opportunities, particularly in domestically-oriented sectors such as services, will be critical to boosting productivity and shifting the orientation of the Japanese economy towards domestic demand.

As the world's second largest economy and a sustained current account surplus country, Japan has a key role to play in moving us toward a more sustainable pattern of global growth. We look hopefully to Japan as a leader and as a model for export-oriented countries in Asia and around the world.

The global economy has traveled a great distance since this symposium last met in October of last year. We have pulled back from the abyss and we are on the path to economic recovery. But we still have a long way to go, and much work yet to do.

In the same way that close international cooperation was crucial to responding to the crisis, continued cooperation is essential to reforming and strengthening our financial systems and ensuring sustainable, balanced growth for the years to come.

And as we look beyond the financial crisis to the longer-term task of building a more stable global financial system, I firmly believe that the United States and Japan have an opportunity—and an obligation—to lead the way.

Our two nations are bound together by our history, by decades of unparalleled partnership, by a commitment to democracy and to the free market—and also by common interests. We are the two largest economies in the world. And it is in our mutual interest to do all we can to promote stability and growth for many years to come.

That is why the Obama Administration looks forward to working closely with the Hatoyama government in the coming months. And I look forward to working with you, Vice Minister Tamaki.

Thank you.

APPENDIX I

CONCEPT PAPERS

Japan's Financial Mt. Fuji



David L. Asher, Ph.D.

For Club X Conference 2009

May 12-13 Langdon Hall (Toronto)

With special thanks to:
Andrew Smithers (Smithers and Co.) and Yuri Okane

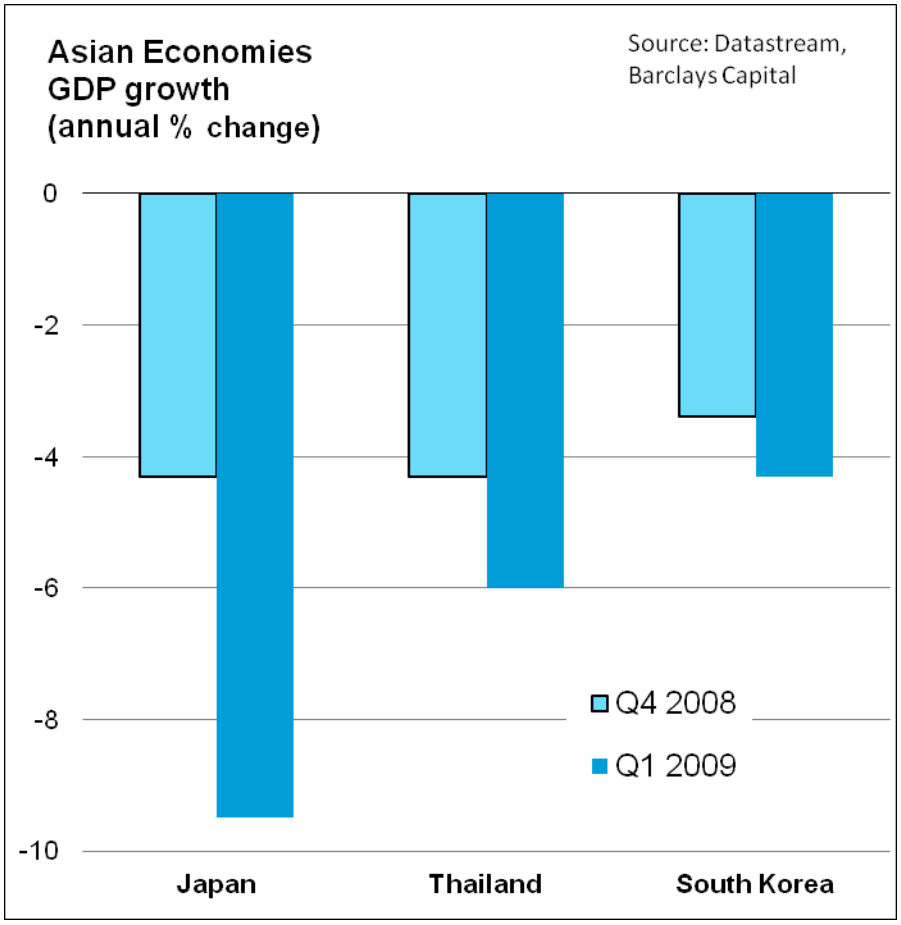
INTRODUCTION

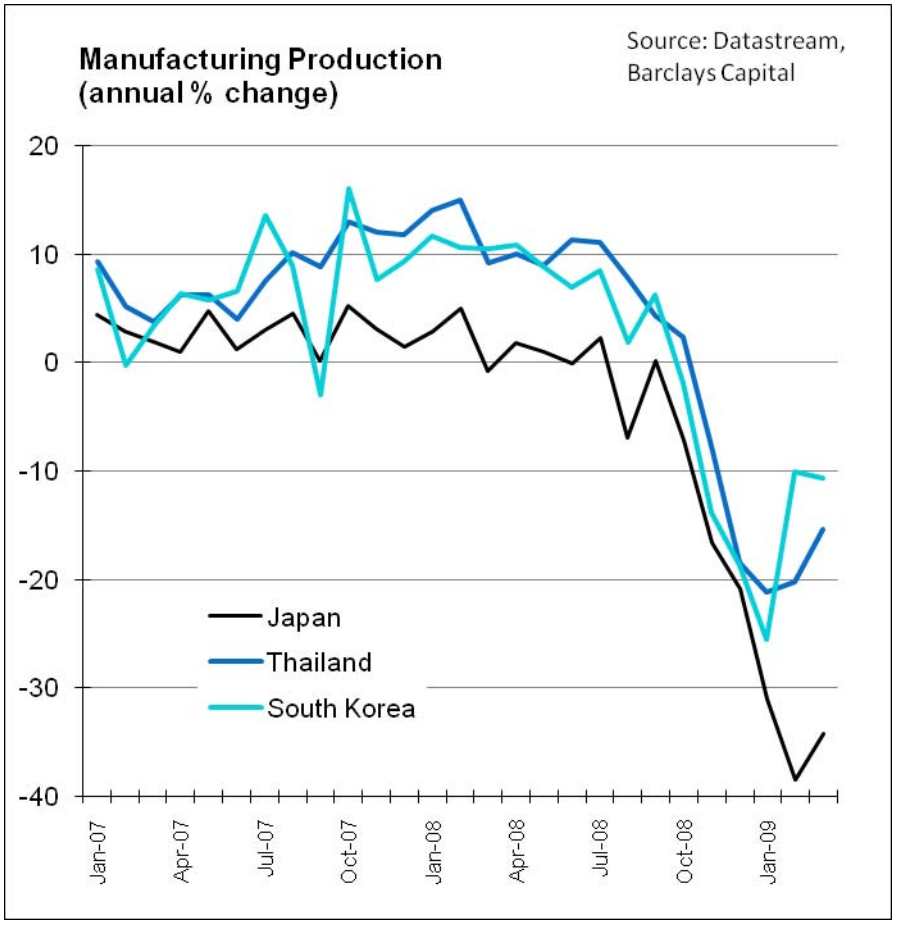
Japan's Outlook

- Japan still has not undergone sufficient reform
- Japan remains remarkably export dependent
- The weight of structural factors on growth is increasing
- Aggressive fiscal and monetary policy are hard pressed to alleviate internal imbalances
- Global pro cyclicality will benefit Japan less than other major economies (but Japan equities will bounce on stimulus/China rebound)
- Japan must take advantage of strong Yen, ultra-low interest, and strong national savings to directly invest more abroad
- The JGB Market ("financial Mt. Fuji") remains stable but might become vulnerable to import price inflation and a weaker Yen in 2010-2011

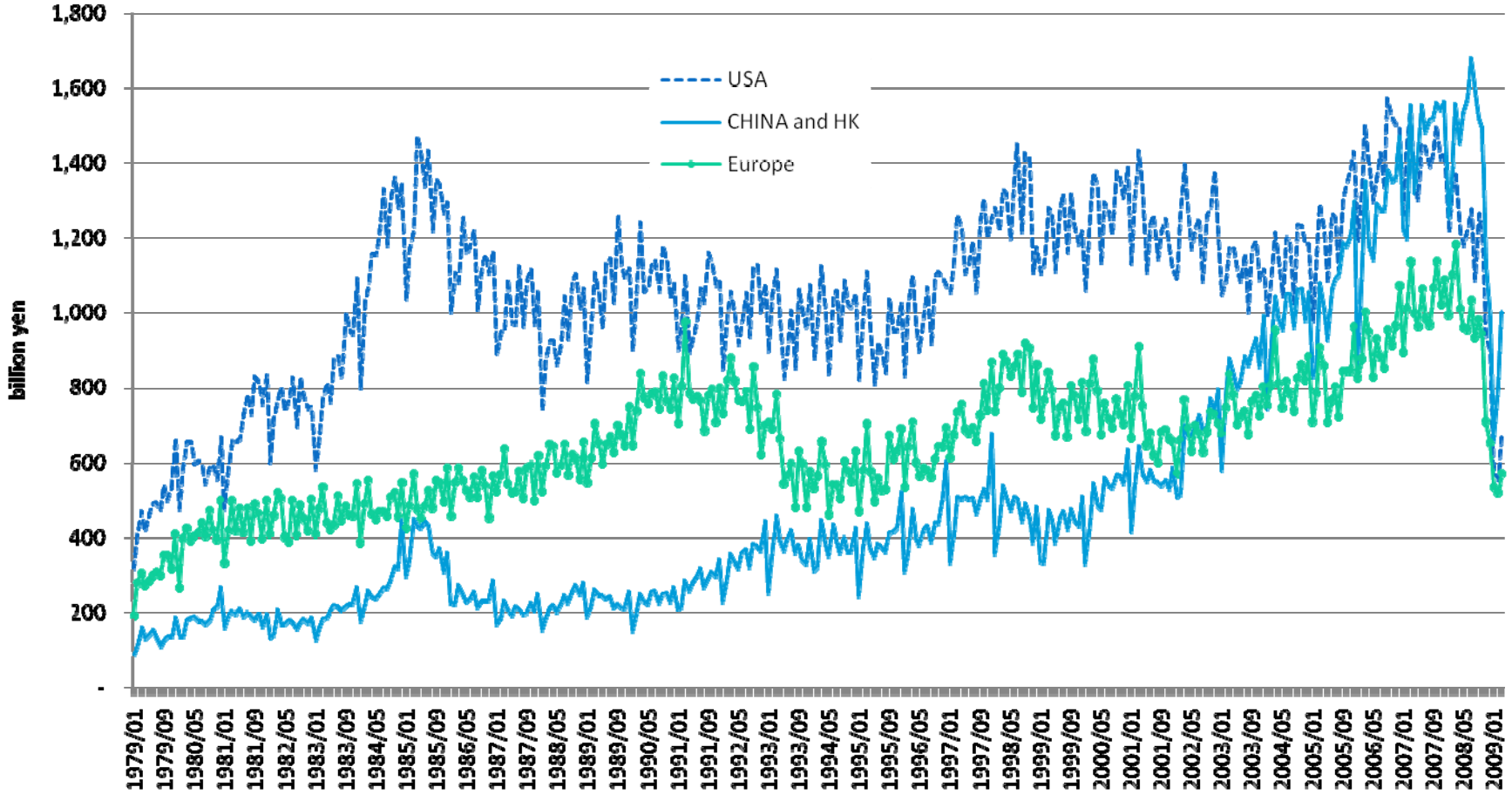
Japan: Hardest Hit Asian Economy

It used to be said that "when the U.S. sneezes, Japan catches a cold," now……



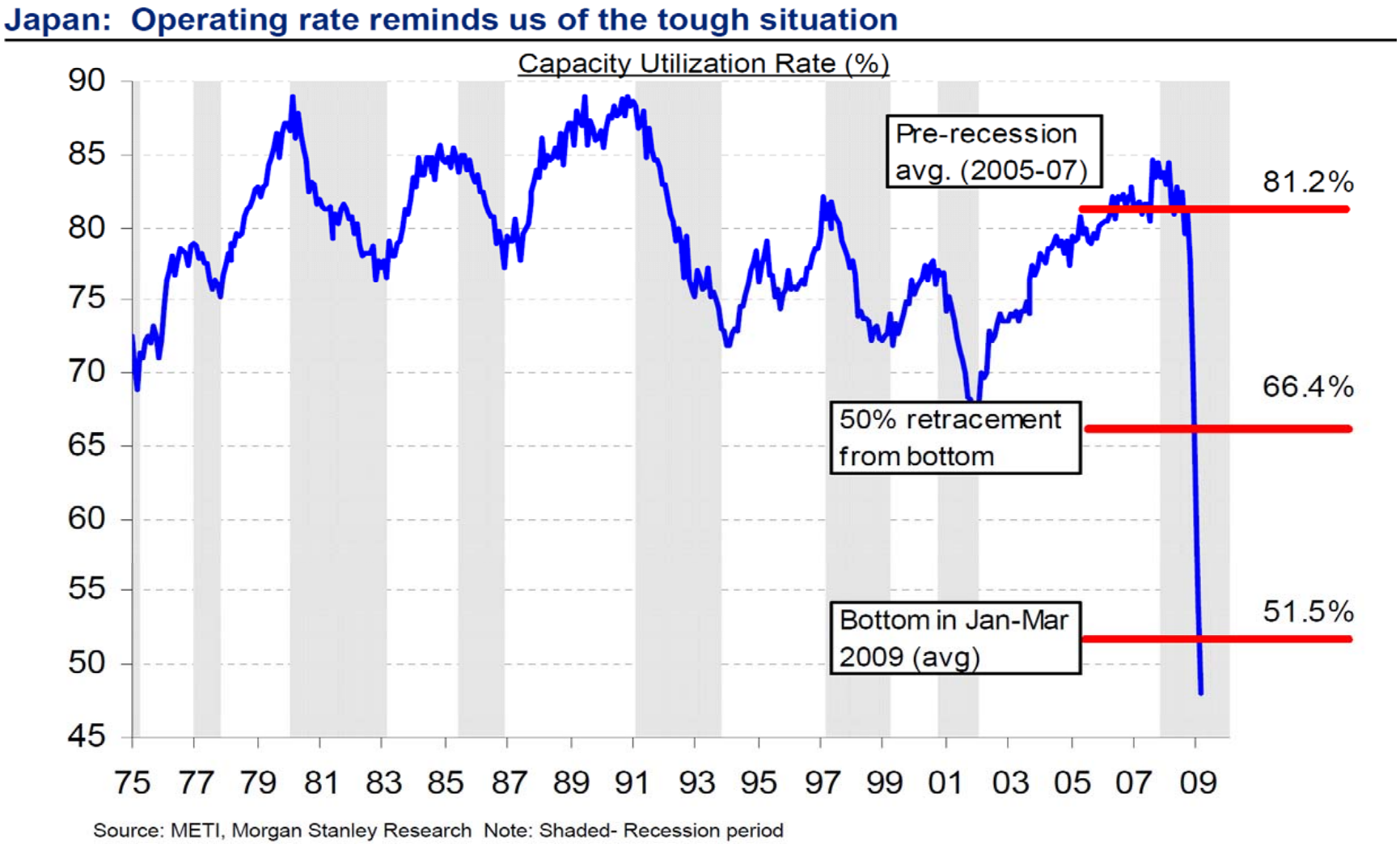


Japanese Exports to Major Trading Partners



Source: MoF

Manic Depression?



Stimulus to the Rescue?

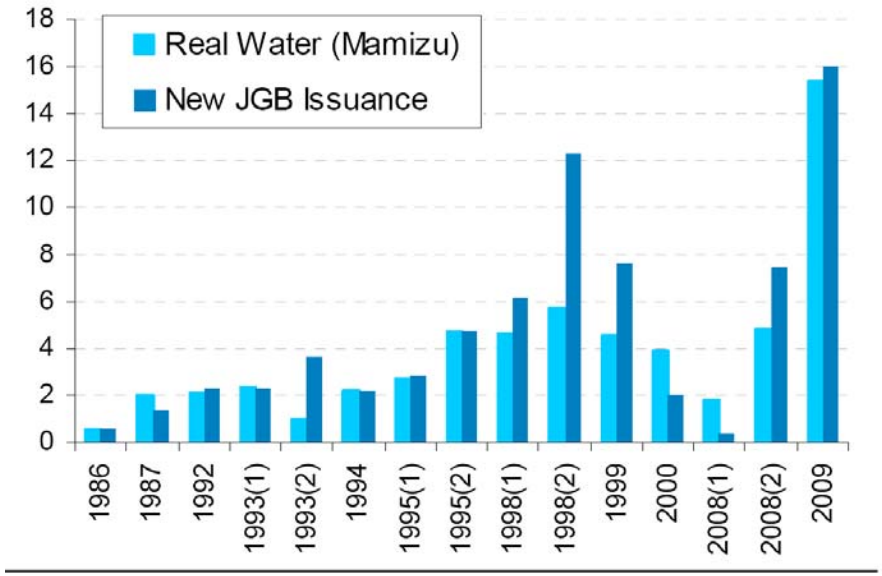
Major Items in the Japanese Government Economic Package

(yen trillion)

	Real Water	Project Size
1. Emergent Measures	4.9	44.4
(1) Labour Market Security	1.9	2.5
(2) Loans and Loan Guarantees	3.0	41.8
2. Longer Term Measures	6.2	8.8
(1) Solar Energy and Clean Energy	1.6	2.2
(2) Health Care	2.0	2.8
(3) Infrastructure	2.6	3.8
3. Subsidies to Households and Municipalities	4.3	5.0
(1) Stimulate Local Economies	0.2	0.4
(2) Subsidies to 4-6 year old Children	1.7	2.2
(3) Subsidies to Municipalities to Conduct Public Works	2.4	2.4
4. Tax Cuts	0.1	0.1
Total	15.4	58.3
Stock Market PKO Funds	0.0	50.0

Source: Nakamae Intl Research

Largest-ever Economic Stimulus Package in F3/10: Effective Demand in Major Economic Packages since Late 1980s and New JGB Issuance (¥trn)



Note: There are latitudes of interpretation about the size of the additional effective demand.
Source: MoF, Cabinet Office, Toshihiro Ibori (2000), Morgan Stanley Research

Japan's Structural Determinants of Growth: The 5 Ds

- **Debt**
- **Deflation**
- **Default**
- **Demography**
- **Deregulation**

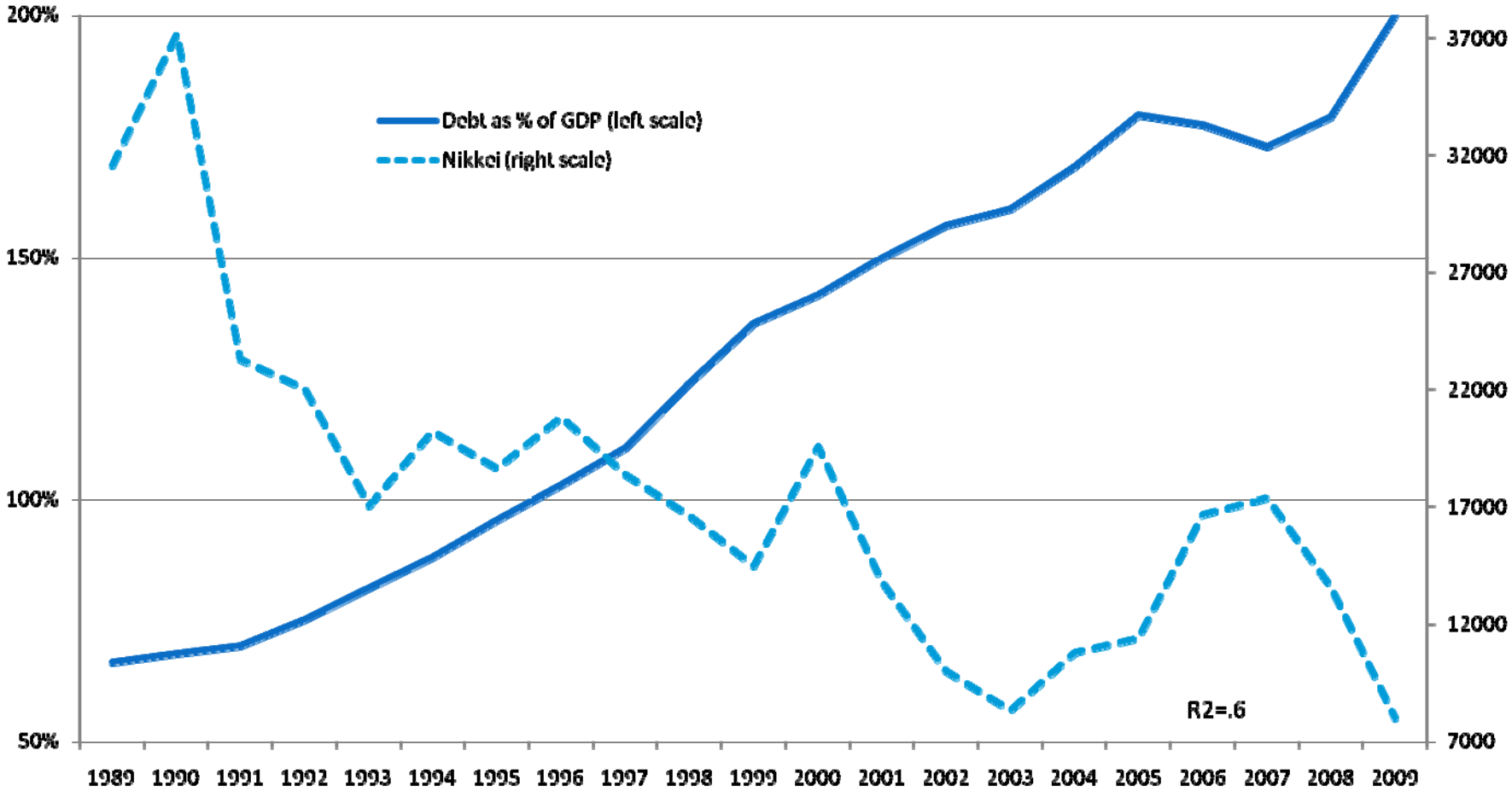
The Japanese economy is also confronted with a "structural crisis." Over the past decade or so, the global economy continued to grow strongly under global imbalances, while Japan enjoyed an economic recovery mainly led by exports. The current financial and economic crisis makes it inevitable for the global economy to undergo a "great adjustment" as countries around the world explore a new balance.

"Policy Package to Address Economic Crisis," Office of the Japanese Prime Minister, April 10, 2009

DEBT

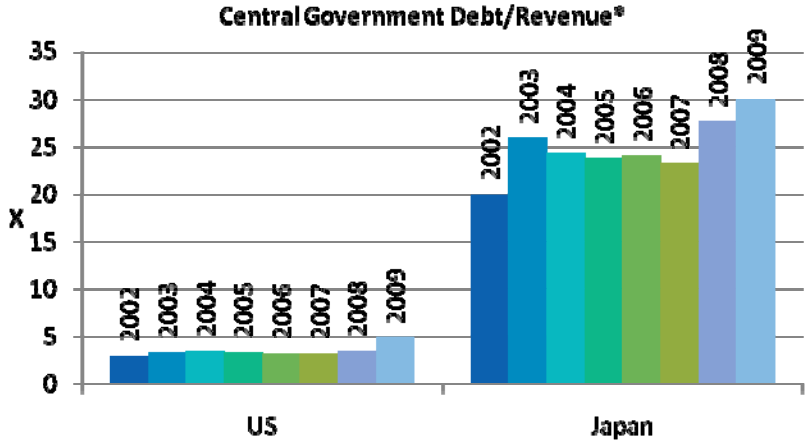
Ricardo was Right:

Japanese Government Debt as a % of GDP and the Nikkei*



* Close of the first trading day of the year

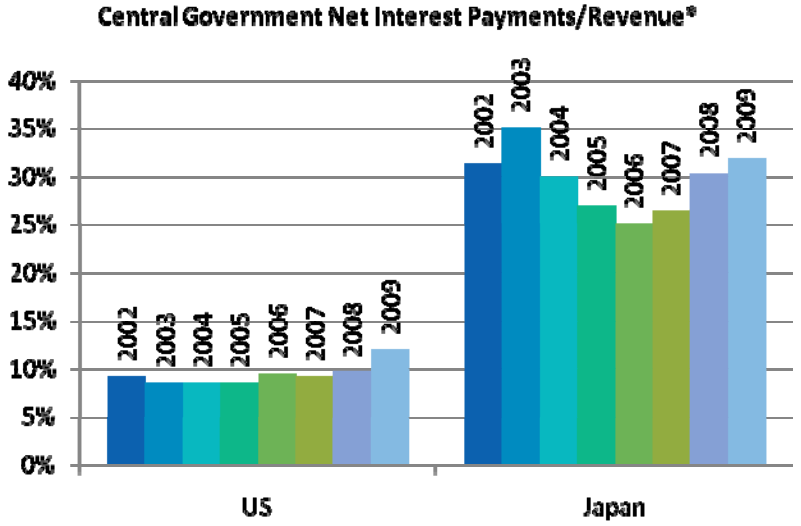
The US vs. Japan in the Debt Olympics

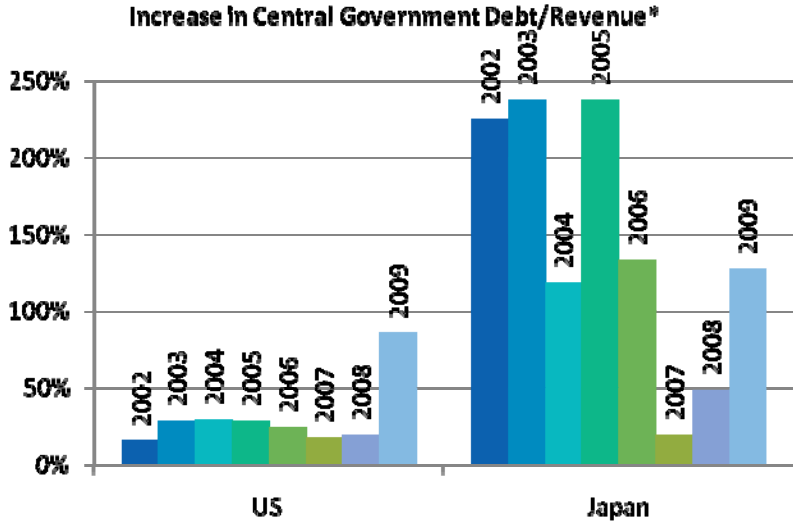


Japan	2008	2009	2010
General Government Balance (GDP%)	-5.552	-9.876	-9.821
Gross General Government Debt (GDP%)	196.287	217.16	227.449
Current Account Balance (GDP%)	3.19	1.529	1.185

US	2008	2009	2010
General Government Balance (GDP%)	-6.073	-13.638	-9.675
General Government Gross Debt (GDP%)	70.517	86.985	97.489
Current Account Balance (GDP%)	-4.72	-2.808	-2.824

Source: IMF

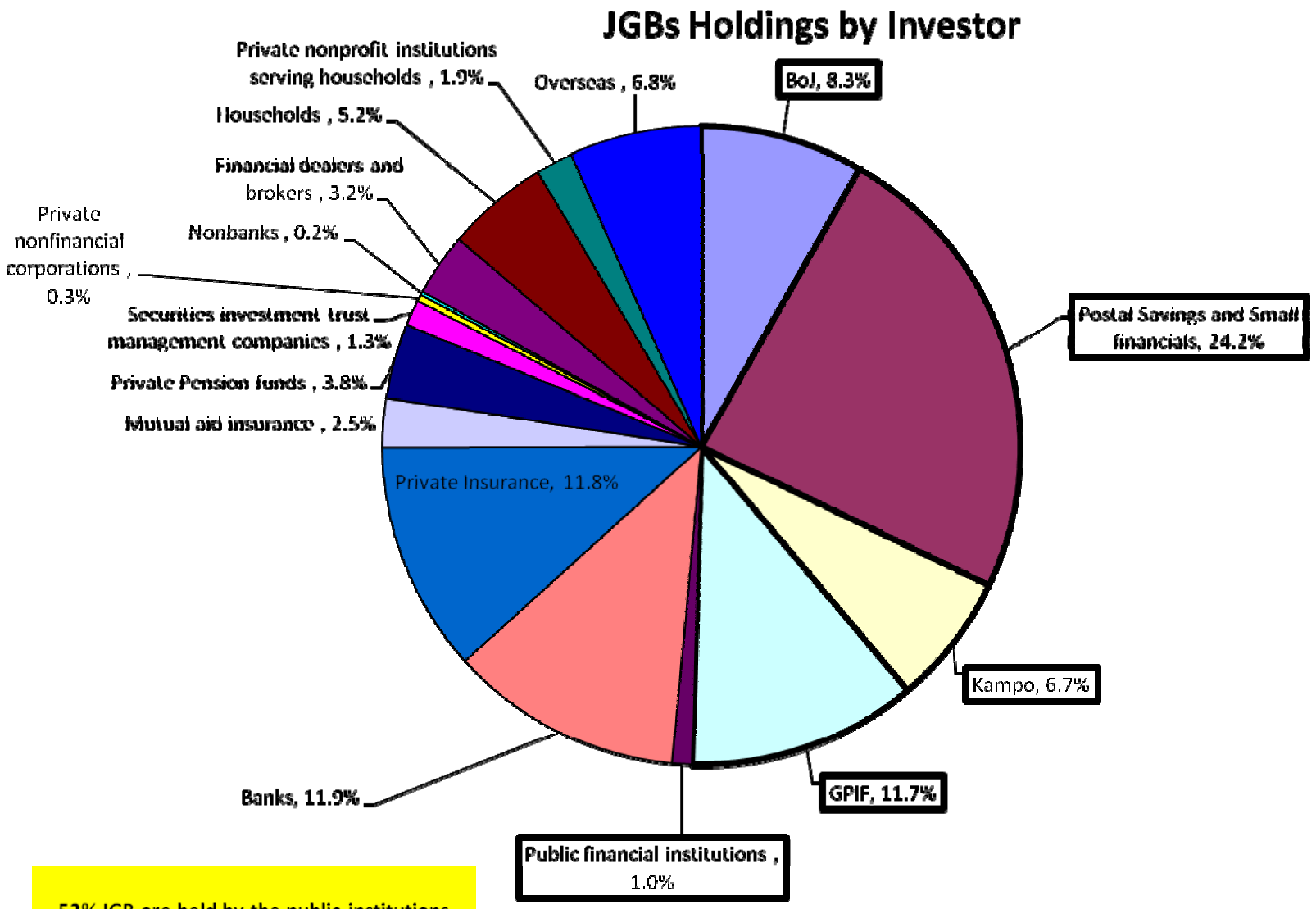




*Note: Japan central government revenue adjusted for the transfer of "local allocation tax" (which accounts for nearly 1/3 of recurring tax revenue) that must be transferred to prefectural governments, not kept by Central Government.

Source: US - Congressional Budget Office, OMB ; Japan - Ministry of Finance

The Government Dominates the Bond Market:



52% JGB are held by the public institutions

What is Supporting the Japanese Bond Market?

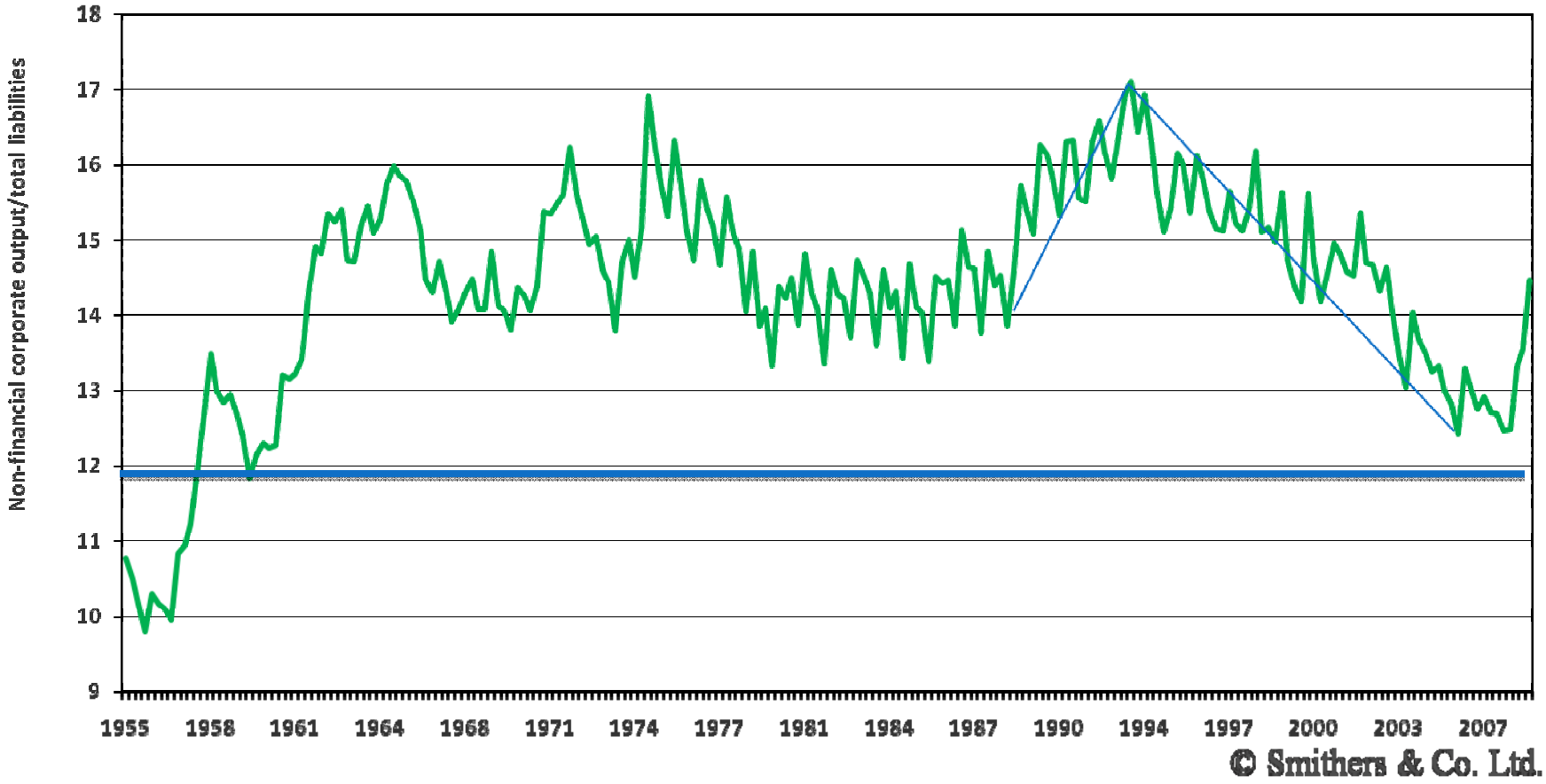
- 0%+ Interest Rate Policy
- Massive Government Purchase of Bonds
- Poor Stock Market
- Low Foreign Investor Exposure
- Shifting Demography
- Convoy System (Public/Private Partnership)
- Strong Yen
- Huge Accumulated Savings
- Large Net External Assets
- Japanese Patriotism/ "*Sakoku* Mentality"

But:

- Inherent Government Credit Fundamentals are Very Poor
- Japan is Vulnerable to Imported Inflation in the Future

Corporate Debt Now Under Control:

Non-financial Companies' Total Liabilities as % of Output

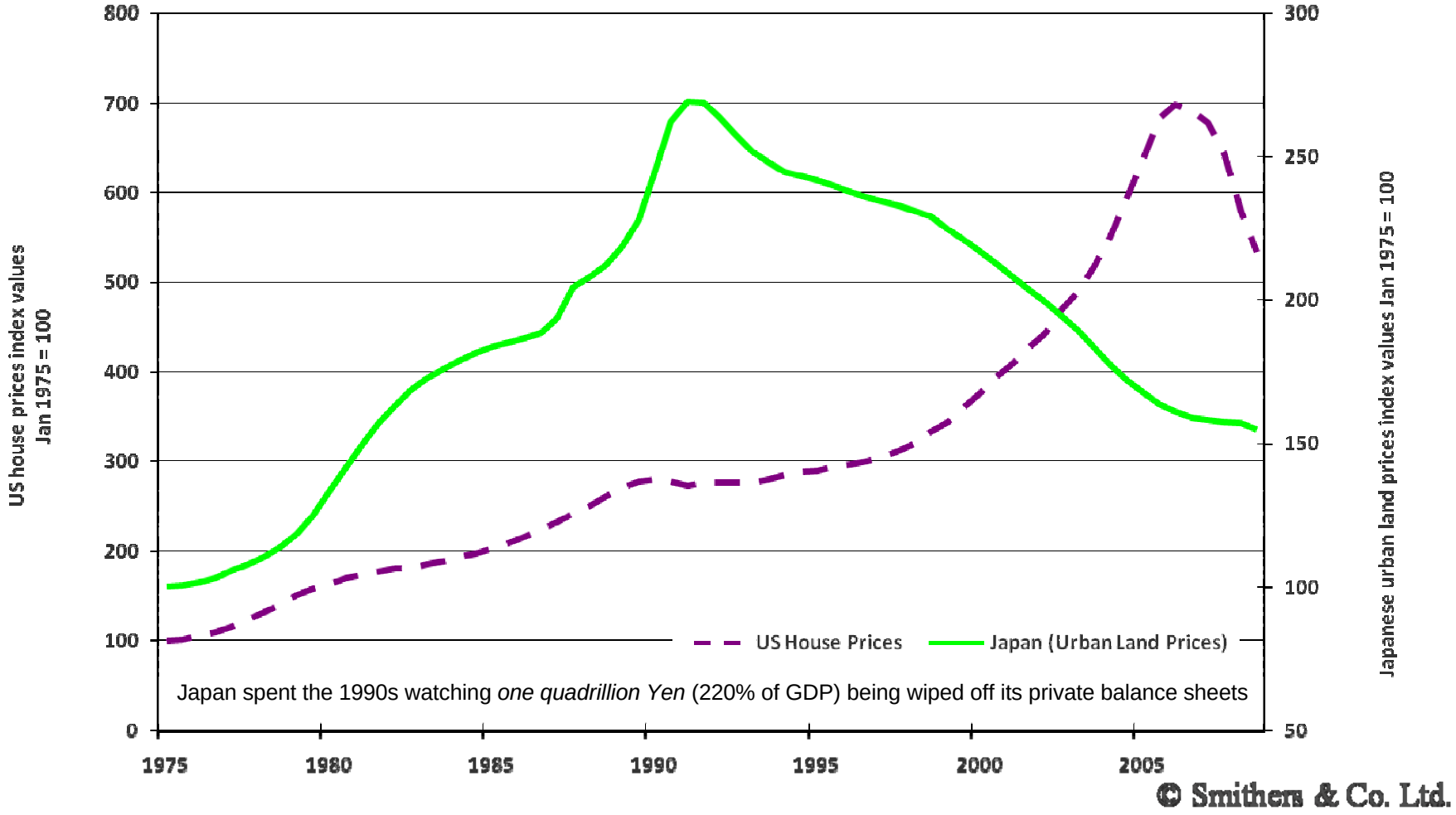


Source: MoF Quarterly Survey of Incorporated Enterprises

DEFLATION

A Tale of Two Bubbles:

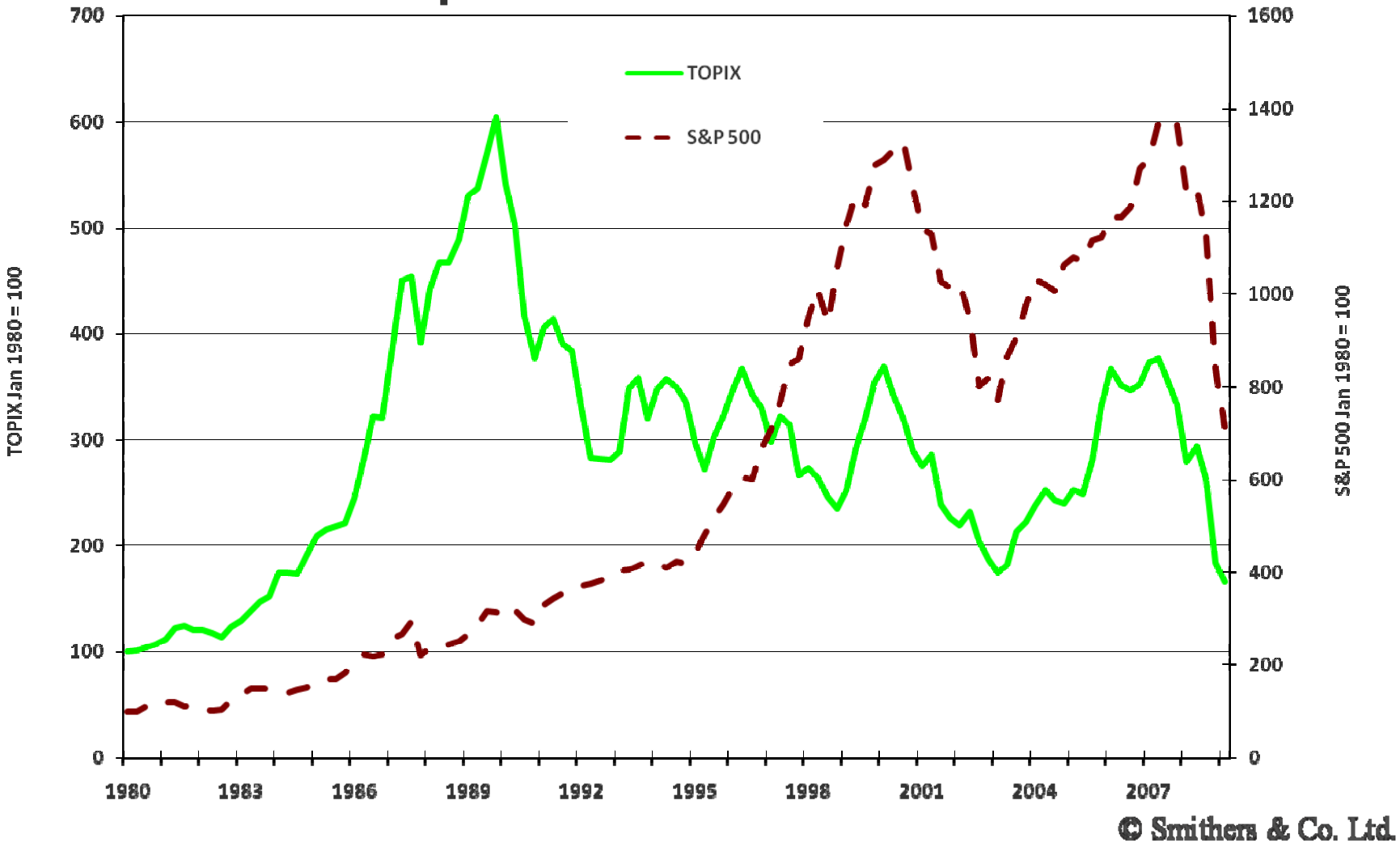
Japan & US: House and Land Prices



Sources: OFHEO, Cash-Shiller & Japan Real Estate Institute via Ecowin

History Repeating Itself (or Rhyming?)

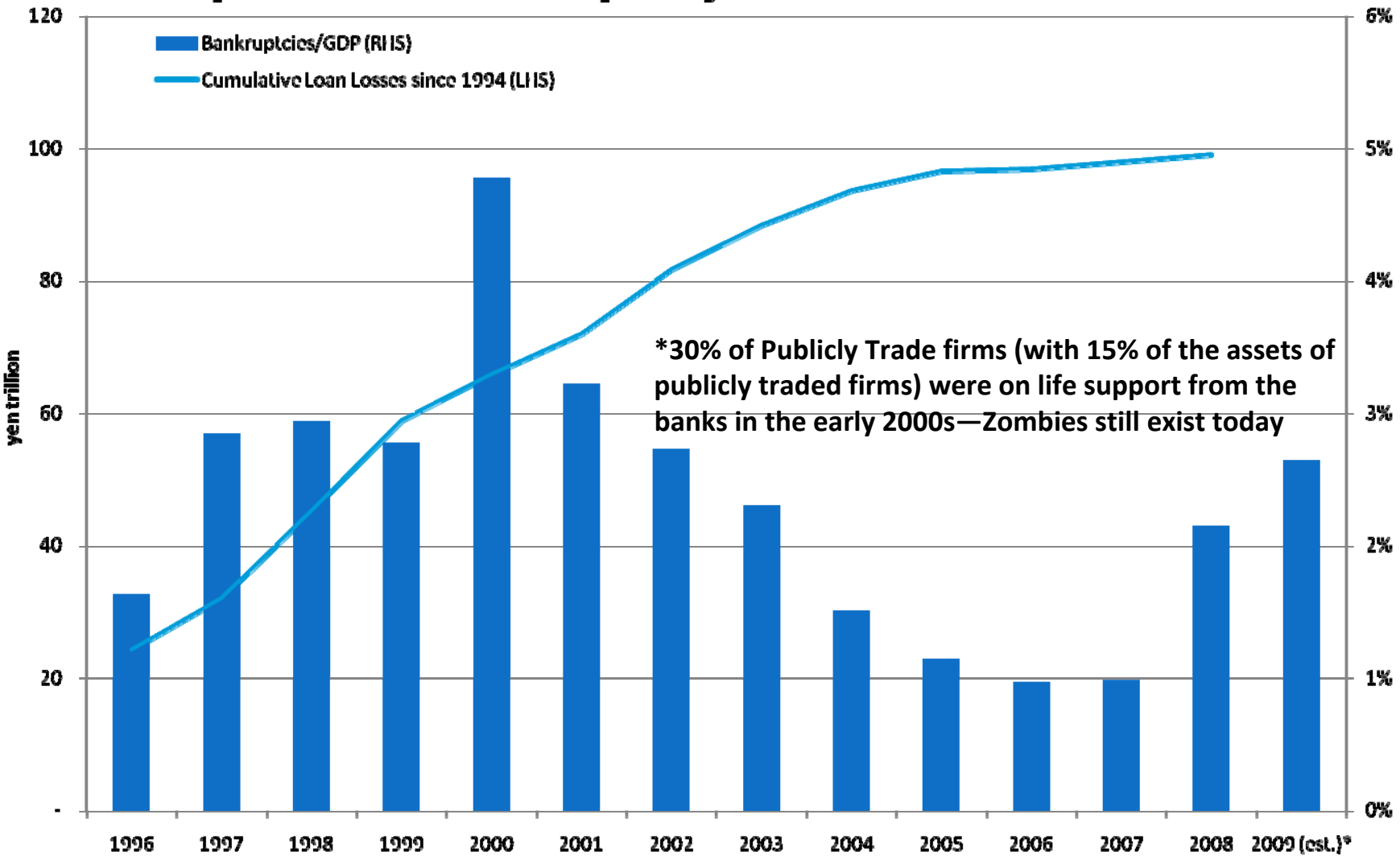
Japan & US: Stock Markets



Sources: TSE & S&P via Ecowin

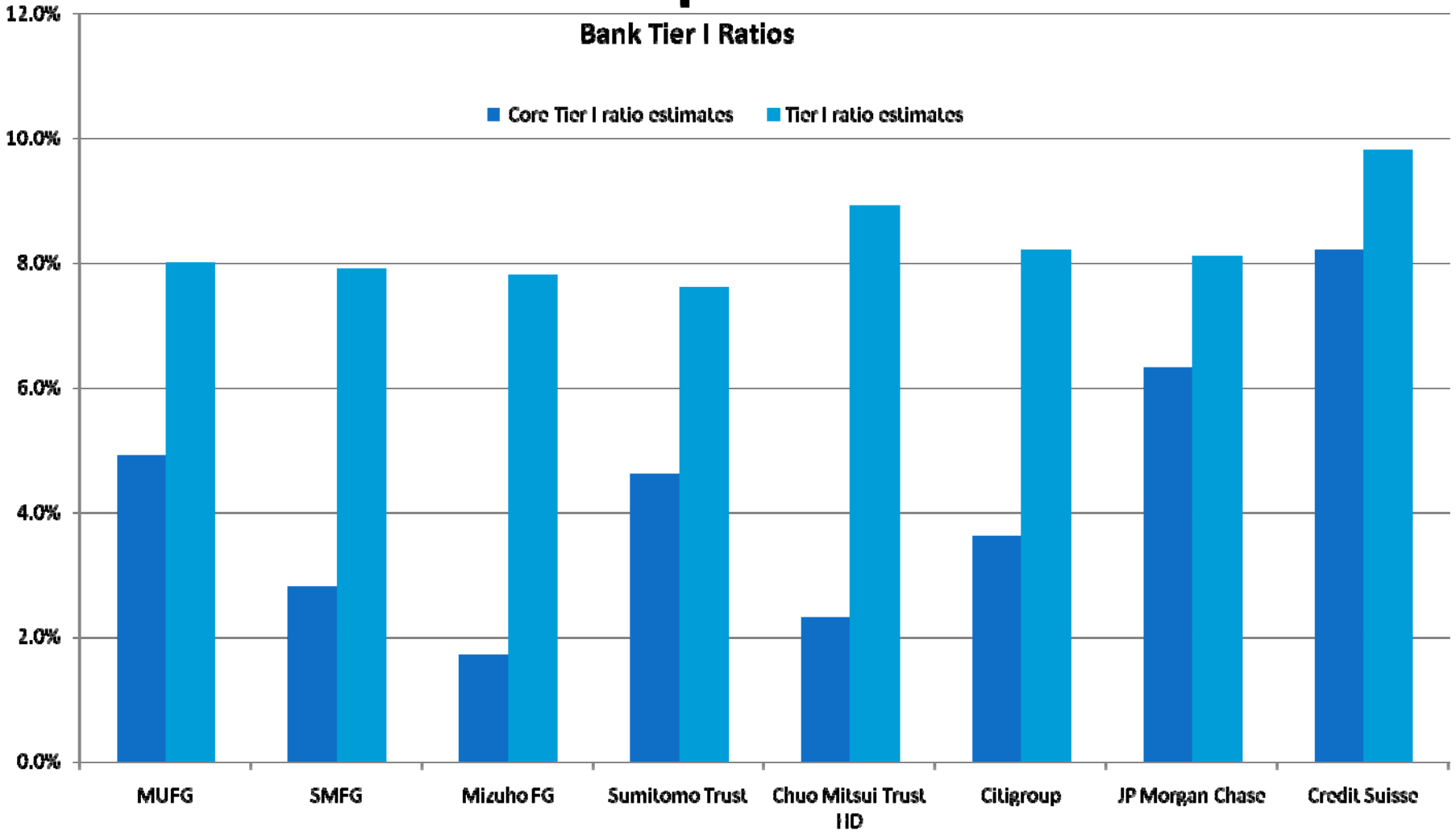
DEFAULT

Japan: Bankruptcy and Loan Losses



Source: Shoko Research; ***Zombie Lending and Depressed Restructuring in Japan,** Ricardo J. Caballero, Takeo Hoshi, Anil K Kashyap, NBER, January 2008

Japanese Banks Still Undercapitalized:

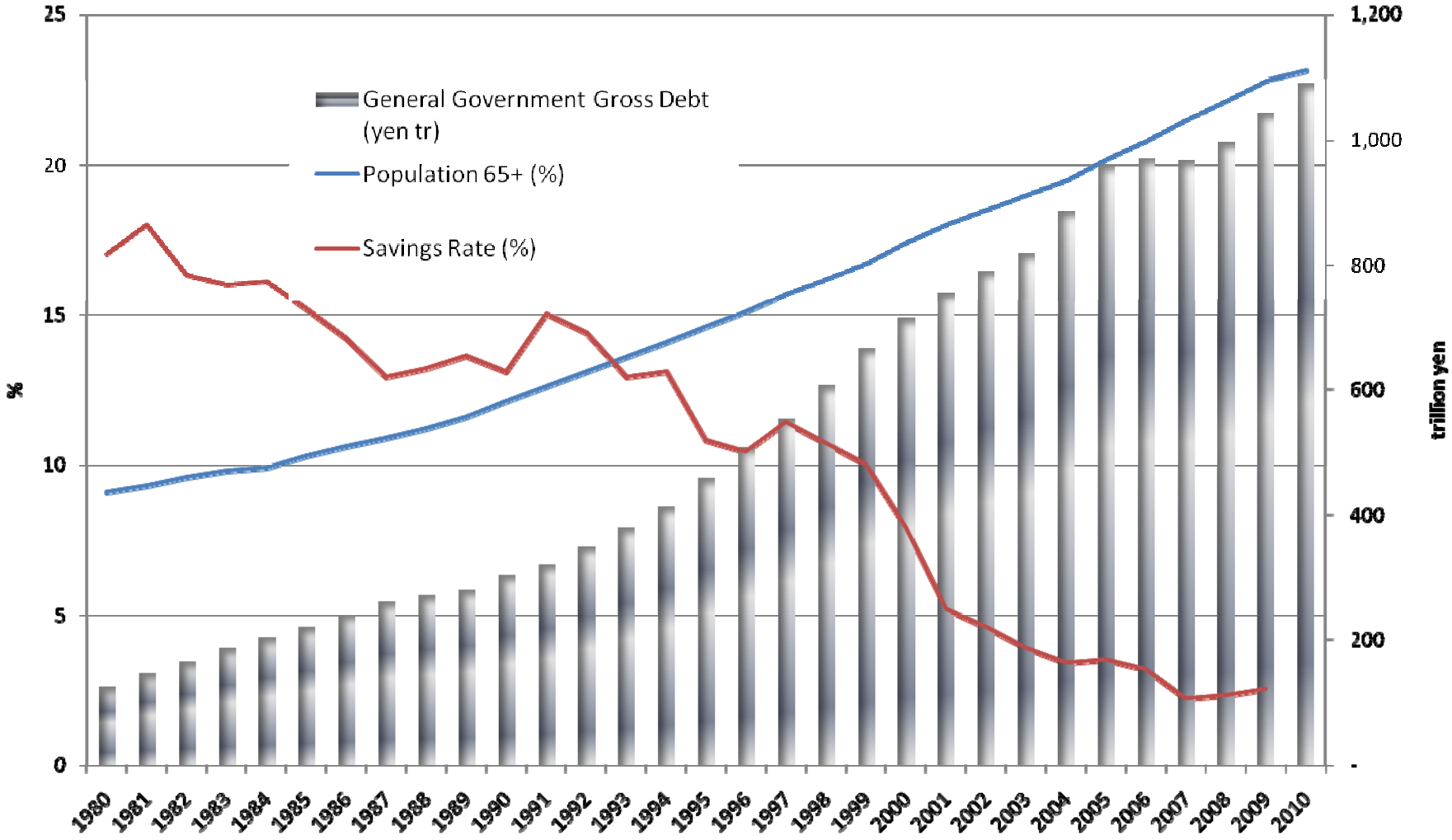


Source: UBS estimates from S&P data

DEMOGRAPHY

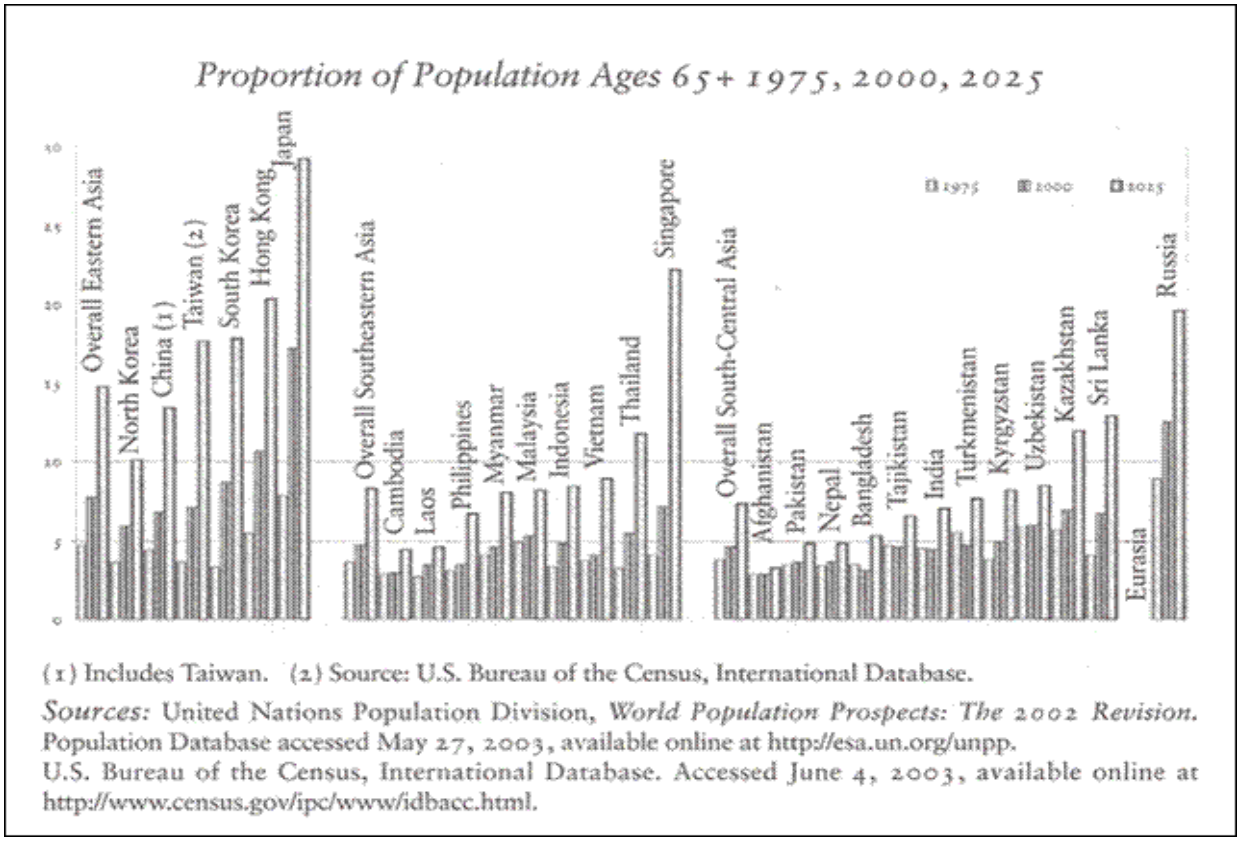
World's Fastest Aging Large Society:

Japan's Declining Population, Savings and Growing Debt



Source:

Population in Freefall



Japan's Child Population Drops To Record Low - Government Survey

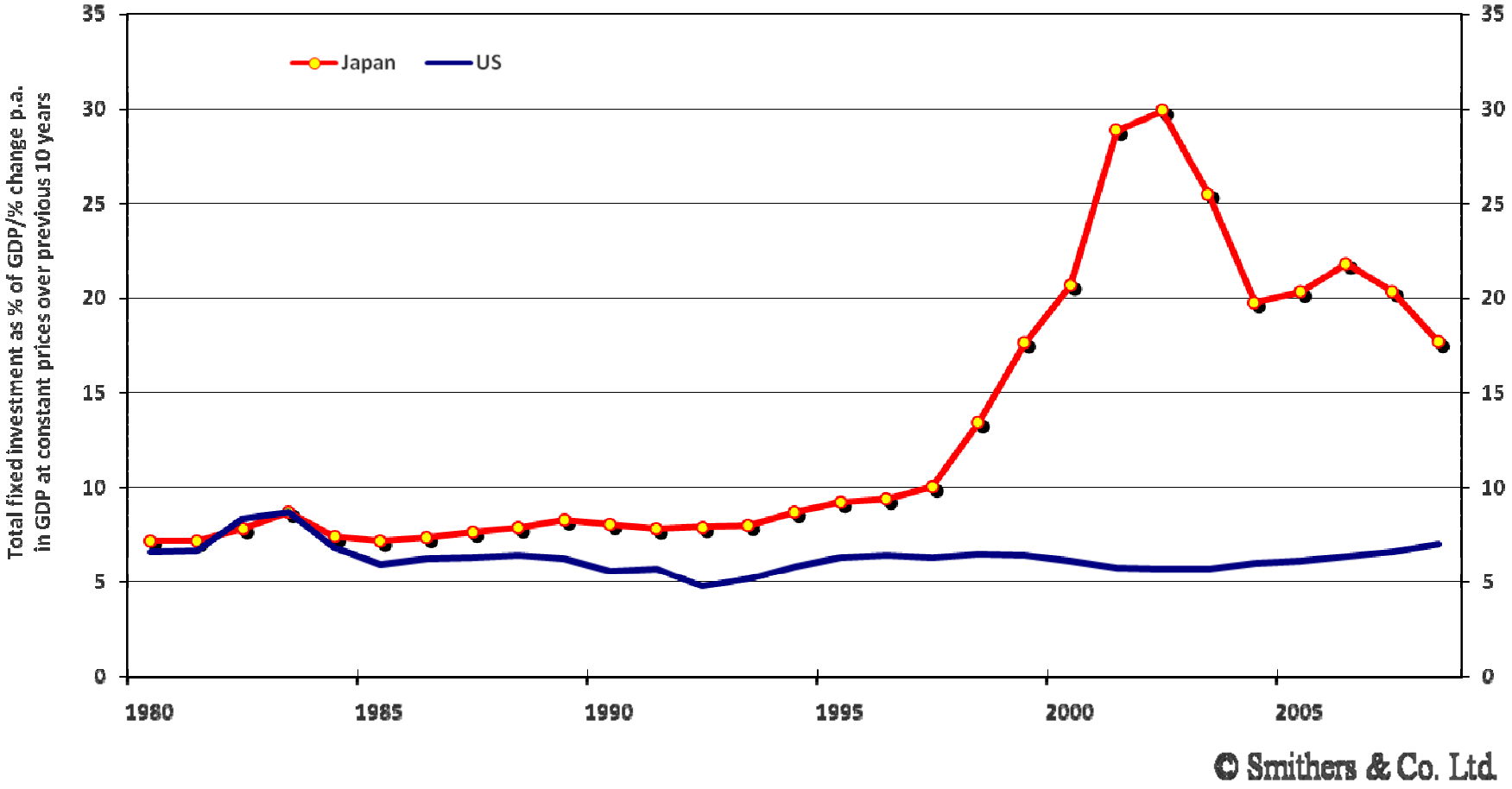
2009/05/04 (May 5: Children's Day, a national holiday) TOKYO (AFP)--The number of children under age 15 in Japan hit a record low of 17.14 million as of April 1, the government said Monday, **the latest sign of the nation's rapid shift to an increasingly elderly society. The child population was down by 110,000 from a year earlier, marking the 28th consecutive annual decline, according to a report released by the internal affairs ministry. It was the lowest since 1950, when the government began releasing breakdowns of its population, the ministry said.**

DEREGULATION

Japan's Capital Productivity Deficit

Incremental Capital/Output Ratio

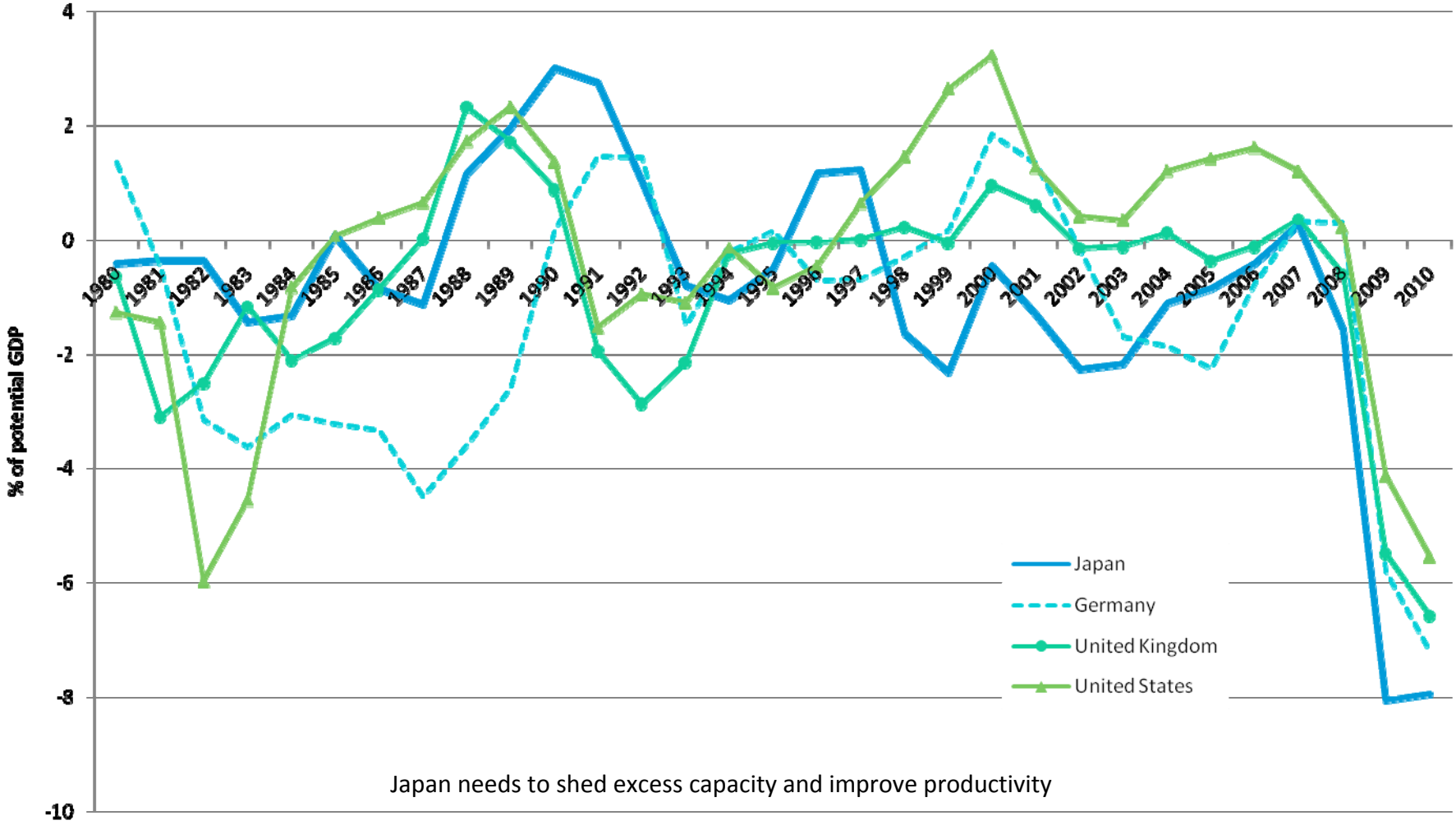
(Lower % = Higher Growth Potential)



Sources: National Accounts

Output Gap:

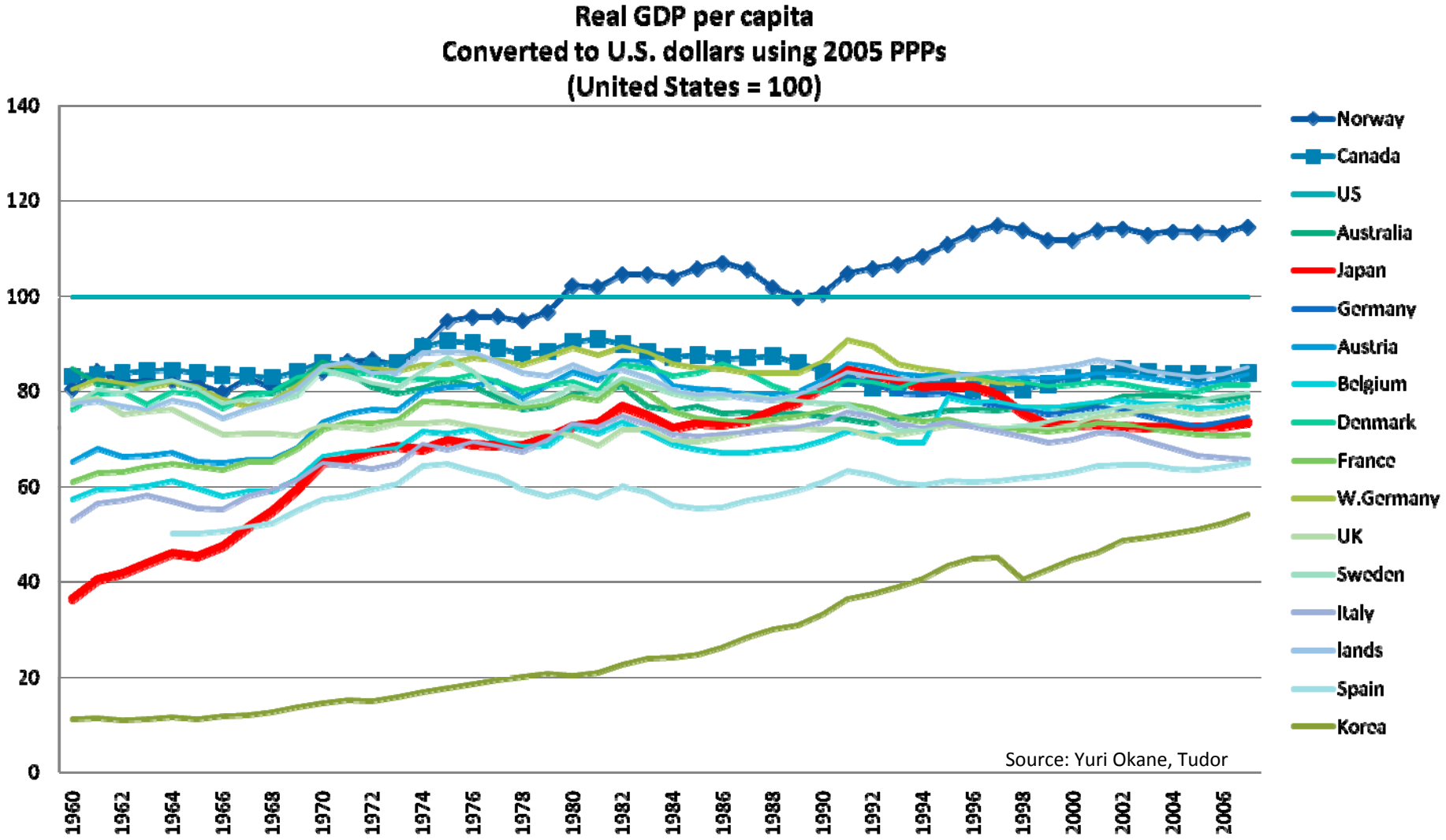
Japan's Output Finally Recovered in 2007 – Then Imploded



Japan needs to shed excess capacity and improve productivity

Source: IMF

Japan Falling Back in GDP Per Capita



CONCLUSION

Lessons for US and Japan

Lessons from Japan for US:

•Massive stimulus will create short-term growth—but stimulus will not fix structural problems

•ZIRP/QE can stop asset deflation but not necessarily spur on sustainable growth

•A tough love policy toward banks is warranted: the US banking system remains structurally hobbled by insufficient equity, reliance on securitization (that is no longer possible), and inability to make "sufficient returns" from old fashioned lending

•Tax increases in the midst of near-Depressions are a big mistake: looming US plan to raise taxes (2011 marginal hikes on wealthy+ impose Café standards/CapNTrade) echo Japan consumption tax experience of mid-1990s (and repeat a major error of Herbert Hoover's)

•Pro-cyclical trades make sense, but only in the near to mid-term (trade the stimulus while prepare for eventual mean reversion— "don't fight the Feds, but don't trust them, either")

Lessons for Japan from Japan:

•Japan's 5 Ds are more daunting than ever

•Stimulus shot in the arm more narcotic than therapeutic – short term gain, long term pain

•Japan betting on China for recovery rather than fixing Japan is a mistake

•Price Keeping Operations don't work

•Productivity is way too poor – enhancing capital to output ratio remains key for domestic growth

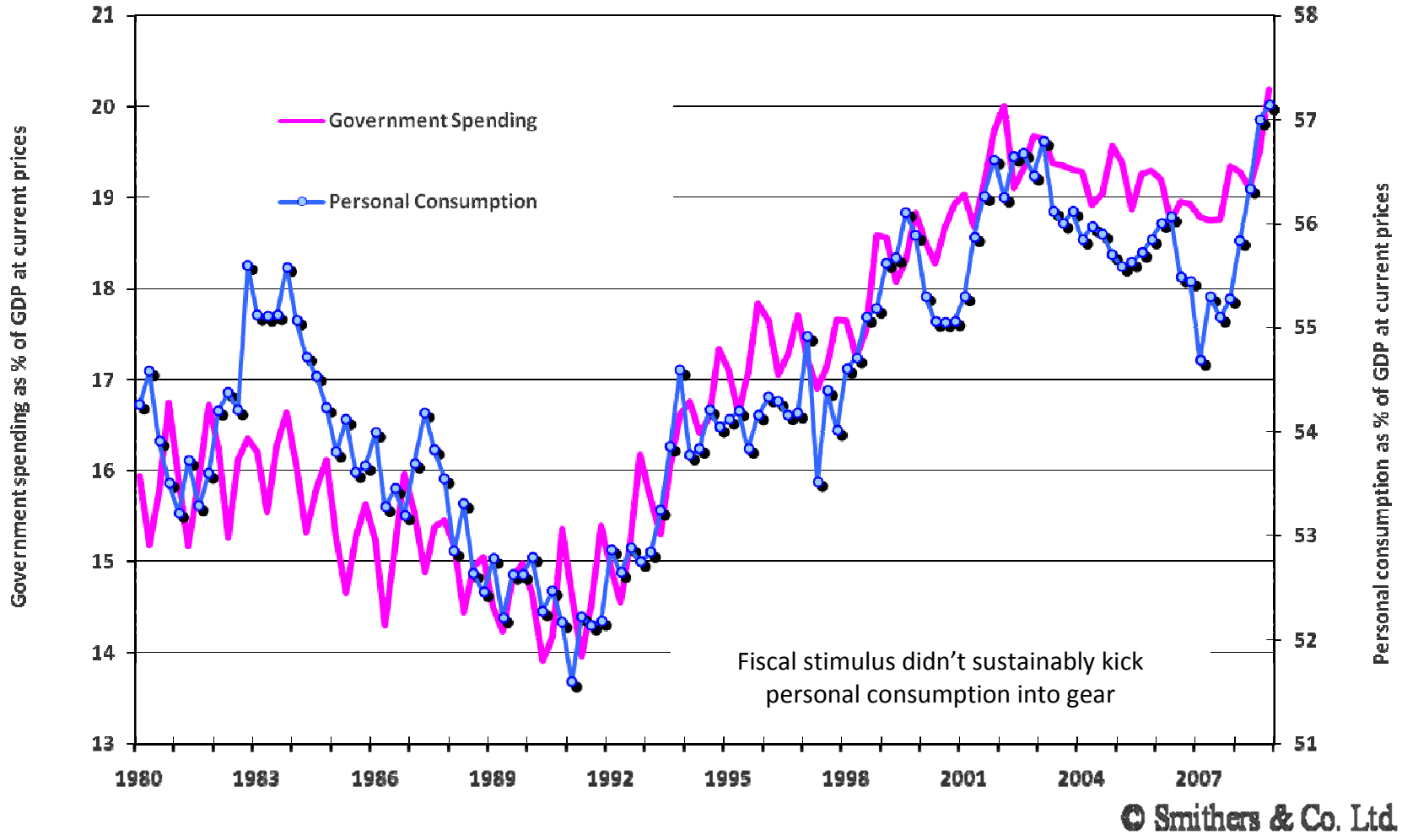
•Time to fix the fiscal system is running short (consider total reform, even abolishing consumption tax)

•Japan is running out of private buyers for JGBs (looming impact of JPIF JGB pullback and Yucho push into equities are particularly important to watch)

•Global reflation risk to JGBs in 2010-2011 (Japan can't create inflation internally but it could import it via producer and consumer good prices spiking and a significantly weaker Yen)

DISCUSSION SLIDES

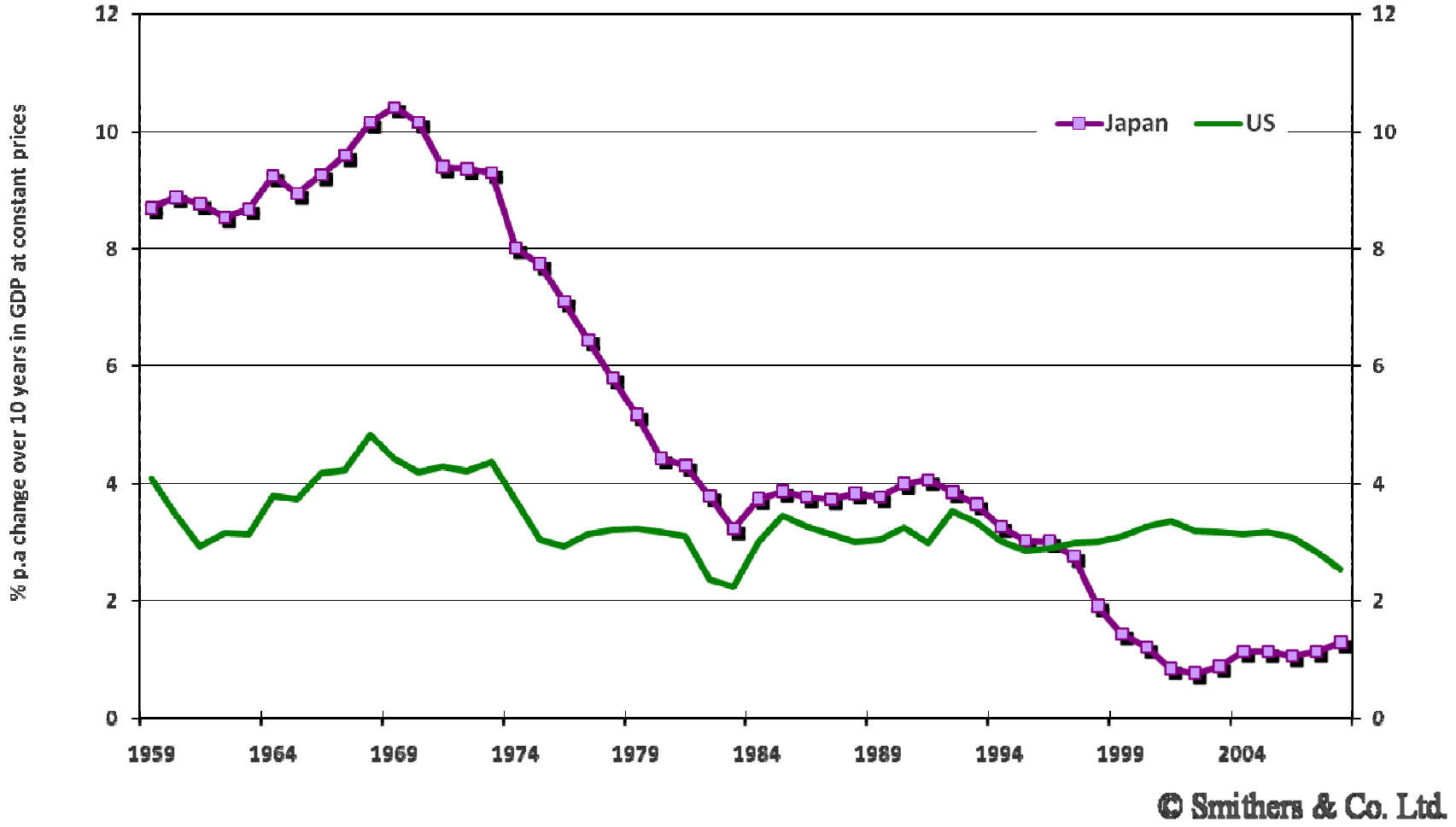
Japan: Does Fiscal Stimulus Work?



Source: Cabinet Office via Ecowin

Is America Turning Japanese?

Japan & US: Growth Rates

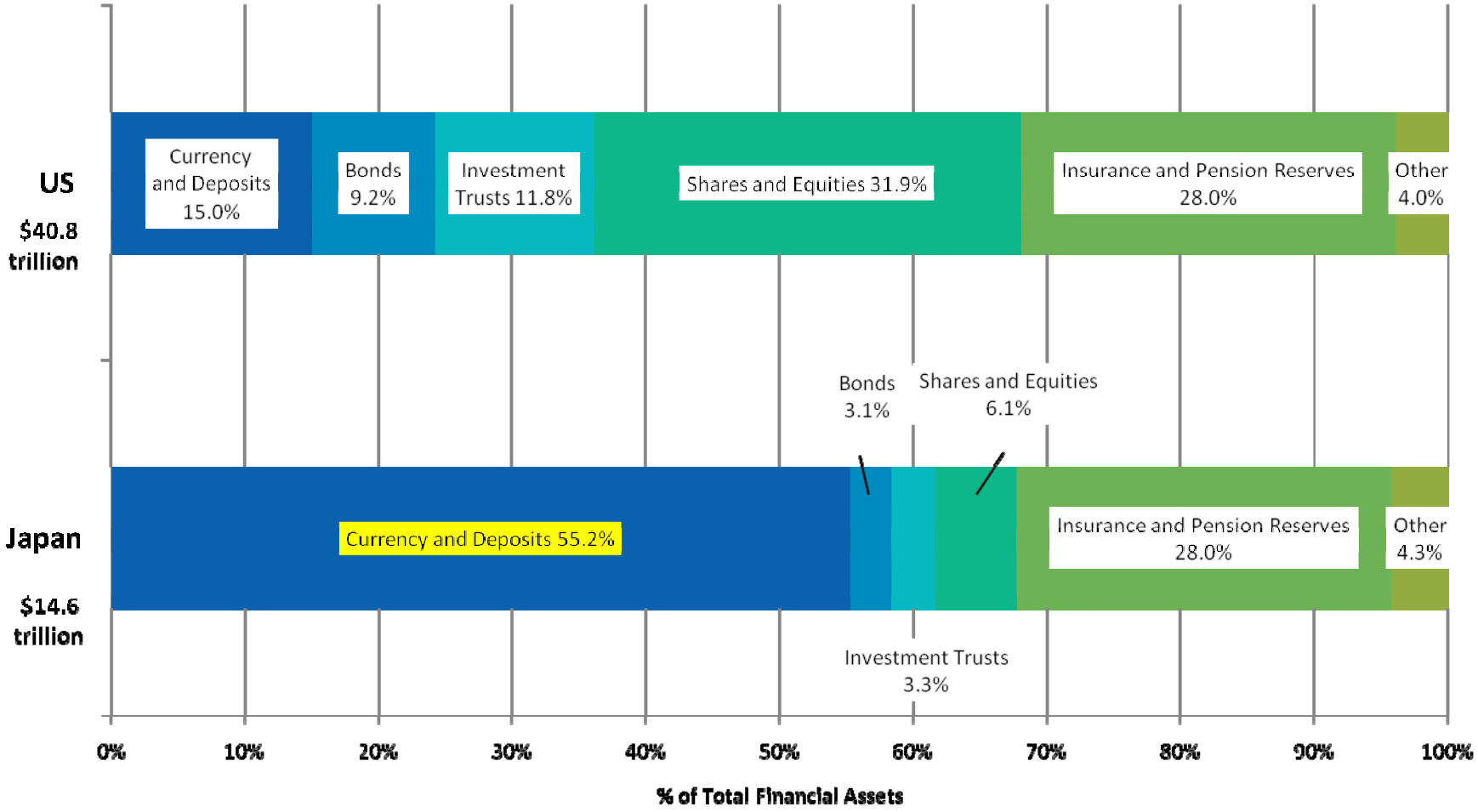


Sources: National Data

Japan's Hope:

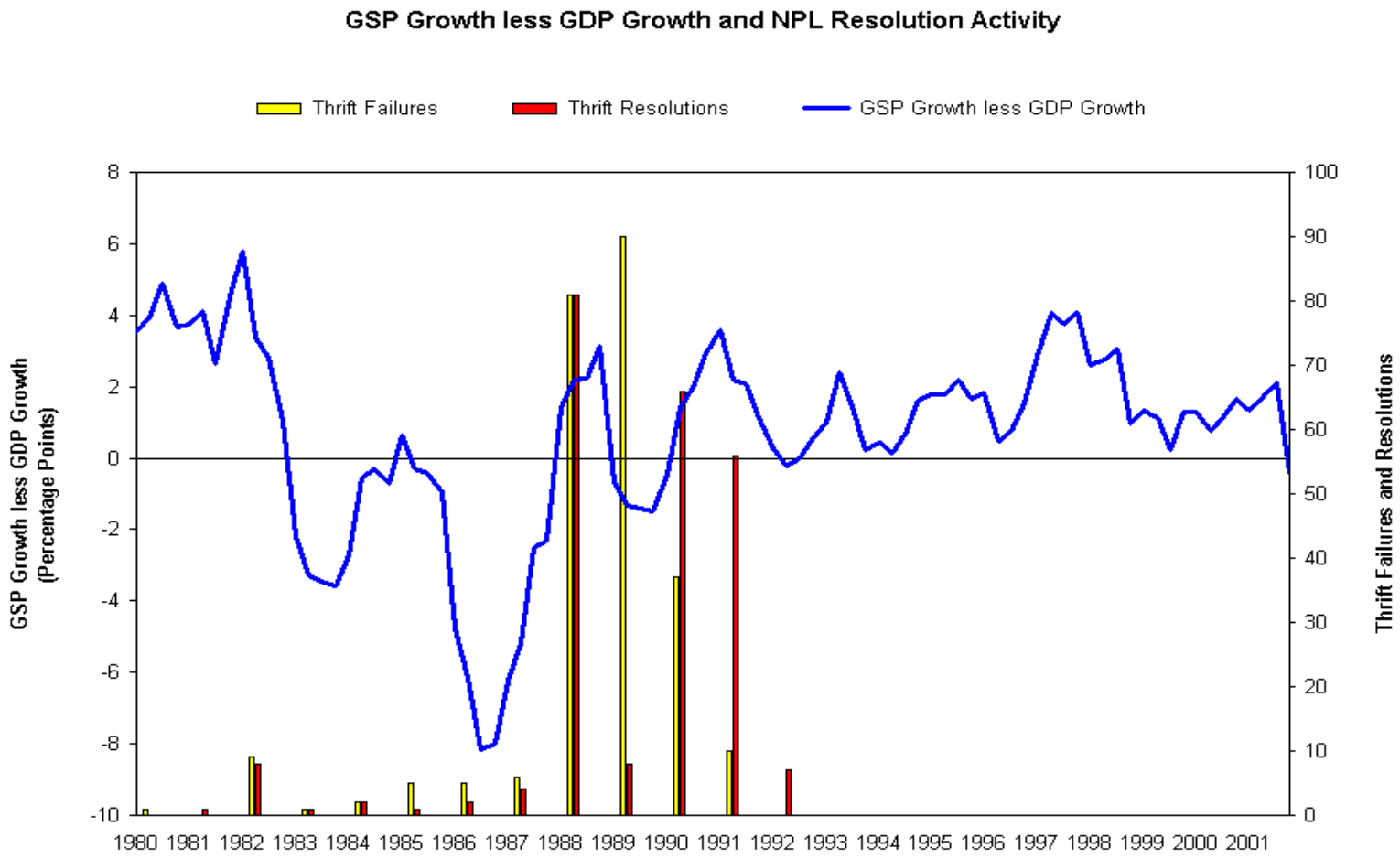
Financial Assets Held by Households

(end of December 2008)

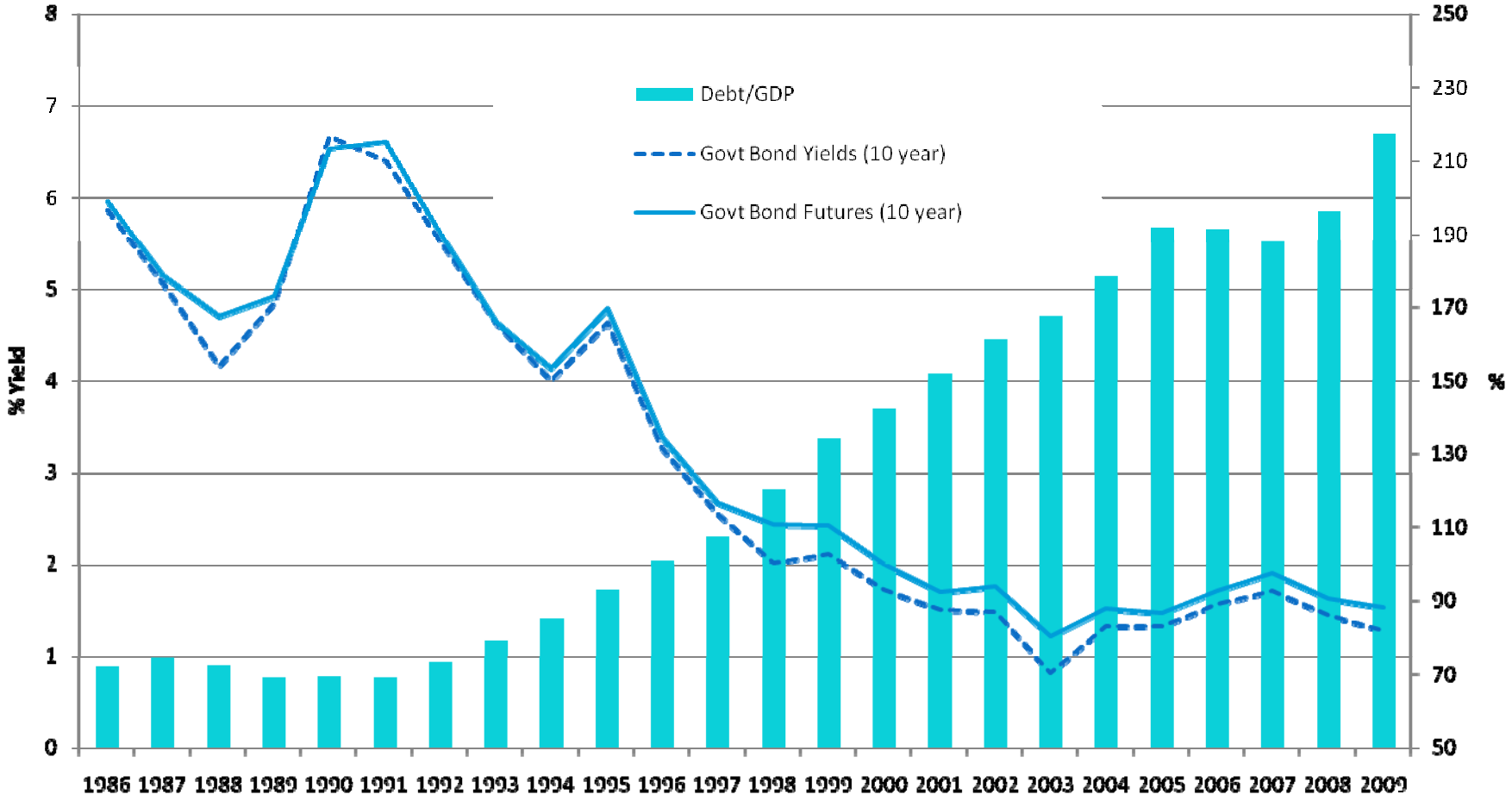


Source: Japan BOJ Flow of Funds Statistics

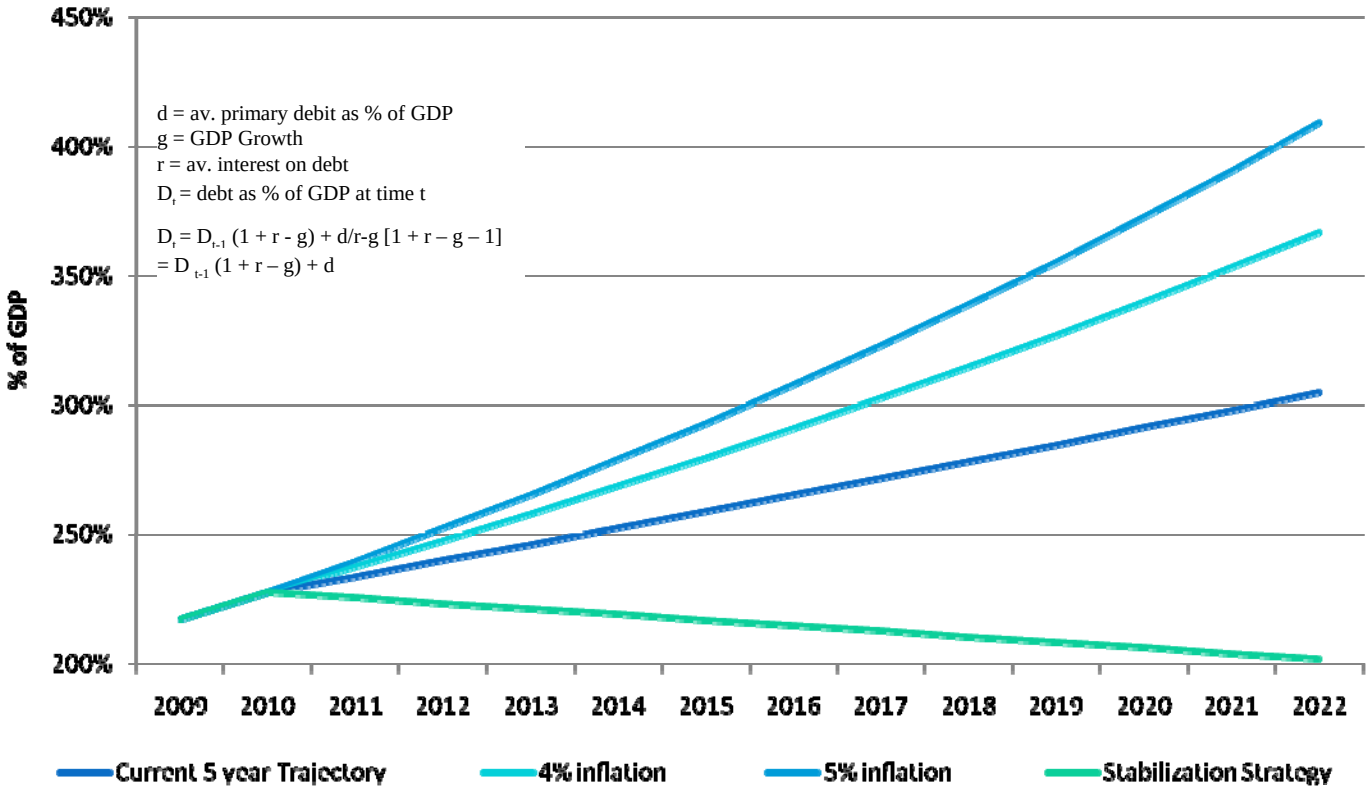
Banks Need a Texas Style Solution, Rather than "Turn Japanese"



Japanese Government Debt vs. Bond Yields



Japan's Dangerous Debt Dynamics



	Current 5 year Trajectory	4% inflation	5% inflation	Stabilization Strategy
Average Nominal Interest on Govt Debt Outstanding	1.43%	4.50%	5.50%	1.43%
Nominal GDP Growth	0.50%	1.50%	1.50%	1.50%
Average Primary Deficit	4.00%	3.00%	3.00%	-2.00%

These are author's rough calculations simply illustrating the scale of Japan's fiscal predicament

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The Obama Administration's Plan for Financial Reform—Part 1

by Michelle Brooks, Izukanne Emeagwali, Fathia Touray, and Kevin Zambrowicz

Campaigning in response to the meltdown of the global economy and US financial markets, Barack Obama heavily criticized the lack of government oversight in regulating Wall Street, and promised that if elected to office he would "move quickly to upgrade our financial regulations for the 21st century, establishing new rules of the road and tougher oversight."[1] After six months in office, on June 18, 2009, the Obama administration provided the framework for financial regulatory reform in its proposal, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" (the Plan). The Plan focuses on five areas, which are to:

1. Promote robust supervision and regulation of financial firms;
2. Establish comprehensive regulation of financial markets;
3. Protect consumers and investors from financial abuse;
4. Create a government regulation authority over key non-bank financial institutions; and
5. Raise international regulatory standards and improve international cooperation.

Kevin Zambrowicz is a partner and Michelle Brooks is an associate at Bingham McCutchen LLP. Izukanne Emeagwali and Fathia Touray were summer associates at Bingham McCutchen LLP for the 2009 summer associate program.

In this Part 1, we summarize the key provisions of the Plan. In Part 2 (which will appear in an upcoming issue of *The Investment Lawyer*) we will look at the reaction from the financial industry to the Plan, the legislation that the Plan has created so far, and how the Plan compares to initiatives in the rest of the world to stabilize economies affected by the recent financial crisis and to regulate the systems which may have contributed to their collapse.

Promote Robust Supervision and Regulation of Financial Firms

The administration identified four major problems with the supervision and regulation of

financial firms which contributed to the economic downturn. First, the capital and liquidity requirements of the financial institutions were too low. Second, regulators did not take into account or plan for the harm that a financial institution could have on this "large interconnected, and highly leveraged" banking system. Third, there were too many fragmented federal agencies supervising large financial firms. Fourth, the government did not provide proper oversight of investment banks. In order to solve the problems listed above, the administration has suggested improving nine keys areas in the Plan. These areas are detailed below.

Financial Services Oversight Council

The Plan proposes the creation of a permanent Financial Services Oversight Council (the Council), which would replace the President's Working Group on Financial Markets.[2] The purpose of the Council would be to help fill gaps in supervision, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities. Under the Plan, the Council will be created as an independent agency to:

1. Facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, make rules, conduct examinations, oversee reporting requirements, and enforcement actions;
2. Provide a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies; and
3. Identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks.

In addition, the Council may be empowered to recommend firms that will be subject to Tier 1 Financial Holding Company (FHC) supervision and regulation by the Federal Reserve Board (the Fed) (discussed below) and require reports from any US financial firm to assess how the firm's financial activity or market may pose a threat to financial stability. The Council would be chaired by the US Department of Treasury (Treasury) and include the heads of the principal federal financial regulators.

Heightened Consolidated Supervision and Regulation of All Large, Interconnected Financial Firms

In order to implement heightened consolidated supervision and regulation, the Plan would expand the Fed's jurisdiction, by allowing it to supervise and regulate any financial firm whose size, leverage, and interconnectedness could pose a threat to the financial stability of the entire market if it failed.[3] Such firms are designated as "Tier 1 FHCs."[4]

Tier 1 FHCs would be subject to capital requirements that would compel them to have enough "high-quality" capital during good economic times to keep them above prudential minimum capital requirements during stressed economic times. If the Tier 1 FHC's capital levels decline, the Fed would be able to promptly take corrective action.

Capital and Other Prudential Standards Applicable to Banks and Bank Holding Companies (BHCs)

In order to strengthen capital and other prudential standards applicable to all banks and BHCs, the Plan seeks to review and refine the regulatory capital framework, conduct a fundamental reassessment of bank and BHC supervision, revise executive compensation packages, limit capital management requirements for FHC status and strengthen firewalls between banks and affiliates.

The Plan proposes that the Treasury would lead a working group of federal financial regulatory agencies and outside experts to review the capital framework and produce a report with its conclusions by December 31, 2009. In addition, the Treasury and its working group will review and analyze the lessons learned about banking supervision and regulation from the recent financial crisis and provide a fundamental reassessment of the supervision of banks and BHCs.

FHCs would be required to meet capital and management requirements on a consolidated basis in order to engage in the financial activities permitted to FHCs. Additionally, the Plan proposes that Treasury would lead a working group of federal financial regulatory agencies and outside experts to review the capital framework and produce a report with its conclusions by December 31, 2009.

Federal regulators would issue standards to align compensation practices with the interests of shareholders and the stability of firms and the financial principles.[5] The President's Working Group on Financial Markets and its replacement, the Council, will review the compensation practices to monitor their impact on risks.

The Plan also calls for stronger firewalls between banks and their affiliates under Section 23A and 23B of the Federal Reserve Act including:

1. Tougher limits on banks' over-the-counter (OTC) derivatives and securities financing transactions with affiliates;
2. Full collaterization of covered transactions between banks and affiliates for the life of the transactions; and
3. Expansion of the scope of existing transactions so that it covers transactions between banks and private investment vehicles sponsored or advised by banks.

National Bank Supervisor

The Plan would create a single regulator to oversee all federally chartered banks. The so-called national bank supervisor would be established as a separate agency within the Treasury (NBS). It would take over the supervision powers of the Office of the Comptroller, which currently regulates national banks, as well as the responsibilities of the Office of Thrift Supervision, which would both be eliminated. The administration argues a single bank regulator will close gaps in the current structure that contributed to the financial crisis. The new regulator would be given full examination and enforcement powers. Additionally, unitary thrift companies, as well as companies that own industrial loan companies, credit card banks, nondeposit trust companies and "nonbank banks" will become BHCs, and will become fully regulated as such under the Banking Holding Company Act.[6]

The Plan would also apply a thrift's formerly unique ability to operate across state lines regardless of state laws limiting interstate branching to all national and state banks, eliminating the restrictions on interstate banking currently in place.

Under the Plan, the Fed and the Federal Deposit Insurance Corporation (FDIC) would keep their roles overseeing state-charted banks. Likewise, the National Credit Union Administration would continue to regulate credit unions.

Elimination of the Securities and Exchange Commission's (SEC) Programs for Consolidated Supervision

The Plan would eliminate the SEC's Supervised Investment Bank Holding Company Program (SIBHCP). The SEC has already eliminated its Consolidated Supervised Entity Program (CSEP), under which it had been acting as a holding company supervisor for companies such as Lehman Brothers and Bear Stearns. Both the SIBHCP and CSEP allowed certain types of institutions that were supervised entities to be supervised by the SEC on a consolidated basis, rather than at the level of each legal entity. The Plan directs that investment banking firms that "seek" consolidated supervision should be subject to supervision by the Fed, although the Plan does not elaborate as to how such firms would obtain this supervision on a consolidated basis.

Registration of Hedge Fund Advisers and Other Pools of Private Capital

The Plan would require all advisers to private funds over an undefined but "modest" threshold to register with the SEC. The administration proposes further that all investment funds advised by SEC-registered investment advisers be subject to record keeping requirements; requirements with respect to disclosures to investors, creditors and counterparties; and regulatory reporting requirements. The Plan also notes that the SEC should conduct regular, periodic examinations to monitor compliance with these requirements.[7] With respect to the type of reporting requirements for such funds, the proposal suggests reporting, on a confidential basis, of information related to:

- The amount of assets under management;
- Borrowings;
- Off-balance sheet exposures; and
- Other information necessary to assess whether the fund is so large, highly leveraged or interconnected that it possesses a threat to financial stability.

The administration further proposes that the SEC share the reports it receives with the Fed, in order for the Fed to determine whether any of the funds meet the Tier 1 FHC criteria, and if so, such funds should be regulated accordingly.

Reduce the Susceptibility of Money Market Mutual Funds to Runs

To make Money Market Mutual Funds (MMFs) less susceptible to runs, the Plan would require the SEC to move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs. In doing so the Plan directs the SEC to consider:

1. Requiring MMFs to maintain substantial liquidity buffers;
2. Reducing the maximum weighted average maturity of MMF assets;

3. Tightening the credit concentration limits applicable to MMFs;
4. Improving the credit risk analysis and management of MMFs; and
5. Empowering MMF boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders.

The President's Working Group on Financial Markets would also assess whether more fundamental changes are necessary to further reduce the MMF industry's susceptibility to runs, such as eliminating the ability of a MMF to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources.

Enhanced Oversight of the Insurance Sector

The Plan proposes the establishment of the Office of National Insurance (ONI) within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with the following six principles:

1. Effective systemic risk regulation with respect to insurance.
2. Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies.
3. Meaningful and consistent consumer protection for insurance products and practices.
4. Increased national uniformity through either a federal charter or effective action by the states.
5. Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business.
6. International coordination.[8]

Determine the Future Role of the Government Sponsored Enterprises

Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. The Plan points to the importance of preserving the strength and stability of Government Sponsored Enterprises (GSEs) during difficult financial times.

Establish Comprehensive Regulation of Financial Markets

This section of the Plan focuses on recommendations to appropriately distribute risk in the securitization markets, cure weaknesses in loan underwriting standards, accounting, reporting, and rating agency criteria.

The Plan proposes to bring the markets for all OTC derivatives and asset-backed securities into a consistent and coordinated regulatory framework that requires transparency and improves market discipline. The Plan would impose record keeping and reporting requirements on all OTC derivatives. In addition, there is a plan to strengthen the prudential regulation of all dealers in the OTC derivative markets and to reduce systemic risk in these markets. This would be accomplished by requiring all standardized OTC derivative transactions to be executed in regulated and transparent venues and cleared through regulated central counterparties.

The Plan also proposes to enhance the Federal Reserve's authority over market infrastructure to reduce the potential for corruption among financial firms and markets. Finally, the plan proposes to harmonize the statutory and regulatory regimes for futures and securities.

Strengthen Supervision and Regulation of Securitization Markets

The financial crisis was triggered by a breakdown in credit underwriting standards in subprime and other residential mortgage markets. The Plan proposes several initiatives to address this breakdown in market discipline:

1. Changing the incentive structure of market participants;
2. Increasing transparency to allow for better due diligence;
3. Strengthening credit rating agency performance; and
4. Reducing the incentives for over-reliance on credit ratings.[9]

In order to incentivize lenders and securitizers to consider the performance of the underlying loans after asset-backed securities (ABS) are issued, under the Plan, federal banking agencies would be required to enforce that loan originators

or sponsors retain five percent of the credit risk of securitized exposures. The regulations would prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these regulations. Federal banking agencies would also have the authority to provide exceptions or adjustments to these requirements "as needed," including the authority to raise or lower the five percent threshold and to provide exemptions from the "no hedging" requirement.

According to the Plan, the securitization process should provide appropriate incentives for participants to best serve the interest of their clients. Thus, the administration proposes, "[t]he compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process should be linked to the longer-term performance of the securitized assets, rather than to the production, creation or inception of those products." For example, the Plan proposes that US Generally Accepted Accounting Principles (GAAP) would be changed to eliminate the immediate recognition of "gain on sale" by originators at the time of securitization and require instead that income be recognized as the securitized assets perform over time. The proposed changes to GAAP would also require that "many securitizations" be consolidated on the originator's balance sheet and their asset performance be reflected in the originator's financial statements.

In order to enhance incentives for market participants to focus on underwriting standards, implementation of similar approaches to performance-based, medium-to-long term performance of the securitized assets is necessary. For example, the fees and commissions received by loan brokers and loan officers, who otherwise have no ongoing relationship with the loans they generate, would be disbursed over time and should be reduced if underwriting or asset quality problems emerge over time.

The Plan provides that issuers of ABS would be required to disclose loan-level data as well as the nature and extent of broker, originator and sponsor compensation for each securitization, although no specifics are provided as to what data, beyond that already required by the SEC's Regulation AB, should be required to be provided.

The Plan also calls on regulators to reduce their use of credit ratings in regulations and supervisory practices, wherever possible and to recognize the potential differences in performance between structured and unstructured credit products with the same credit rating. Such differences in performance will be reflected in risk-based regulatory capital requirements.

Create Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (CDS)

Under the Plan OTC derivatives markets, including CDS markets, would be subject to comprehensive regulation that addresses four relevant public policy objectives:

1. Preventing activities in those markets from posing risk to the financial system;
2. Promoting the efficiency and transparency of those markets;
3. Preventing market manipulation, fraud, and other market abuses; and
4. Ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

The Plan would require clearing of OTC derivatives through regulated central counterparties (CCPs). CCPs would be subject to robust margin requirements and other necessary risk controls. Although the Plan does not bar customized derivatives, it provides for a presumption that any derivative which a CCP is willing to clear is required to be standardized and centrally cleared. The Plan also requires that all derivatives, including customized derivatives, be reported to a centralized trade repository, and that the Commodity Future Trading Commission (CFTC), SEC and other regulators have access to an institution's trades and positions in derivatives. The CFTC and SEC are to establish limits on what types of investors may participate in derivatives transactions (for example, small municipalities may not be permitted), as well as establish disclosure and standard of care requirements.

Harmonize Futures and Securities Regulation

The Plan calls for the CFTC and the SEC to make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities. The Plan notes that "while differences exist between securities and futures markets, many differences in regulation between the markets are no longer justified." While the Plan does not propose that the two systems be merged, it does point to the administration's belief that the broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency.

Clearing and Settlement Systems and Related Activities

The Plan also proposes that the Fed has the responsibility and authority to conduct oversight of systemically important payment, clearing and settlement systems, and activities of financial firms, as well as the authority to provide systemically important payment, clearing, and settlement systems (Covered Systems) access to Reserve Bank accounts, financial services, and the discount window. Covered Systems will be required to have robust risk management standards, which are to take into account international standards and are subject to periodic review in consultation with the Council. To the extent that a Covered System is regulated by the SEC or CFTC, market regulator will remain the primary regulator and will retain primary enforcement responsibility. The Plan also grants to the Fed emergency enforcement authority if the primary regulators fail to agree on enforcement action.

The Plan proposes to eliminate the risk posed by impediments to timely settlement by providing (where not already available under other authorities) direct access to Reserve Bank accounts and financial services and to the discount window for payment, clearing, and settlement systems for the Covered Systems. Discount window access would be provided for emergency purposes only.

Protect Consumers and Investors from Financial Abuse

Consumer Financial Protection Agency

The Plan proposes the creation of a single regulatory agency, a Consumer Financial Protection Agency (CFPA), with the authority and accountability to make sure that consumer protection regulations are "written fairly and enforced vigorously." The intent of the CFPA is to:

- Reduce gaps in federal supervision and enforcement;
- Improve coordination with the states;
- Set higher standards for financial intermediaries; and
- Promote consistent regulation of similar products.[10]

The CFPA program of comprehensive reform would be based on the four principles of transparency, fairness, accountability, and access. These objectives would entail making disclosure forms clear, simple and concise and imposing consumer communication duties that are reasonable and not just technically compliant. The CFPA would be responsible for regulating and enforcing against unfair, deceptive, and abusive practices concerning credit, savings and payment products and services.

The CFPA would be created as an independent agency, with sole rule-making authority for consumer financial protection statutes, as well as the ability to fill gaps in such statutes through rule making authority. The CFPA would become the central location for collecting and tracking consumer complaints about financial service institutions and products. Other federal agencies would be directed to refer consumer complaints to the CFPA but complaint data would be shared across agencies. The CFPA would also coordinate complaint information with state regulators.

SEC's Role in Consumer Protection

The SEC would retain its authority with respect to consumer protection of investors. The Plan grants the SEC authority to harmonize the legal standards for broker-dealers and investment advisers and directs the SEC to impose a fiduciary duty standard on broker-dealers when making investment recommendations to customers. The SEC would also be permitted to, among other things:

1. Require greater disclosure to investors;
2. Expand sanctions available in enforcement actions and reward "whistle blowers" for information; and
3. Impose "say on pay" rules applicable to all public companies in order to allow shareholders to voice their opinions with respect to executive compensation.

Finally, in this area, the Plan proposes the establishment of the Financial Consumer Coordinating Council, consisting of the heads of the SEC, the Federal Trade Commission, the Department of Justice, and the CFPA or their designees, and other state and federal agencies to address potential gaps in consumer and investor protection and to promote best practices across different markets.

Provide the Government with the Tools It Needs to Manage the Financial Crisis

The Plan imposes more stringent capital, activity, and liquidity requirements on large interconnected firms, and requires prompt corrective action of these firms should their capital decline.

In particular, the Plan recommends the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace) and be modeled on the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act, and is designed to replace ordinary course bankruptcy procedures where a "systemic risk exception" is triggered.

The authority to decide whether to resolve a failing firm under the regime would be vested in the Treasury, which could invoke the authority only after consulting with the President and only upon the written recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the members of the Board of the Federal Deposit Insurance Corporation (FDIC Board). Where the largest subsidiary of the firm (measured by total assets) is a broker-dealer, then FDIC Board approval is not required and two-thirds of the commissioners of the SEC must approve. If the failing firm includes an insurance company, ONI will provide consultation to the Fed and FDIC Boards on insurance specific matters.

Once the Treasury has determined that the firm is in need of the resolution regime's help, the Treasury would be empowered to: appoint a conservator or receiver, stabilize the failing institution (including one that is in conservatorship or receivership) by providing loans to the firm, purchase assets from the institution, guarantee the liabilities of the firm, or make equity investments in the firm.

Additionally, the Plan proposes legislation to amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of the Treasury for any extensions of credit by the Fed to individuals, partnerships, or corporations in "unusual and exigent circumstances."[11]

Raise International Regulatory Standards and Improve International Cooperation

In its final proposal, the Plan seeks to implement an international regulatory standard to insulate other nations from devastating financial crisis and prevent firms from moving to jurisdictions with looser standards. The administration seeks to reach international consensus on four core issues:

1. Regulatory capital standards;
2. Oversight of global financial markets;
3. Supervision of internationally active financial firms; and
4. Crisis prevention and management.

In addition, the Plan calls on the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB), the Committee on the Global Financial System, and foreign governments to adopt various G-20 regulatory standards proposed during the April 2009 London Summit.

In particular, the Plan recommends that the BCBS continue to modify and improve Basel II by refining the risk weights applicable to the trading book and securitized products, introducing a supplemental leverage ratio, and improving the definition of capital by the end of 2009; expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009; and take steps to improve liquidity risk management standards for financial firms and that the FSB work with the Bank for International Settlements (BIS) and standard setters to develop macroprudential tools.

The Plan also calls on national financial regulation authorities to, among other things:

1. Improve information-sharing arrangements and implement the FSB principles for cross-border crisis management;
2. Determine the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms;
3. Implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively;
4. Put guidelines in place to align compensation with long-term shareholder value and to promote compensation structures that do not provide incentives for excessive risk taking; and
5. Enhance their regulatory regimes to effectively oversee credit rating agencies, consistent with international standards and the G-20 Leaders' recommendations.

Additionally, the Plan recommends that international accounting standard setters clarify fair value accounting standards and the standards for loan loss provisioning. The Plan urges standard setters to continue their progress in converging GAAP and International Financial Reporting Standards (IFRS). The Proposal notes that such convergence has been set by the SEC as a precondition to the adoption in the US of IFRS for all US issuers. The Plan urges US and international

standard setters to work together in raising international standards with respect to prudential supervision, anti-money laundering laws and tax information exchange.

Conclusion

The Plan outlined above would impose a broad range of changes throughout the financial industry. Regulators have been generally receptive to the Plan, and expressed a desire to work quickly to implement it.[12] Speaking shortly after the Plan was introduced, administration officials noted that much of the proposal would not require Congressional action and would be adopted by regulators.[13] However, financial industry push back can be expected with respect to any level of additional or new regulation in many sectors of the financial industry, and so the initiatives summarized above are subject to possible significant change. Additionally, many elements of the Plan would require new laws, and the administration has already proposed several draft pieces of legislation to Capitol Hill in order to implement the Plan. Moreover, the effects of the financial crises have been felt around the world, and the Plan notes that international cooperation is needed in order to create a financial system that can survive on a global level, as well as nationally. In an upcoming article we will look at the draft legislation and other efforts that have so far been taken in order to implement the Plan. We will also discuss the reaction to the Plan and such efforts to implement it from the financial industry and financial industry commentators. Finally, we plan to look at the ways in which the international community has responded to the economic crisis in introducing financial regulatory reform initiatives.

NOTES

1. *See* "Obama Statement on Financial Plan Breakthrough," Sept. 28, 2008, available at *http://www.barackobama.com/2008/09/28/obama_statementt_on_financial.php.*

2. On July 22, 2009 the administration introduced draft legislation to create a Financial Services Oversight Council. *See* "Financial Services Oversight Council Act of 2009," available at *http://www.treas.gov/press/releases/reports/title%20i%20fsoc%207222009%20fnl.pdf*.

3. Also, if the Fed is unable to determine whether the financial firm poses a threat using these factors, then it should have the ability to examine any US financial firm that meets a certain minimum size threshold.

4. On July 22, 2009 the administration introduced a draft bill to Supervise and Regulate All of the Largest, Most Interconnected Firms. *See* "Bank Holding Company Modernization Act of 2009," available at *http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf*.

5. Compensation factors that should be considered include: the measure of good performance, the time horizon of risks, risk management, the use of golden parachutes and supplemental retirement packages, and transparency and accountability.

6. On July 22, 2009, the administration introduced draft legislation to close "loopholes" in banking regulation. *See* "Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009," available at *http://www.treas.gov/press/releases/reports/title%20vi%20bhca%20amndts%20%200722%20fnl.pdf*.

7. On July 15, 2009 the administration provided Congress with a draft bill which proposes legislation to implement the recommendations regarding hedge fund oversight. *See* "Private Fund Investment Advisers Registration Act," available at *http://www.treas.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%2015%2009%20fnl.pdf*.

8. On July 22, 2009, the administration proposed draft legislation to establish ONI. *See* "Office of National Insurance Act of 2009," available at *http://www.treas.gov/press/releases/reports/title%20v%20ofc%20natl%20ins%207222009%20fnl.pdf*.

9. On July 22, 2009, the administration proposed legislation to increase transparency, tighten oversight, and reduce reliance on credit rating agencies. *See* the "Investor Protection Act of 2009," available at *http://www.ustreas.gov/press/releases/reports/titleix_subtc.pdf*.

10. On June 30, 2009 the administration proposed legislative text which would establish the CFPA. *See* "Consumer Financial Protection Agency Act of 2009," available at *http://www.financialstability.gov/docs/CFPA-Act.pdf*.

11. On July 22, the administration sent draft language proposing changes to the Federal Reserve Act to Capitol Hill. The legislative language is available at *http://www.treas.gov/press/releases/reports/title%20xiii%20fed%20rsrv%20act%20amndt%2072209%20fnl.pdf*.

12. *See, e.g.* SEC Chairman Mary Schapiro's "Testimony Concerning SEC Oversight: Current State and Agenda," July 14, 2009, available at *http://www.sec.gov/news/testimony/2009/ts071409mls.htm*.

13. *See* Stephen Labaton, "Some Lawmakers Question Expanded Reach for the Fed," *The New York Times*, June 17, 2009.

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Japan and the U.S.: Looking More and More the Same

Prepared for Symposium on Building the Financial System of the 21st Century: An Agenda for Japan and the United States, Armonk, New York, October 23-25, 2009

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Introduction: U.S. financial and economic distress commenced with the collapse of residential real estate prices in late 2006 then intensified with the shift from expansion to contraction in the real economy December 2007 and finally reached financial crises levels in September 2008. These events rekindled memories of Japan's "decade and a half" of economic and financial distress from 1990 to 2005 and raise the question of what each country can learn from the other's experience. The common elements are numerous: deregulation of the financial system; asset bubbles; monetary and fiscal policy errors; lax regulatory standards; government credit allocation policy; and, government response to distress rooted in forgiveness, forbearance and "Too Big to Fail" (TBTF) policy.

The important question is whether these and other common elements suggest the U.S. will repeat Japan's experience. The September 2008 crisis is over, but the financial and real sectors exhibit continued distress. It is far too early to project the course of economic and financial events in the U.S.; however, this paper argues the similarities are far more important than recognized and the U.S. could easily fall into a long-period of stagnation.

Posen (2003) writing before the collapse of real estate prices argued that despite the evolving real estate bubble in the U.S., "it takes more than a bubble to become Japan". Posen

argued there were so many structural and policy differences between the two countries that Japan offers few lessons. More recently, Katz (2009) argued the same point. According to Katz, the more structurally sound U.S. financial system, the smaller degree of economic and financial distress in the U.S. and most important, the more immediate policy response by the government will prevent the U.S. from repeating Japan's experience. At a minimum, Katz understated the severity of the distress in the U.S.

At a more fundamental level, both perspectives were premature. The experiences of Japan and the U.S. share more similarities than Posen and Katz recognize. Japan does not have a monopoly on structurally unsound economic institutions or government policy errors.

This paper outlines the causes of Japan's long-period of distress, draws implications of those causes for the U.S. and argues that the view "the U.S. is no Japan" is premature at best.

Japan's Fifteen Years of Distress: Japan's distress can be best understood by considering four periods. The asset bubble period from 1985 to 1990 which was the outcome of easy monetary policy and flawed financial liberalization policies. Japan did not readily embrace financial liberalization and attempted to change the structure of the financial system while at the same time adhering to the key elements of the old regime based on mutual support and government allocation of credit. The close relationship between bank capital, bank lending, equities and land prices provided a foundation for asset inflation. The burst of the asset bubble from 1990 to 1997 period was accompanied by disinflation and deflation because of policy errors by the Bank of Japan. The regulatory response to troubled financial institutions was based first on denial of any problem and when denial was no longer credible, by a policy of forgiveness and forbearance. Fiscal policy based on Keynesian pork-barrel spending contributed to the distress. The economic and financial crisis period from 1997 to 2001 was the outcome of accumulating

stress in the financial system, increasing the consumption tax in 1997 and to some extent, the Asian Financial Crises. During this period there was a major effort to recapitalize the banking system and reduce the nonperforming loan problem. The Koizumi period from 2001 to 2005 reflected a more serious effort to resolve nonperforming loans, reverse deflationary anticipations and implement market reforms. The political and economic institutional aspects of these four periods are discussed in Cargill and Sakamoto (2008). Hoshi and Kashyap (2009) provide a detailed discussion of efforts to recapitalize Japan's banking system.

The basic problem in Japan can be summarized under three headings: monetary policy errors; government financial intermediation and the close relationships between regulatory authorities, politicians and their "client" industries/sectors; over reliance on TBTF policies, forgiveness and forbearance; and, stimulus packages that increase debt. Unfortunately, these four elements exist in the U.S. and make the U.S. look more and more like Japan. Each will be considered in turn.

Monetary Policy: In 1997 Goodfriend argued monetary policy had come of age in the 20th century during the 1990s (Goodfriend, 1997, p. 18). Central bank policy could now be expected to achieve the goal of a stable financial and monetary environment by shifting away from short run demand management and multiple goals to a single goal of long run price stability. In hindsight, the assessment was premature. The Bank of Japan and the Federal Reserve both contributed to the run up of asset prices with easy monetary policy; however, the policies of the two central banks differ after the collapse of asset prices. The Bank of Japan imposed tight monetary policy after the collapse and then, slowly shifted to ease and as a result contributed to a decade of deflation (Cargill and Guerrero, 2007). The Federal Reserve did not make this mistake in part because of the Japanese experience; however, the rapid response of the

Federal Reserve has raised additional concerns regarding its exit strategy. The expanded Federal Reserve balance sheet raises concerns about the political ability as opposed to the technical ability to implement an "exit strategy" as the economy recovers and some (Taylor, 2009) have suggested the current Federal Reserve policy amounts to an industrial policy to support specific sectors of the U.S. economy. The Federal Reserve has moved into unchartered territory with its new industrial policy, close relationship with the U.S. Treasury and the administration and increasing calls in Congress for more "oversight" of Federal Reserve operations. The Federal Reserve has the tools to exit, but does it have the political will to do so? The formal independence of the Federal Reserve is a weak reed to hang noninflationary monetary policy outcomes. History, the current political environment in the U.S. and large government deficits are not very reassuring.

Japan's long period of distress was importantly due to the failure of the Bank of Japan to prevent prices from falling. In contrast, the potential problem in the U.S. is rapid inflation which has the potential to contribute to a long period of distress such as in the 1970s and early 1980s (Meltzer, 2005). This has not yet occurred; however, the potential is large.

Government Financial Intermediation Government sponsored enterprises played a major role in the financial distress of Japan and the U.S. by diverting financial resources to unproductive ends, encouraging imprudent lending practices and restraining the bankruptcy process that would have resolved the crisis. Japan's Postal Savings System and the Fiscal Loan and Investment Program misallocated capital by supporting unproductive sectors, contributing to Japan's nonperforming loan problem, complicating Japan's deposit insurance system and encouraging disintermediation from private banks to postal deposits. Fannie Mae and Freddie Mac had a similar impact on the U.S. economy; and in addition, played a major role in the run up

of housing prices and the subprime mortgage problem (Wallison, 2008) despite the assurances of Krugman (2008) that Fannie and Freddie had little to do with the subprime problem. Cargill and Scott (2006) emphasized the similarities of the two sets of institutions in Japan and the U.S.

Like the Postal Savings System, Fannie and Freddie are large (assets about 30 percent of GDP in 2005), enjoy competitive advantages over private sector competitors by borrowing with implicit government guarantees and have strong grass roots support in the real estate industry and among politicians. It would not be an exaggeration to argue Japan's "iron triangle" existed in the U.S. in the form of strong ties between politicians, Fannie and Freddie, and their client industries – real estate, financial institutions and securities markets. While the U.S. version of the "iron triangle" was not as entrenched as in Japan nor as encompassing in terms of players, it nonetheless was a framework in which moral hazard, forgiveness and forbearance brought the U.S. financial system to near collapse in September 2008 and will impose a heavy burden on taxpayers in years to come.

Fannie and Freddie despite repeated assurances by the government were financially strong had to be nationalized in late 2008 and continue to support the housing market along with the Federal Housing Administration. There is no evidence the administration has any plans to significantly reduce the role of Fannie and Freddie in the near future. In fact, these institutions might become even more important given the administration's efforts to bailout nonperforming mortgages and support housing.

Government Forgiveness and Forbearance: History illustrates how forgiveness and forbearance generates financial distress, increases the burden on the taxpayer, and prolongs the resolution of weak or insolvent financial institutions and firms. In Japan, it was not until forgiveness and forbearance policies were reduced in 2003 during the Koizumi administration

that nonperforming loans declined, corporate balances sheets improved and the economy began to recover. While the TARP and related programs may have averted a collapse of major financial institutions, they have failed to end the credit church or eliminate the toxic assets on the balance sheets of financial institutions. The fact Lehman Brothers is the only major financial institution to fail raises serious moral hazard concerns for the future. The massive bailout of large financial institutions in the TARP program, extension of the TARP to nonfinancial entities, lack of a clear policy for distributing TARP funds, lack of a clear exit policy and lack of transparency in how the funds are being spent by receiving banks and insurance companies combine to represent a policy of forgiveness and forbearance in the U.S. that is hard to distinguish from Japan. The Federal Reserve with the support of the Obama administration is attempting to assume more regulatory power by being responsible for regulating "systemic risk". The phrase is so vague as to ensure forgiveness and forbearance as the preferred regulatory response to trouble financial institutions will increase in the U.S. Volcker (2009) expressed concerns about the spread of moral hazard as a result of the Bush and Obama administration's wide extension of the financial safety net and planned changes in regulatory responsibilities for limiting systemic risk. "What all this amounts to is an unintended and unanticipated extension of the official 'safety net'…The obvious danger is that with the passage of time, risk-taking will be encouraged and efforts at prudential restraint will be resisted. Ultimately, the possibility of further crises – even greater crises – will increase" (Volcker, 2009, p. 6).

One perspective is the constraint it will impose on the Federal Reserve and again, the Japanese experience offers insights. The Ministry of Finance's forgiveness and forbearance policies and associated increase in government debt were a major source of disagreement between the Ministry and Bank of Japan. A "war of attribution" emerged by the end of the

1990s as the Bank of Japan resisted accommodation to Ministry policies. To date, there is little evidence of discord between the Federal Reserve and the Treasury; and in fact, they have cooperated closely – perhaps too closely. Nonetheless, extensive forgiveness and forbearance policies in the U.S. will have much the same effect they had in Japan. They will not correct the structural problems, they will postpone recovery, they will increase the amount of government debt and they will constrain Federal Reserve policy to prevent price inflation (Greenspan, 2009).

Stimulus Packages: Japan from 1992 to 2001 enacted 13 stimulus packages that failed to stimulate the economy; and instead, left Japan with a huge debt problem (Cargill and Sakamoto, 2009, p. 186). The stimulus packages greatly contributed to a deficit of unprecedented magnitude. Crowding out effects of government deficits contributed to Japan's long period of financial and economic distress and made sustained recovery difficult. Government spending will not provide a foundation for sustained recovery, but instead, like an albatross around the neck of the ancient mariner, will crowd out private spending as the public increasingly expects major tax increases to pay for the deficits. In this regard, the U.S. is looking more like Japan.

The Bush administration's $152 billion stimulus package in March 2008 was designed to prevent a recession. It was largely a waste of resources. The recession had already started in December 2007 and a financial crisis emerged in September 2008. The much larger Obama administration $787 billion stimulus in February 2009 was designed to keep unemployment under 8 percent. Unemployment is currently 9.7 percent and anticipated to exceed 10 percent in 2010 and come down only slowly over time. The simulative effects of the government spending and tax reductions are grossly exaggerated in the February 2009 stimulus.

The Obama administration claims for every $1.00 of government spending, GDP will increase by $1.50. Academic research, however, suggests $1.00 of government spending will at most increase GDP by $0.70 because it "crowds out" private spending, as higher taxes or interest rates often result from increased government spending. In fact, there is evidence the net impact on GDP is closer to zero and there is no credible evidence the situation is different in Japan. The so-called tax reductions are mainly tax refunds and credits. In contrast, cuts in tax rates would provide individuals with more dollars to spend and businesses with more incentive to invest and hire. In fact, the tax rebates in both the Bush and Obama administration stimulus packages did not increase consumer spending, but instead, where used to reduce debt and/or increase saving.

The Congressional Budget Office estimated in March 2009 the stimulus would have a short-run positive effect on the economy (which has failed to materialize) but a long-run negative effect (which will materialize). The long-run negative effect is the result of crowding-out of private spending by the government. Some are even calling for another stimulus package to "stimulate" the last stimulus. Sounds more and more like Japan in the 1990s.

Differences and Similarities: The above elements played an important role in the long period of distress in Japan. They are just as important and have the potential to play the same adverse role in the U.S. There are many structural and policy differences between the two countries, but the question is whether the similarities pale in comparison to the differences. No quantitative analysis can provide the answer. The question is inherently one of qualitative judgment. Two important differences are often raised, but they are not very reassuring.

The U.S. is not likely to face the type of deflationary experiences of Japan because the Federal Reserve has been far more aggressive to prevent such an outcome. In contrast, inflation is a more likely problem in the U.S. with the increased politicalization of Federal Reserve policy.

Combined with high levels of unemployment the type of stagflation in the 1970s may revisit the U.S. The issue is one of political economy and not whether the Federal Reserve has the technical tools or the Federal Reserve is formally independent.

The government response has been far more aggressive across the board but one must keep in mind bad policies whether enacted slowly or rapidly are still bad policies. The government has embarked on a major policy of TBTF using taxpayer funds without a clear exit strategy other than hope sustained economic recovery is beginning. The toxic assets remain on the balance sheets of depository institutions and depository institutions have unprecedented levels of excess reserves as a result of the Federal Reserve's quantitative easing policy. This is nothing less than forgiveness and forbearance on the scale exhibited by Japan.

There are many reasons why a Japan-like period of prolonged economic and financial distress is less likely in the U.S.; however, to argue the U.S. is no Japan is inconsistent with a balanced review of two-decades of Japanese economic and financial history and recent events in the U.S.

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Japan Economics

How Japan Got Financial Reform Right

History does not repeat itself, but it rhymes.
– Will Rogers

What's new: Japan's financial reforms of 1992-2004 show both mistakes to avoid and successes to emulate.

Conclusions:
(a) Japan had three false starts on financial sector reform, but eventually succeeded in 2002-04.
(b) The Japan success model of 2002-04 suggests five factors needed for successful reform: (i) National growth strategy, (ii) Safety net, (iii) Capital injections, (iv) Popular support, and (v) Strict asset assessment. All factors are necessary for success.
(c) Japan's biggest mistake was early emphasis on blanket fiscal stimulus. Traditional macro policies could not address structural problems.
(d) Japan's biggest success was building regulatory infrastructure for strict asset assessment.
(e) Other countries have much to learn from Japan's eventual success, despite differences of national institutions and global conditions.
(f) Japan today is backsliding. The nation must recall its own recent success, in order to return to growth.

Differences: (a) Japan's financial crisis was local, while the current crisis is global. (b) Japan relied in part on exchange rate changes for economic support; current crisis countries cannot use the exchange rate as a tool. (c) Global growth was mostly strong during Japan's crisis period, but weak now. (d) Japan had to develop much regulatory infrastructure; the rest of the world already has such infrastructure.

Market Implications: Risky assets may benefit in nations that implement the Japan success model of 2002-04. Growth strategy and strict asset assessment are the hardest and most important elements.

Appendix I: Papers on financial reform in Japan - The appendix provides a 1997-2008 selection of papers on financial reform issues. Please see Morgan Stanley Client Link, or contact the author.

Exhibit 1
How Japan Succeeded: The five factors that came together in 2002-04, and brought recovery.

	1992-94	1995-96	1997-99	2002-04
Economic Strategy				
Supply reforms		●	●	●●
Corporate governance		●	●	●●
Workouts			●	●●
Safety Net				
Deposit insurance		●	●	●
Collateral in money markets			●	●●
Market liquidity guarantees			●	●
Small business support	●	●	●	
Easy money			●	●
Fiscal spending	●	●	●	
Capital Injections				
Large size			●	●
Strict conditionality				●
Systemic impact				●
Public Support				
Taxpayer gain in injections			●	●
Fair compensation			●	●
Prosecution of criminals				●
Effective politics				●
Strict Asset Assessment				
Suffiicient personnel			●	●
Close coordination				●
Clear rules for inspections				●
Strict asset valuation				●●
Cross-border impact				●

Source: Morgan Stanley Research

For important disclosures, refer to the Disclosures Section, located at the end of this report.

Investment Case

A Brief History: Japan's Three False Starts
Japan's path to successful financial sector reform was characterized by three false starts from 1992-1999. Various parts of the eventual success cumulated through these three false starts. Finally, in 2002-04, the reform process finally succeeded.

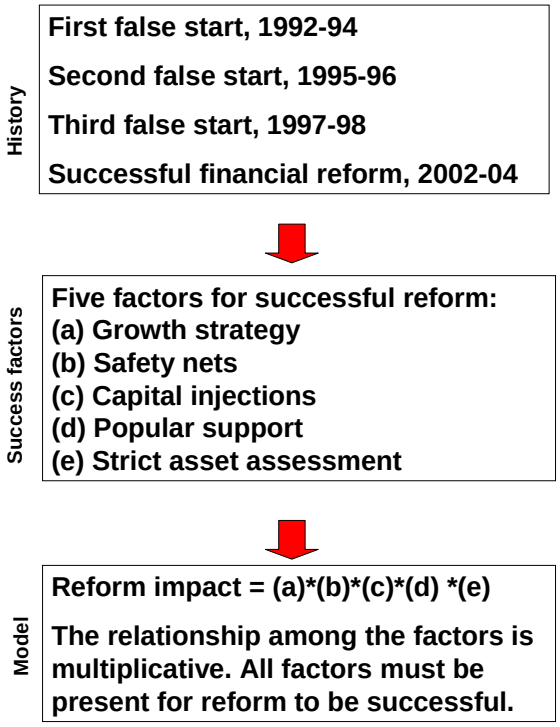
The first false start came from 1992 through early 1994. As growth collapsed in 1992-93 (see Exhibit 2), the Bank of Japan (BoJ) cut rates. In addition, there were large fiscal expansions, first by the Miyazawa Cabinet (mostly spending) and then by the succeeding Hosokawa Cabinet (mostly tax cuts). Structural weaknesses in the financial system and the corporate sector and a sharp bout of yen strength in 1993-94 (in part due to loss of confidence in the US) ended the hopes for a quick revival from the collapse of the equity bubble.

Japan had three false starts on economic reform, before finally getting it right.

Notably minor in the policies of this period were micro-economic and political reforms. The Mayekawa Reports (deregulation blueprints from the 1980s) were largely left on the shelf. The Structural Impediments Initiative (SII) was negotiated with the US, and proved popular with the Japanese public. However, SII remained mostly a tool to contain American protectionism. (SII did, however, serve as blueprint with ideas for later reform.) Most disappointing was the failure of election district reform under reformist PM Kaifu of the long-ruling Liberal Democratic Party (LDP), who resigned when this initiative died. Election district reform, which partly corrected the over-representation of rural areas and shifted Japan away from the multi-seat district system that over-represented small parties, would have to wait until 1994, and only be implemented in the 1996 election.

During this period, substantial worries about the financial system emerged. As the stock market tumbled, the capitalization of banks was questioned.[1] As bankruptcies mounted, fears emerged about the level of bad loans, and confidence eroded. A first attempt at resolution was made, with the creation of the Cooperative Credit Purchase Corporation (CCPC), but the latter was not actively used. Moreover, by realizing gains on long-held assets, financial institutions were able to withstand market pressures.

Schema of the Argument



[1] Unlike most other industrial countries, commercial banks in Japan are permitted to hold equities. Moreover, under the initial implementation of the BIS bank capital rules, 45% of the unrealized gains on stock holdings could be included in Tier II capital.

Exhibit 2
Japanese Markets and the Economy, 1986-2008

	Japan Markets						Japan Economy				
	Overnight call rate	10-yr JGB yield	TOPIX	TOPIX change	Yen/US$	Yen/US$ change	Real GDP	Nominal GDP	GDP deflator	Core CPI	Unemploy -ment rate
1986	4.95	4.91	1325.5	32.9	168.4	-29.4	3.0	5.0	1.9	0.8	2.8
1987	3.66	4.52	1958.5	47.8	144.6	-14.2	3.7	4.5	0.8	0.3	2.8
1988	3.84	4.68	2132.3	8.9	128.2	-11.4	6.8	7.3	0.5	0.4	2.5
1989	5.12	5.25	2569.5	20.5	138.0	7.7	5.3	7.0	1.6	2.4	2.3
1990	7.41	7.39	2178.3	-15.2	144.8	4.9	5.3	8.1	2.7	2.7	2.1
1991	7.52	6.40	1841.7	-15.5	134.6	-7.1	3.3	6.0	2.6	2.9	2.1
1992	4.65	5.12	1363.6	-26.0	126.6	-5.9	1.0	3.3	2.3	2.3	2.2
1993	3.06	4.03	1525.0	11.8	111.1	-12.2	0.2	1.1	0.9	1.3	2.5
1994	2.19	4.21	1599.1	4.9	102.2	-8.0	1.2	2.2	0.9	0.7	2.9
1995	1.21	3.28	1380.7	-13.7	94.0	-8.0	1.9	2.0	0.0	0.0	3.2
1996	0.47	3.02	1605.4	16.3	108.8	15.7	2.8	2.3	-0.5	0.1	3.4
1997	0.48	2.13	1395.0	-13.1	121.0	11.2	1.6	1.6	0.0	1.8	3.4
1998	0.37	1.29	1178.0	-15.6	130.9	8.2	-2.1	-1.6	0.5	0.3	4.1
1999	0.06	1.73	1387.1	17.8	113.9	-13.0	0.0	-0.9	-0.8	-0.1	4.7
2000	0.11	1.74	1545.8	11.4	107.8	-5.4	2.8	1.1	-1.7	-0.4	4.7
2001	0.06	1.33	1194.5	-22.7	121.6	12.8	0.2	-1.2	-1.4	-0.9	5.0
2002	0.00	1.26	979.2	-18.0	125.3	3.0	0.3	-1.2	-1.4	-0.8	5.4
2003	0.00	0.99	918.6	-6.2	115.9	-7.5	1.5	-0.2	-1.7	-0.3	5.2
2004	0.00	1.50	1118.7	21.8	108.2	-6.7	2.7	1.4	-1.3	-0.1	4.7
2005	0.00	1.38	1269.7	13.5	110.2	1.8	1.9	0.9	-1.0	-0.1	4.4
2006	0.13	1.74	1626.6	28.1	116.3	5.5	2.4	1.2	-1.2	0.1	4.1
2007	0.47	1.67	1662.7	2.2	117.7	1.3	2.1	1.4	-0.7	0.0	3.8
Jan-Sep 08	0.49	1.50	1255.3	-24.5	105.2	-10.6	0.7	-0.9	-1.6	1.6	4.0
Latest	0.31	1.40	802.7		94.2		-0.1	-1.7	-1.6	2.4	4.0

Note: For market data, "latest" is 3Q08; for economic data, "latest" is 3Q08 for GDP data and September for CPI and unemployment
Source: Nikkei Data, Cabinet Office, Ministry of Internal Affairs and Communications.

The second false start came from mid-1995 through mid-1996, when a blockbuster fiscal package, more aggressive rate cuts by the BoJ, and an important deregulation in the telecom sector under PM Murayama[2] temporarily stoked public works and business investment. The equity market recovered temporarily, but the bond market was not fooled. Despite the GDP revival, both nominal and real bond yields fell. When PM Hashimoto took over in January 1996, the market saw fiscal austerity coming. The combination of spending cuts, tax hikes, and the Asian crisis in mid-1997 ended Japan's second try at revival.

Financial system worries deepened substantially during this period. The problems of housing loan companies (*jusen*) were highlighted as their bad loans emerged. Private sector banks were held responsible for pushing bad projects onto the *jusen*, which had received a great deal of their financing from agricultural-related institutions. Despite harsh public opposition, the Diet voted in early 1996 to make capital injections into the *jusen* companies. A Housing Loan Administration Corporation was formed under the Deposit Insurance Corporation (DIC) in 1996, to dispose of bad assets of the *jusen*. In addition, as concerns over the financial system spread, the DIC expanded its deposit insurance program.

Nevertheless, this second period did see interesting steps forward. In the corporate area, one crucial reform was the amendment of the Anti-Monopoly Law to allow holding companies. This change paved the way for the corporate M&A boom that helped improve efficiency so much in the 2000-05 period. In government, a reorganization of ministries and creation of the Council on Economic and Fiscal Policy (to be the highest body for making and integrating economic policy across ministries) occurred. These changes smoothed the decision process for reform significantly, and prepared the ground for PM Koizumi to act.

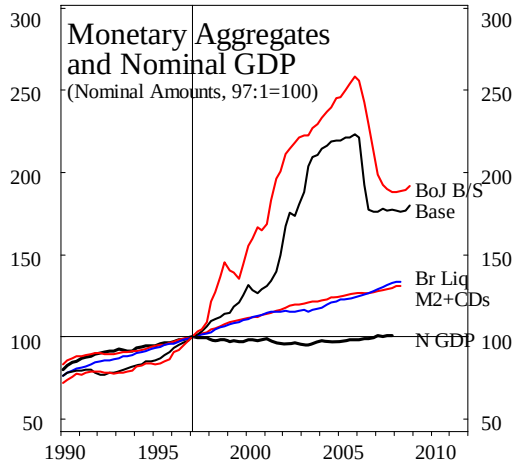
[2] Murayama was a Socialist, but the fiscal package was designed largely by the LDP, which had formed a coalition of convenience with the Socialists in order to return to power after the loss to PM Hosokawa's Japan New Party in the 1993 general election.

The third false start came in 1997-99. The banking panic of 1997 triggered another massive fiscal package under PM Obuchi, this time focused on government guarantees for small business borrowing, starting at Y15 trl (about 3% of GDP) and growing to Y20 trl. Other measures in financial reform included support for money market transactions, which had frozen after the failure of Sanyo Securities in early November. The failures of Hokkaido Takushoku Bank and Yamaichi Securities in late November also triggered a major rethink of financial crisis management methods.

As part of measures to stabilize financial markets, the BoJ launched a major expansion of base money and its balance sheet (see Exhibit 3), with extra support in light of worries about the Y2K problem. Unfortunately, the linkage between monetary policy and nominal GDP had collapsed. The correlation between base money and nominal GDP continued to worsen, went negative, and remained so until early 2004. (Exhibit 4). Moreover, the signal from quantitative policy and interest rate policy remained inconsistent. While pushing hard on quantity, the BoJ refrained from cutting rates until late 1998; only in March 1999 did the BoJ move to a "near-zero rate" policy.

Exhibit 3

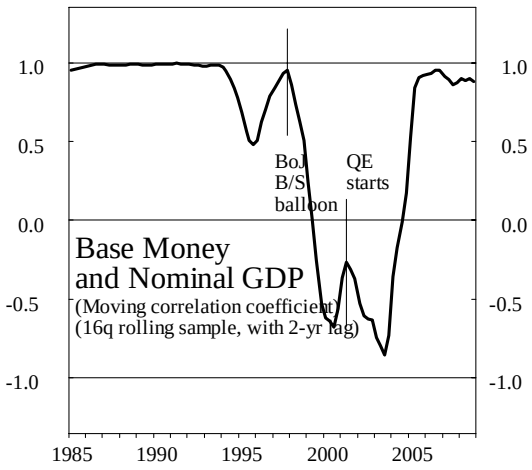
Monetary Policy, Money Growth, and Nominal GDP



Sources: Bank of Japan, Cabinet Office, and Morgan Stanley calculations.

Exhibit 4

Base Money and Nominal GDP Correlation Coefficients



Sources: Bank of Japan, Cabinet Office, and Morgan Stanley calculations.

During this period, the global IT boom brought hopes that technological progress would rescue Japan from its financial and non-performing asset problems. These hopes were in vain. The global IT bubble collapsed from mid-2000, and the Obuchi spending and credit guarantees generated little permanent demand. The near doubling of TOPIX from mid-1998 to early 2000 was mostly gone by autumn 2001.

Despite the failure of the Obuchi-Mori macro policies, this period provided a foundation for future growth. The importance and power of structural reforms was recognized, and the very depth of the financial crisis prompted a deeper look at Japan's structural woes. PM Obuchi commissioned the Economic Strategy Council (ESC) to write a new blueprint for Japanese growth strategy. A driving force behind the report was Heizo Takenaka, then a university professor with little clout in political circles.[3] In the succeeding Mori Cabinet, Economics Minister Taiichi Sakaiya -- a former MITI official with a strong bent toward structural reform -- provided a more comprehensive forum to plan and execute the next phase of deregulation. Academics and think tankers began to have a real impact on policy. Moreover, the Mori government implemented the "e-Japan" program, a highly successful push to increase broadband connectivity, and thus raise productivity.

[3] The ESC report of February 1999 became the basis for both the LDP and the Democratic Party of Japan (DPJ) manifestos in the elections of the Koizumi period.

The greatest area of failure during the Obuchi-Mori period was the lack of effective action on non-performing loans/assets. Despite the financial panic, measures avoided getting at the root of non-performing loan numbers and focused on capital injections to the banks with only weak accounting of bad loans. That said, at least a start was made: The financial regulatory oversight function was separated from the Ministry of Finance, in light of the failure of the latter to prevent the crises. Work began immediately on increasing the staff and honing the inspection methods for the new oversight agency. In addition, a new agency to aid disposal of bad loans was formed, the Resolution and Collection Corporation (RCC). This institution merged the agency charged with resolving bad loans from the *jusen* and other resolution institutions, and then expanded activities as more assets needed action. However, this institution was also hobbled by the lack of pressure on banks to transfer non-performing assets into the RCC.

Interestingly, the Obuchi-Mori years saw less public opposition to the capital injections. Public support came for two reasons. First, the financial crisis convinced the public that support was needed. Second, the conditionality on the funds injections was severe. Not only did recipients of the public injections (in the form of preferred shares) have to pay significant dividends to the government, but cuts of total compensation (by 20%-30% from peak levels) were forced on the institutions.

The Real Thing: Financial reform in 2002-04

The BoJ's ill-timed exit from the near-zero rate policy in August 2000, just as industrial production began to collapse, was eventually recognized as a mistake, as the economy weakened. Moreover, confidence fell further, as continued political scandals, stock market weakness, and slow progress on financial sector reform brought the support rate of the Mori government to single-digit levels. BoJ cut rates first on March 1, 2001 and then moved to the zero interest rate policy (ZIRP) on March 22. Simultaneously, BoJ announced the shift to quantitative easing, and committed to maintain extremely easy monetary conditions until core consumer price changes sustainably returned to positive territory.

Political events came to a head in April. As the Mori government lost popularity, the ruling Liberal Democrat Party faced a crisis. In a four-way battle for party leadership, maverick Junichiro Koizumi emerged victorious, on a platform of "structural reform." Initially, there was deep skepticism on whether Koizumi could run an effective government, particularly in the face of strong internal opposition in the LDP to his platform – appealing though it was to the electorate. (His popularity rating initially reached 80%.) However, implementing policies took time to achieve, largely because keeping the LDP together required so much effort and compromise.

Japan got it right when growth strategy, safety nets, capital injections, popular support, and strict asset assessments all came together at the same time.

During the first period of the Koizumi government, 2001/4-2002/9, the metabolism of many economic reform policies accelerated, but financial reform continued at the same pace as the Obuchi/Mori years. Markets remained skeptical of Japan's economic future, because the internal fighting in the LDP had yet to be resolved. Koizumi had appointed Takenaka as his economics minister, and used the Council on Economic and Fiscal Policy to push the reform agenda. However, bureaucratic resistance continued, fueled by persistent rumors of attempts to dump PM Koizumi.

Conditions changed suddenly at end-September 2002. Koizumi sent a strong signal by reshuffling his Cabinet, in which Takenaka now doubled as financial affairs minister. Within a month, the "Takenaka Plan" for cleanup of financial institutions was formulated, and aggressive actions began. In particular, the Financial Services Agency, now directly under Takenaka, revised its methods of checking the classification of bad loans by banks, and insisted on uniform treatment across banks. Moreover, Takenaka began to hold auditors legally liable for the corporate results that they authorized. The impact of these actions was to trigger further large write-offs of non-performing loans, and to force actual liquidations.

On fiscal policy, the government adopted a target of eliminating the deficit in the primary balance, then about 6% of GDP, by 2011. At first, PM Koizumi set a goal of reducing deficit bond issuance to below Y30 trl., but this target was not achievable due to the worsening economy. However, he stuck to the philosophy of reduced government spending, and cut public works from 6.5% of GDP when he took office by an average of 0.5%pts of GDP every year during his tenure through 2006.

Nor was the structural policy agenda ignored, particularly the agenda on corporate governance. In light of the slow pace of corporate restructuring, particularly of large troubled borrowers, the government decided to create a new, private-sector staffed entity. The concept for the Industrial Revitalization Corporation of Japan (IRCJ) emerged in late 2002, and the entity began operations in May 2003. There was tacit encouragement from

the FSA for financial institutions to take troubled borrowers to the IRCJ, which then used special powers to enforce cooperation among creditors, based on realistic revival plans. The IRCJ was a huge success. It completed its task and closed shop well before the 5-year deadline, and even returned a small profit to the taxpayer.

Despite the more aggressive stance taken by PM Koizumi from autumn 2002, the equity market continued to fall until May 2003. The market needed incontrovertible proof that Koizumi and Takenaka were serious. That proof came when the government took harsh action on a large troubled bank. Takenaka and Koizumi ejected 140 senior managers as a condition for financial assistance, and confidence returned to the financial system. After the asset liquidations, the start of strict asset assessments, and the actions taken against the management of the failed banks, the market had a clear reading. Once these policies were implemented, Japan entered its longest economic expansion in the postwar period.

One other part of the story, the importance of an expanding global economy, is often emphasized. However, while world recovery after the 9/11 incident was clearly helpful to Japan, the role of the global economy should not be exaggerated. Domestic demand, especially business investment, was the driver once policies began to gain traction in 2003. Indeed, from 2003-06, only 2.6%pts of GDP growth came from net exports (see Exhibit 5). Of the 5.9%pts from domestic demand, fully 3.4%pts came from business investment. In short, the data show that the structural reform policies, especially financial reform policies, were crucial in reviving growth.

Exhibit 5

GDP Growth Contributions, CY2001-07

		Contributions			
	GDP growth	Net exports	Domestic demand		
				of which: Capex	Non-capex
	%	%pt	%pt	%pt	%pt
2001	0.2	-0.8	1.0	0.2	0.8
2002	0.3	0.7	-0.4	-0.7	0.3
2003	1.5	0.6	0.8	0.6	0.2
2004	2.7	0.8	1.9	0.8	1.1
2005	1.9	0.3	1.6	1.3	0.3
2006	2.4	0.9	1.5	0.7	0.9
03-06 Total	8.5	2.6	5.9	3.4	2.5

Source: Company data, Morgan Stanley Research

What's Different

Of course, not every aspect of the Japanese case is applicable in other nations. Indeed, there are several aspects that differ from the cases of other countries today, and so the Japan success model must be adapted to circumstances.

First, Japan's financial crisis was local. The bad loans of Japanese institutions were almost wholly local, and the regulatory problems were as well. Japan did not need to coordinate closely with other countries, in trying to solve the domestic financial problems. Today, the situation for other nations is quite global. Decisions in one country can affect other countries very quickly and severely, because of close electronic connections among markets. Hence, regulatory rule changes and resolution actions must consider effects on other countries.

Second, the yen exchange rate played a safety valve role in the Japan crisis. That is, Japan relied in part on exchange rate changes for economic support. Sweden was another country where exchange rates were quite crucial to recovery. However, for the financial system crises today, the exchange rate is not a major safety value (although exchange rates may move significantly), because reliance on exports for economic support is not viable for large countries or regions.

Third, global growth was strong during most of Japan's crisis period. Hence, foreign demand supported the economy to an extent. More important, however, is that economic shocks from abroad were not as disruptive (with the exception of the Asian Crisis in 1997-98) as they are now. In the current crisis, not only must countries worry about export demand, they must also worry about foreign financial system shocks and contagion.

Finally, Japan started her decade of financial troubles with an inadequate regulatory system, poor accounting and disclosure standards, and low levels of corporate governance. Thus, Japan had to develop much regulatory infrastructure as the crisis evolved. Fortunately, the rest of the world already has a great deal of financial regulatory infrastructure.

From History to Roadmap

In my view, the similarities are more important than the differences. Thus, other countries have much to learn from Japan's history of financial reform. Japan is NOT merely a source of warnings about mistakes to avoid. Rather, the wonder is that Japan actually did get the reform model right, in the end. It took enormous efforts and creativity over a decade to create infrastructure from scratch, to overcome political and bureaucratic infighting, and to summon the political courage to take needed steps and to share the pain.

Japan's bitter history of financial sector reform suggests a roadmap. In order to become a roadmap, however, Japan's history must be converted into a model of financial reform. In my view, that model comprises five factors (Exhibit 6). These factors are:

1. **Economic strategy.** The nation needs an approach to improving the supply side of the economy, be it through education, capital deepening, technology, or corporate reorganization. Strong corporate governance is a part of national economic strategy. The strategy must be formulated with global economic trends in mind.

2. **Safety net.** Those hurt by economic reforms need assurance that they will not be abandoned. Such assurances must extend to a broad range of the populace. The problem is to give support without falling subject to moral hazard. Areas include deposit insurance, money market confidence, small business support, monetary policy, and fiscal spending.

3. **Capital injections.** Restoring confidence in financial institutions requires public capital injections in many cases. The difficulty is to enforce adequate conditionality on stockholders, employees, and management while keeping taxpayers happy and keeping the operations of troubled institutions alive.

4. **Public support.** When public money is involved, politics become involved too; hence public support for the economic strategy, the fairness of the safety net, and the conditionality on capital injections are all essential to achieve public support.

5. **Strict asset assessment.** Confidence in the financial system cannot return unless depositors and investors believe that asset valuations are correct. Oversight agencies must be sufficiently staffed with expert personnel, and must coordinate closely across bureaucratic lines and across international borders. There must be clear, public standards for asset valuations, and clear rules for how to deal with deviations.

Exhibit 6

Japan achieved the necessary factors for successful reform only in 2002-04.

	Phase I	Phase II	Phase III	Phase IV
	1992-94	1995-96	1997-99	2002-04
Economic Strategy				
Supply reforms (regulatory rationalization)		●	●	●●
Improved corporate governance		●	●	●●
Effective workout methods for troubled firms			●	●●
Safety Net				
Expanded deposit insurance		●	●	●
Broad collateral for central bank discounts			●	●●
Money market liquidity guarantees			●	●
Small business lending support	●	●	●	
Extremely easy monetary policy			●	●●
Fiscal spending	●●	●●	●●	
Capital Injections				
Sufficient size to enhance confidence			●	●
Clear standards of conditionality			●	●
Consider systemic impact				●
Public Support				
Taxpayer benefit from capital injections			●	●
Fair compensation / Accountability			●	●
Prosecution of malefactors				●
Effective, popular political leadership				●
Strict Asset Assessment				
Sufficient personnel in inspection and oversight			●	●
Close coordination among government agencies				●
Clear, public standards for inspections				●
Strict asset valuation (DCF)				●●
Cross-border impact assessments				●

Source: Morgan Stanley Research

The key point is that ALL five of the factors below were necessary to fix the financial sector problem. In Japan's initial phase, only canonical fiscal policy and politically convenient lending support were really tried in any major amounts. The second phase was largely the same, although some progress started on both the safety net and economic strategy. After the financial panic of 1997 occurred, the economic strategy (if not the ability to implement) became clearer, and the safety net was expanded. Capital injections began as well, but their main impact was stabilization, not recovery. Only in the 2002-04 phase, when public support and strict asset assessment were added, did the program become complete. And effective.

Japan in 2008: Backsliding

Japan's history of financial reform has many lessons for other countries to learn. Unfortunately, Japan herself seems to have forgotten the lessons already. The economic strategy of the Koizumi years has been discarded by the ruling LDP, even though the party still uses the huge majority he won in the 2005 election. Moreover, there is no economic strategy proposal from both major parties which remain in flux. Even a change of government is not likely to correct the lack of stable economic strategy. Hence the first condition for overcoming a financial system crisis is not met.

Japan's safety net remains strong, with broad deposit insurance and very low interest rates. However, the moral hazard issues inherent in yet more expansions of safety net have been lost in the clamor for more support.

Japan has forgotten its own success model, and is backsliding into domestic recession.

Capital injections are again under discussion, but Diet debate is bogged down in political gamesmanship, prior to the next general election (which must come by autumn 2009). There is no clear strategy on which regional financial institutions should get support, or on what conditions.

Public support for the Aso government is dropping, but the opposition party fares little better. The lack of a clear manifesto from the Democratic Party of Japan (DPJ) has hobbled attempts to establish policy credibility with the voters. Apart from problems in the individual parties, public confidence in the ability of political, bureaucratic, and business leaders to lead the country remains low.

Finally, there have been some steps away from strict assessment of assets at financial institutions, particularly regional banks.

In light of these facts, foreign countries are not the only ones who need to review the Japanese model of financial sector reform.

Exhibit A1

A selection of this author's papers on financial system reform in Japan, 1997-2008

Title	date	publisher		Content
Poor Richard and Structural Reform	27-May-98	Morgan Stanley	Real economy reform	Why piecemeal reforms will not work
Prospects for Market Liberalization and Economic Reform	14-Jul-98	Morgan Stanley	Real economy reform	Testimony to US Senate Finance Committee
Creative Destruction: Japan's Only Hope	26-Aug-98	Morgan Stanley	Real economy reform	Why structural reform and financial sector reform are inseparable
Sharing the Pain Fairly	8-Jun-99	Morgan Stanley	Real economy reform	Why public support is needed for financial reform
What Europe Could Learn from Japan	23-May-06	Morgan Stanley	Real economy reform	Retrospective on Japan's Reforms
The Posen Program for Japan, Warts and All	21-Sep-98	Morgan Stanley	Fiscal/Monetary policy	Why fiscal policy alone will not save Japan
Macro Horns of the Restructuring Dilemma	8-Apr-99	Morgan Stanley	Fiscal/Monetary policy	No conceivable macro policy could fix Japan's corporate balance sheets
Macro Growth Can't Eliminate the Bad Loan Problem	16-Oct-01	Morgan Stanley	Fiscal/Monetary policy	No conceivable macro policy could fix Japan's corporate balance sheets
Pertinacious Princes of the Printing Press	19-Nov-01	Morgan Stanley	Fiscal/Monetary policy	Monetarism is the wrong model for financial system problems
The Fed's Wrong Lessons from Japan	9-Aug-02	Morgan Stanley	Fiscal/Monetary policy	How using the wrong model leads to the wrong conclusion
Happyo Shiryo, zaisei to Kinyu no Arikata ni Kan Suru Kyogikai	16-Jan-98	Morgan Stanley	Regulatory policy	Handout forJapan Diet working group
William Seidman's Seven Deadly Sins	8-Dec-98	Morgan Stanley	Regulatory policy	Write-up of Tokyo speech by L. William Seidman
Seidman's Checklist on Japanese Financial Reform	9-Dec-98	Morgan Stanley	Regulatory policy	Write-up of Tokyo speech by L. William Seidman
Three Roles, No Actors	29-Mar-01	Morgan Stanley	Regulatory policy	How politics, macro, and micro reform must work together
What Does "Strict" Mean?	2-Apr-02	Morgan Stanley	Regulatory policy	Bottom up calculation of capital shortage
Dawn!	1-Oct-02	Morgan Stanley	Regulatory policy	Koizumi gets serious about solving the financial problem
A Hint from Nietzche	15-Dec-06	Morgan Stanley	Regulatory policy	Presentation material for Japan FSA conference
Financial Regulation Rethink	11-Jan-07	Morgan Stanley	Regulatory policy	Next steps in Japan's financial sector reform
Japanese Financial Market Competitiveness: Concrete Ideas	14-Feb-07	Morgan Stanley	Regulatory policy	Specifics on what Japan needs to do.
Financial System Reform: Lessons from Japan	15-Oct-08	Morgan Stanley	Regulatory policy	Retrospective on financial reforms
Restructuring - The Long Road Ahead	24-Mar-99	Morgan Stanley	Corporate reform	Balance sheet approach to restructuring
Raising RoA - Hobbes Got It 2/3rds Right	23-Apr-99	Morgan Stanley	Corporate reform	Long period needed for corporate rebalancing
Excess Capital -- How Much, So What?	26-Jan-00	Morgan Stanley	Corporate reform	Balance sheet approach to restructuring
How Much Restructuring Is Still Needed? By Whom?	31-Aug-00	Morgan Stanley	Corporate reform	Balance sheet approach to restructuring
The Capital Shortage	10-Jul-01	Morgan Stanley	Corporate reform	Balance sheet approach to restructuring
A Brief History of Japan's Capital Shortage	25-Oct-01	Morgan Stanley	Corporate reform	Balance sheet approach to restructuring
The Closet Hardliners at METI	24-Oct-02	Morgan Stanley	Corporate reform	Tougher policy on corporates starts
Sharp Teeth Behind the IRO's Smile	21-Feb-03	Morgan Stanley	Corporate reform	Corporate reform accelerates
Market Failure, Government Failure, and the IRCJ	25-Apr-03	Morgan Stanley	Corporate reform	Why "markets vs. regulation" is the wrong distinction
Who's on First (for the IRCJ)?	3-May-03	Morgan Stanley	Corporate reform	Which companies might be IRCJ targets
The IRCJ: Another Reason for Optimism on Japan	22-Mar-04	Morgan Stanley	Corporate reform	Why corporate reform will accelerate growth
METI, MoF, and MoJ Join Hand for Corporate Reform	22-Dec-04	Morgan Stanley	Corporate reform	New corporate governance rules

Note: These papers are all available on Morgan Stanley Research Link, with the exception of "How much BoJ Money for Financial System Support?" "A Hint from Nietzsche," and "Happyo Shiryo." Any of the papers may be requested from the author.
Source: Morgan Stanley Research

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2008 年 11 月 28 日

日本経済

日本の金融改革は成功例でもある

歴史は繰り返さないが、韻を踏む
—— ウィル・ロジャース

新しい材料：日本が 1992-2004 年に行った金融改革は避けるべき間違いはたくさんあったが、見習う成功例でもある。

結論:
(a) 日本の金融改革は 3 回にわたって失敗したが、最終的に 2002-04 年に成功した。
(b) 日本の 2002-04 年の成功モデルは、改革を成功させるには、(i)成長戦略、(ii)セーフティ・ネット、(iii)資本注入、(iv)国民の支持、 (v)厳格な資産査定の 5 つの要素が必要であることを示唆している。
(c) 日本が犯した最大の間違いは財政のバラマキに重点を置いたことである。伝統的なマクロ政策では、構造的な問題に対処することはできなかった。
(d) 日本の最大の成功は厳格な資産査定を行なうための監督機能を整備したことである。
(e) 国内の制度や取り巻くグローバル環境は違うものの、最終的に成功を収めた日本から他国が学ぶべき点は多い。
(f) 現在の日本は逆戻りしつつある。日本が成長軌道に戻るには、過去の自らの成功を思い起こすことが必要である。

相違点: (a)日本の金融危機は日本だけだったが、現在の危機は世界的なものである。(b)日本は景気下支えの手段の 1 つとして為替相場に頼ったが、現在危機に見舞われている国は為替レートを活用することはできない。(c) 日本が金融危機にあった当時の世界景気は概ね好調だったが、現在は停滞している。(d)日本は監督機能の整備が大きく遅れていたが、他国はそうした制度がすでに整っている。

市場へのインプリケーション: 日本の 2002-04 年の成功モデルを取り入れる国でリスク資産が恩恵を受ける可能性がある。最も困難かつ重要な要素は成長戦略と厳格な資産査定である。

付表 I: 日本の金融改革に関するレポート——付表に 1997-2008 年に発表した金融改革関連レポートの一覧を掲載した。レポートは Morgan Stanley Client Link にて閲覧、もしくは筆者に問い合わせされたい。

図表 1
日本がいかにして成功したのか：2002-04 年に成功した回復への 5 つの要素

	1992-94	1995-96	1997-99	2002-04
経済戦略				
供給改革		●	●	●●
企業統治		●	●	●●
検査			●	●●
セーフティ・ネット				
銀行預金保険		●	●	●
短期金融市場の担保			●	●●
資金流動保証			●	●
中小企業支援	●	●	●	
金融緩和			●	●
財政支出	●	●	●	
資金注入				
多額の資金量			●	●
厳格な条件				●
全体的な影響				●
国民の支持				
資本注入により納税者利益			●	●
公平な報酬			●	●
犯罪者起訴				●
有効な政治力				●
厳格な資産査定				
充分な人員			●	●
緊密な連携				●
明確な検査基準				●
厳格な資産評価				●●
越境効果を評価				●

出所:モルガン・スタンレー・リサーチ

重要な開示事項は本レポート巻末の情報開示セクションをご参照ください。

日本の金融改革は成功例でもある

過去を簡潔に振り返る: 日本が犯した３回の失敗
日本の金融改革が成功するまでの道筋は、1992-1999 年の 3 回の失敗に特徴付けられる。最終的に成功に結びついた様々な要素は、これらの失敗を通して培われたものだった。改革プロセスは 2002-04 年にようやく成功したと言えよう。

1 回目の失敗は、1992 年から 1994 年前半に起こった。1992-93 年に景気が失速する中(図表 2 参照)、日銀は利下げに踏み切った。さらに、まず、宮澤内閣(主に歳出増)、次いで、その後に誕生した細川内閣(主に減税)によって大型財政出動が実施された。金融システムと企業セクターの構造的な問題や(米国に対する信認の低下を一因とする)1993-94 年の急激な円高を受け、株式バブル崩壊の痛手から早期に回復するとの期待は消えた。

日本の経済改革は 3 回の失敗を経て、ようやく成功した

この期間の政策でとりわけ影が薄かったのは、ミクロ経済および政治改革であった。前川リポート(1980 年代からの規制緩和の青写真となった)は概ね見捨てられた格好だった。日米構造協議(SII)が行われ、日本の世論からは好意的に受け入れられた。しかし、SII は主に米国の保護主義を抑制するためのツールという域を超えることはなかった(ただ、SII は後の改革で参考とされる青写真となった)。最も失望させられたのは、長期与党である自民党の改革派であった海部首相の下で選挙制度改革が失敗したことであった。海部首相は改革頓挫を機に退陣した。議席数の地方への偏りが一部是正され、小党に有利だった中選挙区制度が改正された選挙制度改革が実現したのは 1994 年で、実行に移されたのは 1996 年の選挙からであった。

この間、金融システムを巡る強い懸念が浮上した。株式市場の急落を受け、銀行の資本基盤に疑問符が付いた [1]。企業倒産が増えるにつれ、不良債権の規模を巡る不安が広がり、信頼感が低下した。そこで、最初の対応策として、共同債権買取機構(CCPC)が設立されたが、同機構が積極的に活用されることはなかった。しかも、金融機関は長期保有資産の含み益を吐き出すことで市場の圧力に抵抗することができた。

議論の図式

歴史
- 1回目の失敗、1992-94年
- 2回目の失敗、1995-96年
- 3回目の失敗、1997-98年
- ようやく成功、2002-04年

成功要因
- 改革が成功するための５つの要素:
- (a) 経済戦略
- (b) セーフティ･ネット
- (c) 資金注入
- (d) 国民の支持
- (e) 厳格な資産査定

モデル
- 改革の有効性 = (a)*(b)*(c)*(d) *(e)
- これら要素同士の関係は密接。
- 改革が成功するために全ての要素が同時に存在していなければならない。

[1] 大半の先進諸国と違い、日本の商業銀行には株式保有が認められている。さらに、BIS 自己資本規制が最初に導入された当時は保有株式の含み益の 45%までを自己資本補完的項目に算入できた。

図表 2
1986-2008 年の日本の金融市場と景気

	日本金融市場						日本経済				
	翌日物ｺｰﾙﾚｰﾄ	10年国債	TOPIX	TOPIX 変化	ﾄﾞﾙ円	ﾄﾞﾙ円 変化	実質 GDP	名目 GDP	GDP ﾃﾞﾌﾚｰﾀｰ	ｺｱ CPI	失業率
1986	4.95	4.91	1325.5	32.9	168.4	-29.4	3.0	5.0	1.9	0.8	2.8
1987	3.66	4.52	1958.5	47.8	144.6	-14.2	3.7	4.5	0.8	0.3	2.8
1988	3.84	4.68	2132.3	8.9	128.2	-11.4	6.8	7.3	0.5	0.4	2.5
1989	5.12	5.25	2569.5	20.5	138.0	7.7	5.3	7.0	1.6	2.4	2.3
1990	7.41	7.39	2178.3	-15.2	144.8	4.9	5.3	8.1	2.7	2.7	2.1
1991	7.52	6.40	1841.7	-15.5	134.6	-7.1	3.3	6.0	2.6	2.9	2.1
1992	4.65	5.12	1363.6	-26.0	126.6	-5.9	1.0	3.3	2.3	2.3	2.2
1993	3.06	4.03	1525.0	11.8	111.1	-12.2	0.2	1.1	0.9	1.3	2.5
1994	2.19	4.21	1599.1	4.9	102.2	-8.0	1.2	2.2	0.9	0.7	2.9
1995	1.21	3.28	1380.7	-13.7	94.0	-8.0	1.9	2.0	0.0	0.0	3.2
1996	0.47	3.02	1605.4	16.3	108.8	15.7	2.8	2.3	-0.5	0.1	3.4
1997	0.48	2.13	1395.0	-13.1	121.0	11.2	1.6	1.6	0.0	1.8	3.4
1998	0.37	1.29	1178.0	-15.6	130.9	8.2	-2.1	-1.6	0.5	0.3	4.1
1999	0.06	1.73	1387.1	17.8	113.9	-13.0	0.0	-0.9	-0.8	-0.1	4.7
2000	0.11	1.74	1545.8	11.4	107.8	-5.4	2.8	1.1	-1.7	-0.4	4.7
2001	0.06	1.33	1194.5	-22.7	121.6	12.8	0.2	-1.2	-1.4	-0.9	5.0
2002	0.00	1.26	979.2	-18.0	125.3	3.0	0.3	-1.2	-1.4	-0.8	5.4
2003	0.00	0.99	918.6	-6.2	115.9	-7.5	1.5	-0.2	-1.7	-0.3	5.2
2004	0.00	1.50	1118.7	21.8	108.2	-6.7	2.7	1.4	-1.3	-0.1	4.7
2005	0.00	1.38	1269.7	13.5	110.2	1.8	1.9	0.9	-1.0	-0.1	4.4
2006	0.13	1.74	1626.6	28.1	116.3	5.5	2.4	1.2	-1.2	0.1	4.1
2007	0.47	1.67	1662.7	2.2	117.7	1.3	2.1	1.4	-0.7	0.0	3.8
2008/1-9月	0.49	1.50	1255.3	-24.5	105.2	-10.6	0.7	-0.9	-1.6	1.6	4.0
直近	0.31	1.40	802.7		94.2		-0.1	-1.7	-1.6	2.4	4.0

注: マーケット･データの直近は 2008 年第 3 四半期、経済指標の直近は 2008 年第 3 四半期、CPI と失業率は 9 月値を指す。 出所: 日経データ, 内閣府, 総務省

2 回目の失敗は、大型財政出動、日銀のより大幅な利下げ、村山政権[2]による通信業界の重要な規制緩和を背景に、公共事業と設備投資が一時的に活発になった 1995 年半ばから 1996 年半ばにかけて起きた。株式市場は一時的に持ち直したが、債券市場がごまかされることはなかった。GDPの回復をよそに、利回りは名目、実質ともに低下した。1996 年 1 月に橋本政権が誕生すると、市場は緊縮財政路線への転換を察知した。歳出削減と増税に 1997 年半ばのアジア金融危機が重なり、回復を目指す日本の 2 度目の試みは終わった。

この期間に金融システムに対する懸念が著しく強まった。不良債権を抱える住宅金融専門会社(住専)の問題が表面化した。民間銀行は農林系金融機関から多額の融資を受けていた住専に不良案件を押し付けたことへの責任を問われた。世論の激しい反対をよそに、1996 年前半、住専への資本注入を認める法案が成立した。同年、住専の不良債権を処理するために、預金保険機構(DIC)の下に住宅金融債権管理機構が設立された。さらに、金融システムへの懸念が広がるにつれ、DIC は預金保険制度を拡大した。

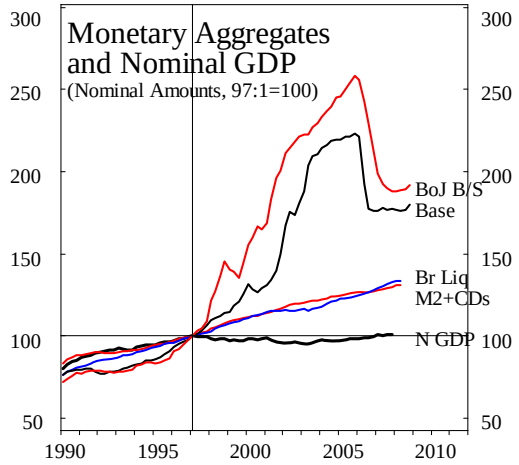
とはいえ、この 2 回目の試みが行われた時期には興味深い前進が見られた。企業セクターでは、持ち株会社を解禁するための独禁法改正という重要な改革が行われた。この改正は、2000-05 年に経営効率の目覚ましい改善を促した企業の M&A ブームへの地ならしとなった。官の分野では、省庁再編が実施され、(省庁横断で経済政策を策定・統合するための最高機関として) 経済財政諮問会議が発足した。こうした変化の効果で、改革に向けた意思決定は格段に円滑に進むようになり、後に登場する小泉首相が改革を推進するための素地が作られた。

3 回目の失敗は 1997-99 年に起きた。1997 年の金融危機を受け、小渕政権が大規模経済対策を再び打ち出した。軸となったのは、中小企業借入に対する政府保証で、規模は当初の 15 兆円(対 GDP 比で約 3%)から最終的に 20 兆円に拡大した。他の金融改革措置として、11 月初めの三洋証券の破綻を機に結局凍結されることになった短期金融市場取引の支援などが行われた。11 月終盤に起きた北海道拓殖銀行と山一證券の破綻も金融危機管理のあり方を大幅に見直すきっかけとなった。

[2] 村山首相は社会党党首だったが、景気対策は自民党が中心となってまとめた。自民党は 1993 年の総選挙で敗れ、日本新党の細川代表が首相に就任した経緯から、社会党と便宜上の連立を組んだ。

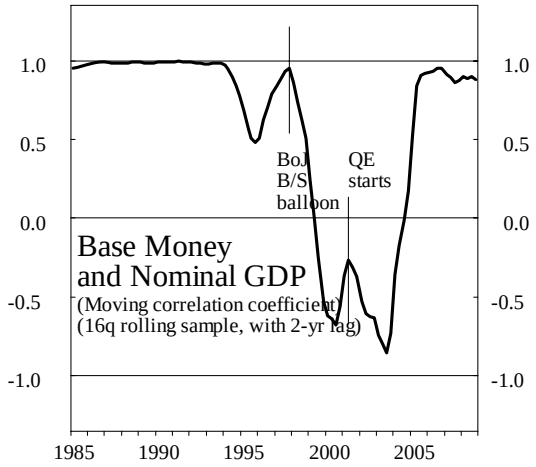
2000 年問題を巡る懸念に対応する意味もあって、日銀は金融市場安定化策の一環としてベースマネーと自らのバランスシートの大幅拡大に動いた(図表 3 参照)。残念ながら、金融政策と名目 GDP の連動性はすでに崩壊していた。ベースマネーと名目 GDP の相関は悪化し続け、最終的には逆相関に転じ、2004 年前半までその状態が続いた(図表 4)。だが、ベースマネーと金利政策が送るシグナルは一貫性に欠けていた。日銀は積極的にベースマネーを増す一方で、1998 年終盤まで利下げには慎重だった。日銀がようやく「ゼロ金利政策」に動いたのは 1999 年 3 月になってからであった。

図表 3
金融政策、通貨供給、名目 GDP



出所: 日本銀行, 内閣府, モルガン･スタンレー･リサーチ推計

図表 4
ベースマネーと名目 GDP の相関関係



出所: 日本銀行, 内閣府, モルガン･スタンレー･リサーチ推計

この間、世界的な IT ブームが日本を金融不安や不良債権問題から救ってくれるという期待をもたらしたが、結局、空振りに終った。世界の IT バブルは 2000 年半ばにはじけ、小渕政権による歳出増と信用保証が息の長い需要を生み出すことはほとんどなかった。1998 年半ばから 2000 年前半にかけて 2 倍近く上昇した TOPIX は 2001 年秋までにその上昇分の大半を失った。

小渕政権、森政権のマクロ政策は失敗したものの、この期間に将来の成長に向けた土台が作られた。構造改革の重要性と威力が認識され、金融危機の深刻さが構造問題をより深いところ見つめることを日本に迫った。小渕首相は経済戦略会議に日本の成長戦略の新たな青写真を作らせた。報告書のとりまとめに尽力した一人が、政界への影響力はほとんどない大学教授であった竹中平蔵氏だった [3]。小渕内閣に続く森内閣で、経産省出身で構造改革派の堺屋太一経済企画庁長官が、次の段階の規制緩和を計画および執行するためのより総合的な協議の場を整えた。学者やシンクタンクが政策に実質的な影響を与え始めた。さらに、森政権は「eJapan重点計画」を導入し、ブロードバンド通信の推進を通して、生産性の向上に大きな成果を上げた。

小渕・森政権時代の最大の失敗は、不良債権・資産問題に関して実効性のある対策を打ち出さなかったことである。金融危機にもかかわらず、不良債権の大元の額を突き止めようとせず、不良債権を甘めに計上している銀行への資本注入を重視した。とはいえ、少なくとも手は打ち始めた。大蔵省が危機防止に失敗したことを踏まえ、金融監督機能が同省から切り離された。金融監督庁が新設され、直ちに人員増強と金融検査手法の向上が図られた。さらに、不良債権処理を促進するための組織である整理回収機構(RCC)が新設された。RCC は住専の不良債権を処理するために設立された住宅金融債権管理機構と他の債権整理機関を合併させ、処理を必要とする資産が増えるにつれ、活動を拡大させた。しかし、RCC も、銀行に不良債権を RCC に譲渡するよう迫る圧力が乏しいことがネックとなった。

興味深いことに、小渕・森政権時代には、資金注入に対する世論の反発はそれほどなかった。世論が支持に回るようになったのは 2 つの理由がある。第 1 に、金融危機に見舞われたことで、支援が必要であることを世論が納得した。第 2 に、資本注入には厳しい条件が設けられた。優先株と引き替えに公的資金を受け入れた金融機関は政府に多額の配当を支払うだけでなく、報酬総額の削減(ピーク時と比べて 20-30%減)が義務づけられた。

[3] 小泉政権時代の選挙では、自民、民主両党とも 1999 年 2 月の戦略会議の報告書がマニフェストの土台となった。

本物の成果: 2002-04 年の金融改革

日銀は 2000 年 8 月、鉱工業生産が減少し始める中で実質ゼロ金利政策を不適切なタイミングで解除したが、景気が減速したことから、これは最終的に誤りと判断された。加えて、相次ぐ政治不祥事や株式市場の下落、金融セクター改革の進展の遅さを受けて森政権の支持率は 1 桁まで低下し、信認はさらに低下した。日銀は 2001 年 3 月 1 日に最初の利下げを実施し、さらに 3 月 22 日にはゼロ金利政策(ZIRP)に移行した。同時に、日銀は量的緩和への移行を発表し、コア消費者物価上昇率が持続的にプラス圏に戻るまで著しく緩めの金融環境を維持するとした。

政局は 4 月にピークを迎えた。森政権の不人気を受けて、与党・自民党は危機に直面した。4 人の候補者で争われた総裁選では独自の姿勢を貫く小泉純一郎氏が「構造改革」を掲げて勝利を収めた。当初は小泉氏が実効性のある政権運営をできるかどうかに深い疑念がもたれた。特に、自民党内では小泉氏の政見に強い反対意見があったが、これは有権者にとって魅力的であった(支持率は当初 80%に達した)。しかしながら、自民党をまとめるには多大な努力と妥協が必要であり、このことが主因となって、政策を実行に移すには時間がかかった。

成長戦略、セーフティ・ネット、資金注入、国民の支持、厳格な資産評価が同時に機能した時、日本は正しい方向に進んだ

2001 年 4 月-2002 年 9 月の第一次小泉内閣では多数の経済改革が加速したものの、金融改革は小渕・森政権時代と同じペースで続いた。自民党内の争いが解決していなかったことから、市場は依然として日本経済の将来に疑問をもっていた。小泉首相は竹中氏を経済相に起用し、経済財政諮問会議を活用して改革を進めた。しかしながら、官僚の抵抗は続き、小泉首相に退陣を促す試みがあるとの見方がなされた。

状況は 2002 年 9 月末に急転した。小泉首相は内閣改造で強いシグナルを発信し、竹中氏は金融・経済財政担当大臣を務めた。それから 1 ヵ月以内に金融機関の問題解決のための「竹中プラン」が策定され、積極的な政策が始まった。特に、金融庁は竹中氏の下で銀行の不良債権分類の査定方法を見直し、銀行間の統一的な取り扱いを主張した。さらに、竹中氏は監査人による企業監査結果の法的責任確認に着手した。これらの施策の効果で、さらに大量の不良債権処理と流動化が促された。

財政政策については、政府は当時 GDP の約 6%に達していたプライマリー赤字を 2011 年までに黒字化させることを目標とした。当初、小泉首相は赤字国債発行を 30 兆円以内に抑制する目標を立てたが、この目標は景気の悪化に伴い達成不可能となった。しかしながら、小泉氏は政府支出削減の方針を維持し、公共事業の対 GDP 比率を首相就任時の 6.5%から平均して毎年 0.5%ポイント引き下げ、これを 2006 年の任期終了まで続けた。

また、構造改革の課題、特にコーポレートガバナンスが軽視されることはなかった。企業リストラの進展が遅く、特に問題に直面した大手企業債務者においてこの傾向が顕著であったことから、政府は新しい民間出身者を主体とする機関の設立を決断した。2002 年下期には産業再生機構(IRCJ)の概念が明らかになり、同機構は 2003 年 5 月に活動を開始した。金融庁は問題に直面した借り手を産業再生機構に移行させるよう金融機関に暗黙裡に促し、同機構は特別な権限を使い、現実的な再生計画に基づいて債権者間の協力を促した。産業再生機構は大きな成功を収めた。同機構は 5 年間の期限よりも早く使命を終えて解散し、納税者に対して少額の黒字を還元するという成果も収めた。

2002 年秋以降に小泉首相がより積極的な姿勢を示したにもかかわらず、株式市場の下落は 2003 年 5 月まで続いた。市場は小泉氏、竹中氏の真摯な姿勢を裏付ける、動かぬ証拠を必要とした。その証拠は、問題に直面した大手銀行に厳しい措置が取られた時点で表れた。竹中氏、小泉氏は金融支援の条件として 140 人のシニアマネジャー退任を促し、金融システムの信認は回復した。資産流動化、厳格な資産査定の開始、破綻銀行の経営陣に対する措置を受けて、市場の見通しは明確になった。これらの政策が実行に移された時点で、日本は戦後最長の景気拡大局面に入った。

もう 1 つの側面である世界経済成長の重要性は往々にして強調される。しかしながら、9/11 事件以降の世界経済回復は日本を明らかに後押ししたものの、世界経済の役割を誇張すべきではない。2003 年に政策の実効性が高まり始めると、企業設備投資を中心とする内需が牽引役となった。事実、2003-06 年の GDP 成長率に対する純輸出の寄与は 2.6%ポイントに過ぎない(図表 5 参照)。企業設備投資は内需の寄与度 5.9%ポイントのうち 3.4%ポイントを占めた。簡潔に言えば、データは金融改革を中心とする構造改革政策が景気回復に重要な役割を果たしたことを示している。

図表 5

2001-07 年における GDP 成長率への寄与

	GDP 成長率	寄与度			
		純輸出	内需		
				設備投資	他
	%	%pt	%pt	%pt	%pt
2001	0.2	-0.8	1.0	0.2	0.8
2002	0.3	0.7	-0.4	-0.7	0.3
2003	1.5	0.6	0.8	0.6	0.2
2004	2.7	0.8	1.9	0.8	1.1
2005	1.9	0.3	1.6	1.3	0.3
2006	2.4	0.9	1.5	0.7	0.9
03-06年の計	8.5	2.6	5.9	3.4	2.5

出所: 企業データ, モルガン・スタンレー・リサーチ

相違点は何か

無論、日本の事例における全ての側面が他国に当てはまるわけではない。事実、現在の海外諸国の問題と異なる側面は幾つかあり、日本の成功モデルは状況に応じて調整することが必要である。

第 1 に、日本の金融危機は日本だけであった。日本の金融機関の不良債権はほとんど全て国内債権であり、規制面の問題についても同じことが言えた。国内金融問題の解決においては、日本は他国と協調する必要性に直面しなかった。現在、海外諸国を取り巻く状況は著しくグローバルである。ある国が下す判断は、市場間の密接な電子網が原因で、他国に対して急速かつ強い影響を及ぼす。したがって、規制ルールの変更や解決策においては、他国への影響を考慮する必要がある。

第 2 に、日本の危機においては、円相場が安全弁の役割を果たした。すなわち、日本経済回復の一部は為替相場の変化に支えられていた。為替相場が景気回復に極めて重要な役割を果たしたもう 1 つの国はスウェーデンである。しかしながら、現在の金融危機においては、為替相場は重要な安全弁であるとはいえない。これは、規模の大きな国や地域にとって、輸出に景気回復の後押しを期待することは実現可能ではないためである。

第 3 に、日本が危機に直面している間、世界経済は大半の期間において好調であった。したがって、外需は日本経済をある程度後押ししたといえる。しかし、より重要な点は、海外発の経済ショックが現在ほど大きくなかったことである(例外は 1997-98 年のアジア危機)。現在の危機においては、ほとんどの国々が輸出需要の先行きだけでなく海外金融システムの衝撃と連鎖を懸念している。

最後に、日本の 10 年間の金融危機は、不適切な規制システム、不十分な会計・ディスクロージャー基準、低水準の企業統治といった状況下で始まった。したがって、日本は危機の進行に伴い、規制インフラを大きく発展させる必要があった。幸運にも、海外諸国はすでに十分な金融監督規制インフラを確立している。

歴史から工程表へ

私の見解では、相違点よりも類似点の方が重要である。したがって、海外諸国は日本の金融改革の歴史から学ぶことが多いといえる。日本が提供するものは、回避すべき誤りに関する警告だけではない。むしろ、最終的に日本が改革モデルを実際に正しく機能させた点は驚嘆に値する。日本は 10 年間にわたり多大な努力と創造を重ね、基盤を一から確立し、政治と官僚の争いに打ち勝ち、必要なステップと痛みを分け合う政治的な勇気を奮った。

日本が経験した金融改革の苦い歴史は、1 つの工程表を示している。しかしながら、工程表を得るためには、日本の歴史を金融改革モデルに転換することが必要である。私の見方では、モデルは 5 つの要素で構成される(図表 6)。それらの要素とは、

1. **経済戦略。**教育、資本集約、技術向上、あるいは企業再編を通じて経済の供給側を改善するアプローチが必要である。力強い企業統治は、国の経済戦略の一部である。この戦略は世界経済のトレンドを考慮に入れながら立案することが必要である。

2. **セーフティ・ネット。**経済改革で痛手を負った者が捨て置かれることはない、との確証が必要である。そのような確証は、国民の幅広い層に行き渡る必要がある。問題は、モラルハザードに陥ることなく支援を行えるか否かである。これには預金保険、短期金融市場の信認、中小企業支援、金融政策、財政支出の分野が含まれる。

3. **資本注入。**金融機関の信認を回復させるためには、多くの場合、公的資本注入が必要である。難しい点は、株主、従業員、経営陣に対して適切な条件を設定しながら納税者への配慮も続け、難局に直面した金融機関の事業を継続することである。

4. **国民の支持。**公的資金が関与する時には、政治も関与することになる。したがって、国民の支持を得るためには、経済戦略、セーフティ・ネットの公平性、資本注入条件に対する国民の支持が重要である。

5. **厳格な資産査定。**預金者と投資家が資産評価の正確性を確信しない限り、金融システムへの信認は回復し得ない。監督機関には専門家を登用する必要があり、様々な官僚ラインや国々との間で密接な協力が必要である。資産評価については明確かつ公的な基準と、基準からの逸脱をどう処理するかという点に関する明確なルールが必要である。

図表 6
2002-04 年、日本の改革成功に必要な要素がようやく揃った

	第 1 局面	第 2 局面	第 3 局面	第 4 局面
	1992-94	1995-96	1997-99	2002-04
経済戦略				
供給改革策（規制、税金、競合）		●	●	●●
企業統治の改善		●	●	●●
問題企業への効果的な再生ルール			●	●●
セーフティ･ネット				
銀行預金保険の拡大		●	●	●
短期金融市場の担保拡大			●	●●
金融市場の資金流動保証			●	●
中小企業への資金貸出支援	●	●	●	
金融緩和政策			●	●●
財政支出	●●	●●	●●	
資金注入				
信頼を高めるための充分な資金量			●	●
条件の明確な基準			●	●
全体的な影響を考慮				●
国民の支持				
資本注入による納税者への利益			●	●
公平な報酬 / 説明責任			●	●
犯罪者起訴				●
実効的な政治リーダーシップ				●
厳格な資産査定				
審査や監督に充分な人員確保			●	●
政府機関同士の緊密な連携				●
検査の明確で公平な基準				●
厳格な資産評価				●●
各措置の越境効果を評価				●

出所：モルガン・スタンレー・リサーチ

重要な点は、金融セクターの問題を解決するためには 5 つの要素が全部必要だったことである。日本の初期段階においては、標準的な財政政策や政治的に都合の良い融資支援策が試みられたに過ぎない。第 2 段階もほぼ同様であったが、セーフティ･ネットと経済戦略の面ではある程度の進歩が始まった。1997 年の金融危機発生以降、経済戦略は(実行に移せるかどうかは別として)より明確になり、セーフティ･ネットは拡大した。資本注入も始まったが、主な効果は回復ではなく安定であった。国民の支持と厳格な資産査定が加わった 2002-04 年の段階になってはじめて、プログラムは完成した。

2008 年の日本：後戻り

日本の金融改革の歴史には、他国にとって学ぶべき教訓が多い。不運なことに、日本は教訓をすでに忘れたとみられる。2005 年の選挙で小泉政権が大勝を収め、与党・自民党はその勝利を依然として利用しているにもかかわらず、小泉政権時代の経済戦略は自民党によって切り捨てられた。さらに、依然不安定な二大政党は、経済戦略の提案を行っていない。政権交代が実現した場合でも、安定した経済戦略の不在が修正される可能性は低いとみられる。したがって、金融システム危機克服に必要な最初の条件は揃っていないといえる。

日本のセーフティ･ネットは依然として強く、広範な預金保険と著しく低い金利を伴っている。しかしながら、一層のセーフティ･ネット拡大に内在するモラルハザードの論点は、支援拡大の要求にかき消されている。

日本は自己の成功モデルを忘れ、自家製の景気後退に戻りつつある

資本注入は再び議論の対象となっているが、国会での議論は次の総選挙(期限は 2009 年秋)を控えた政治家の駆け引きによって空回りしている。どの地方金融機関をいかなる条件で支援対象とするかについては、明確な戦略は存在しない。

麻生政権に対する国民の支持は低下しているが、野党への支持も特段高くない。民主党は明確なマニフェストをもっておらず、このことが政策に関する有権者の信頼確立に向けた試みを阻害している。個々の政党の問題以外にも、国を引っ張る政治家、官僚、企業リーダーに対する国民の信頼は依然として低い。

最後に、金融機関、特に地方銀行においては、厳格な資産査定から若干距離を置く姿勢が見られる。

これらの事実に照らすと、日本の金融改革モデルを見直す必要があるのは諸外国だけではないといえる。

図表 A1

日本の金融改革に関する著者の論文の一部、1998-2008 年

ヘッドライン	日付		内容
「貧しきリチャード」と構造改革	5/27/1998	モルガン･スタンレー　経済改革	なぜ一連の小さな改革の成果が現れないのか
米国上院の財政委員会における証言	7/14/1998	モルガン･スタンレー　経済改革	米国上院財政委員会で行った証言
Creative Destruction: Japan's Only Hope	8/26/1998	モルガン･スタンレー　経済改革	Why structural reform and financial sector reform are inseparable
痛みを公平に分かち合う	6/8/1999	モルガン･スタンレー　経済改革	なぜ国民の支援が財政政策に必要なのか
欧州が日本から学べること	5/23/2006	モルガン･スタンレー　経済改革	日本の復活までを再検証
ポーゼン氏の日本経済再建案には賛否両論	9/21/1998	モルガン･スタンレー　財政/金融政策	なぜ財政政策だけで救済できないのか
リストラから生まれるマクロ経済のジレンマ	4/8/1999	モルガン･スタンレー　財政/金融政策	バランスシートとマクロ経済的な影響とのジレンマ
経済成長で不良債権問題は解決できない	10/16/2001	モルガン･スタンレー　財政/金融政策	バランスシートとマクロ経済的な影響とのジレンマ
頑固な新聞界の名士達	11/19/2001	モルガン･スタンレー　財政/金融政策	マネタリズムは金融システム問題には適応しないモデル
連銀の誤診	8/9/2002	モルガン･スタンレー　財政/金融政策	誤ったモデルからは誤った結論を導く
発表資料、財政と金融の在り方に関する協議会	1/16/1998	モルガン･スタンレー　規制政策	ワーキング･グループ向けの資料
William Seidman's Seven Deadly Sins	12/8/1998	モルガン･スタンレー　規制政策	Write-up of Tokyo speech by L. William Seidman
シードマン氏、7つの大罪について語る	12/9/1998	モルガン･スタンレー　規制政策	L・ウィリアム・シードマン氏による講演
Three Roles, No Actors	3/29/2001	モルガン･スタンレー　規制政策	How politics, macro, and micro reform must work together
「厳格化」の意味	4/2/2002	モルガン･スタンレー　規制政策	資本不足へのボトムアップ型計算法
夜明け到来	10/1/2002	モルガン･スタンレー　規制政策	金融システム問題への小泉首相の本気の取り組み
A Hint from Nietzche	12/15/2006	モルガン･スタンレー　規制政策	金融庁主催コンファレンスにて使用した資料より
金融監督の再考	1/11/2007	モルガン･スタンレー　規制政策	金融改革に向けた新たなステップ
日本の金融市場の競争力: 具体案	2/14/2007	モルガン･スタンレー　規制政策	金融改革に取り組む具体案
Financial System Reform: Lessons from Japan	10/15/2008	モルガン･スタンレー　規制政策	Retrospective on financial reforms
リストラ ― 長い道のり	3/24/1999	モルガン･スタンレー　企業改革	バランスシートからのリストラへの対処法
資産収益率の上昇が必要	4/23/1999	モルガン･スタンレー　企業改革	企業改革には長期間必要
過剰資本ストック - 程度と影響	1/26/2000	モルガン･スタンレー　企業改革	バランスシートからのリストラへの対処法
日本のリストラは何合目か	8/31/2000	モルガン･スタンレー　企業改革	バランスシートからのリストラへの対処法
資本不足	7/10/2001	モルガン･スタンレー　企業改革	バランスシートからのリストラへの対処法
日本の資本不足問題小史	10/25/2001	モルガン･スタンレー　企業改革	バランスシートからのリストラへの対処法
経済産業省の隠れ強硬路線	10/24/2002	モルガン･スタンレー　企業改革	企業に対する再建強攻策の開始
産業再生機構の真の実力	2/21/2003	モルガン･スタンレー　企業改革	企業改革の促進
市場の失敗、政府の失敗、再生機構	4/25/2003	モルガン･スタンレー　企業改革	"市場 vs. 政府" の誤った相違点
IRCJの再生候補	5/3/2003	モルガン･スタンレー　企業改革	IRCJの再生候補になりうる企業
産業再生機構: 日本に関する楽観論のもう1つの理由	3/22/2004	モルガン･スタンレー　企業改革	企業の再生計画が改善されていく理由
経産省、財務省、法務省は会社再編促進で足並み	12/22/2004	モルガン･スタンレー　企業改革	新しい会社法現代化法案

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Preliminary Draft

"Future of the Financial Supervision and Regulation after Lehman Shock"
AECF/KIF Conference on "Financial Regulation after the Financial Crisis

October 22, 2009

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1. Introduction and the Summary

In the past, a financial crisis is often generated by the following three factors: excessively easy monetary policy, financial deregulations, and tax distortions. This mixture of factors tends to create speculative bubbles in real estate and financial markets. Japanese financial crisis was caused by these factors due to real-estate bubble in the 1980s. This time, the same mixture of factors created a big bubble in US residential real estate market. The Fed kept real interest rates at a very low level in the early 2000s in the face of real-estate boom and financial deregulations allowed very high leverages in securitization and derivative markets. Tax incentives induced consumers to spend equity in their residential real estates. This environment created twin bubbles; sub-prime mortgage market and derivatives market including CDS. The risky assets are distributed globally through the increasingly integrated financial markets.

This financial crisis emerged in weak links of the market by the spring of 2007 but the real crisis was triggered by the failure of Lehman Brothers on September 15, 2008. US government made a big mistake by allowing a systemically important financial institution to file a protection under Chapter 11 of US bankruptcy law. The unexpected failure of fourth largest investment bank created a chaos in the world financial markets. The failure of AIG, a giant AA rated US insurance company, on the next day due to its excessive risk taking in the CDS market exacerbated the crisis. These events started a genuine credit crunch in US and European financial markets. From the view point of Tokyo, this was a déjà vu of Japanese financial crisis in 1997

triggered by the failure of two security companies and one major bank.

Rapid response by major countries including capital injections to financial institutions, expansion of deposit insurance system and public lending activities stabilized financial market. Almost global zero-interest policy and expansionary fiscal policy limited the downward spiral of expenditures.

In order to reduce the risk of future financial crisis, it is necessary to rectify the causes of speculative bubbles. The conduct of monetary policy should pay attention to the asset price movements including real estates, stock prices, and prices of credit risks. Financial regulations should be adjusted to avoid excessive levels of leverages. Rules on consolidation should be tightened. Valuation of OTC derivatives should be made symmetric between two counterparties; the value of winning side and losing side should add to zero. Executive compensation should be decided by shareholders meetings. The corporate board should not be allowed to decide its own compensation.

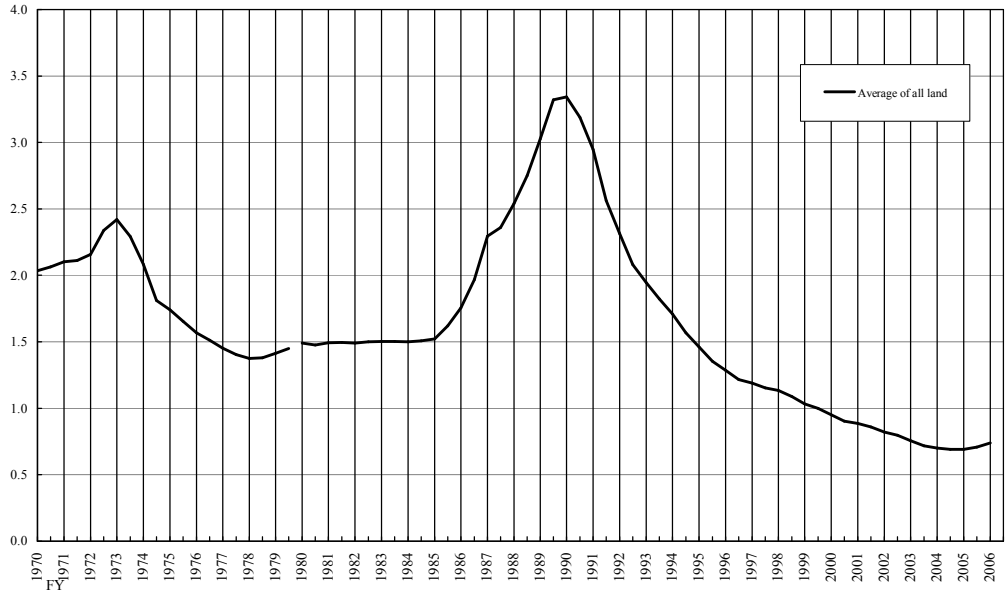
2. Origin of the Financial Crisis

The current world financial crisis initially started in the sub-prime housing loan market in the United States. The excessive credit expansion in the US mortgage market is fueled by the speculative bubble in the housing prices between 2000 and 2007. Japanese financial crisis in the late 1990s is also caused by the speculative bubble in the real estate and stock market in the 1980. In order to find the common factors in these speculative bubbles, let me describe the origin of the Japanese bubble economy in the 1980.

Chart 1

Urban Land Price Index

(Divided by nominal GDP index; times; semi-annual)

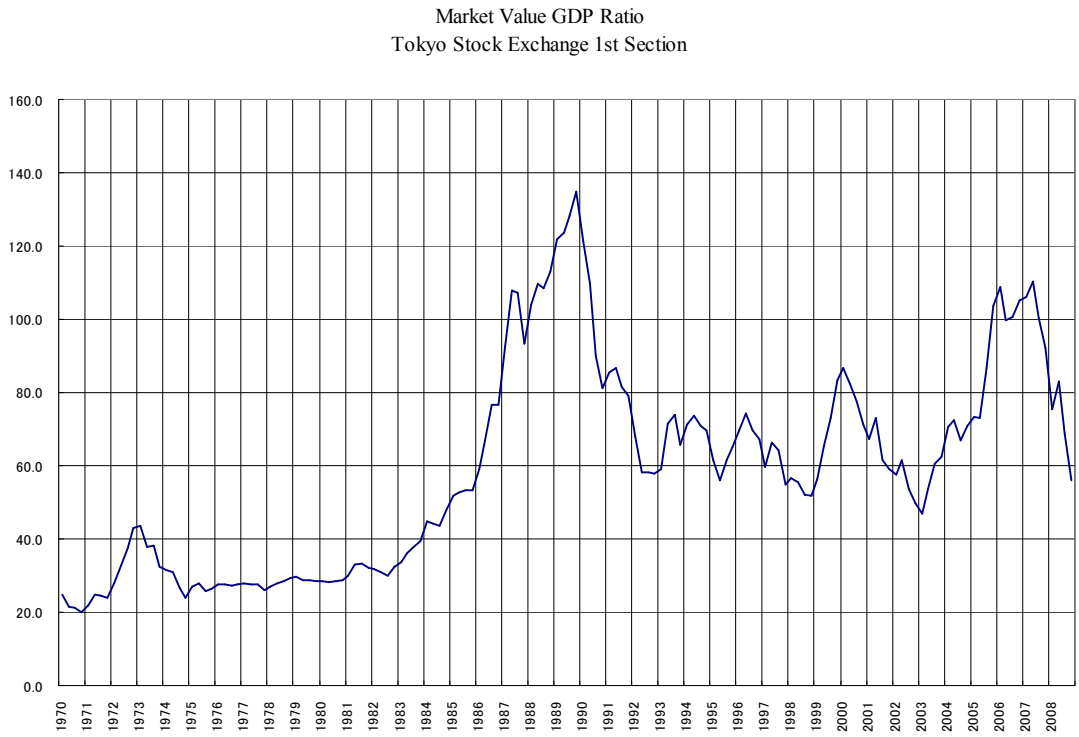


Notes: 1. Urban Land price index (6 large urban areas, second half of fiscal 1999 <end of Mar. 2000>=100) / Nominal GDP index (second half of fiscal 2000=100)
2. Data until second half of fiscal 1979 = 68SNA basis
Data from first half of fiscal 1980 = 93SNA basis

Data source: Japan Real Estate Institute.

The market value of the Tokyo Stock Exchange 1st section as a ratio to nominal GDP had been staying between 20 to 40 percent range from early 1950s to early 1980s. However, the stock prices started to rise in the mid 1980s and reached 150 percent by the end of 1989. After the crush of the bubble, this ratio fell to about 50-70 percent range. In relation to nominal GDP, the residential land price almost doubled in the second half of 1980s and the commercial land price tripled in the same period. After the bubble, the fall of commercial land price index is extremely sharp, falling to only 20 percent of the peak level relative to nominal GDP.

Chart 2



Data source: Nikkei Inc. web site.

The asset price bubble has been often created by the following three factors; loose monetary policy, tax distortions, and financial deregulations.[1] In countries where these three factors were in place, asset price inflation was often observed. In this respect, Japanese case was not an abnormal phenomenon. However, the magnitude of the asset price bubble in Japan was enormous and impact of its collapse was extremely severe.

(1) Easy Money Policy

Japanese monetary policy in the late 1980s was clearly too loose. Policy makers put too much weight on stabilizing the appreciating yen and too little weight on stabilizing the asset price bubble and the overheating economy. The Bank of Japan tried to tighten monetary policy in the late 1987 so as to counter overheating economy and rising asset prices. However, the sharp fall in stock prices on Black Monday in the United States in October prevented this move. The Bank did not raise its discount rate

[1] See Shigemi (1995).

until May 1989, and failed to stop the asset price bubble at an early stage. The stock prices defied the intention of the Bank of Japan and it continued to rise until the end 1989. The land prices hit its peak in early 1990. If the Bank had acted in late 1987, it could have alleviated the severity of asset price deflation in the 1990.

(2) Tax distortions

Japanese tax system favored debt financed real-estate investment until the end of the bubble. Since tax distortions related to real-estate investment are extensive only major factors are illustrated.

(i) Marginal rate of inheritance tax has been very high in Japan. It was 75 percent over 500 million yen until 1988 and it is still 70 percent over 2 billion yen. However, the evaluation of land for taxation used to be about one half of the market value and the debt was evaluated at its face value during the bubble period. As a result, wealthy individuals borrowed money to buy land so as to reduce the inheritance tax.

(ii) Capital gain on land is not taxed until the time of its sales and the interest rate payments can be deducted from taxable income for companies and for those individuals who are investing in condominiums and offices. Moreover, the effective property tax rate on land was very low, about 0.1 percent of the market value, until early 1990s. As a result, a large number of real estate investments were carried out for tax planning purposes.

(3) Financial deregulations.

Financial system in Japan was liberalized very gradually. Driving forces behind this liberalization process were the massive issuance of government bonds in the late 1970s and the increasing internationalization of financial markets. Ceilings on bank deposit interest rates were liberalized gradually from large-denomination to smaller ones from 1985 to 1994. Restrictions on the issuance of corporate bonds were gradually liberalized during 1980s. As a result, large listed companies, which are traditional customers of Japanese banks, gradually shifted their funding from banks to capital market. Banks faced a prospect of profit squeeze due to rising funding cost and declining customer base.

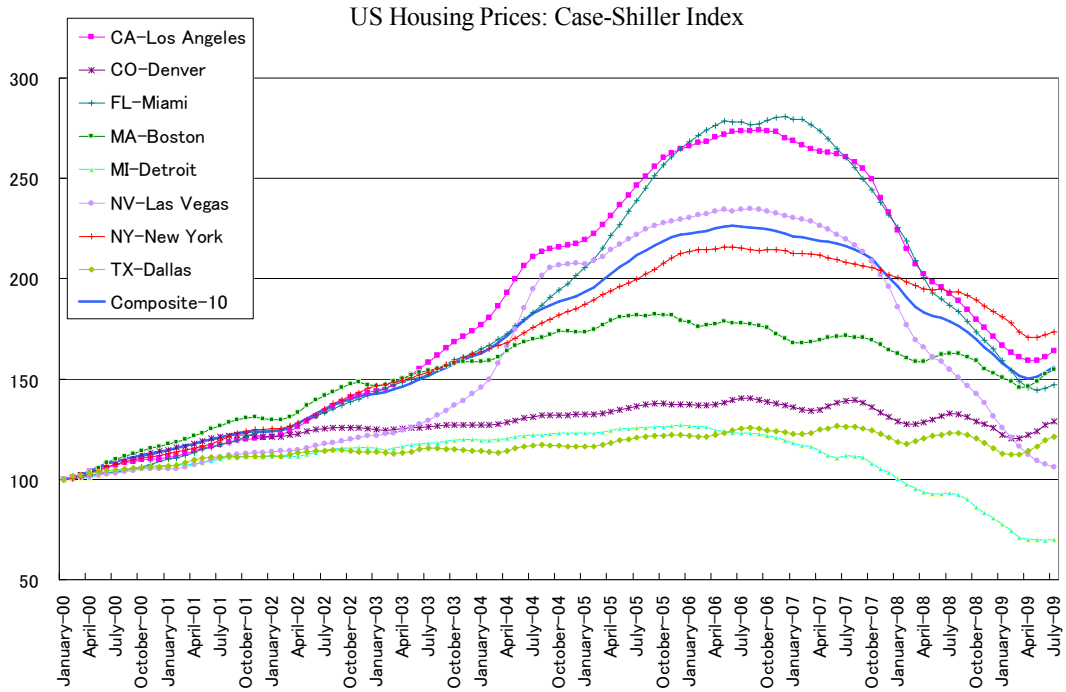
In view of the declining rent from traditional business of retail deposit taking

and commercial lending to large firms, banks tried to increase middle-market business. Most banks started to increase real estate lending. In expanding such lending, banks exclusively relied on collateral and paid little attention to cash flow of underlying business. This was because the nominal land price in Japan was on a rising trend since the end of the World War II and the pace of land-price inflation was higher than government bond interest rates on average. This land price performance created a general perception to bankers that they can always avoid loan losses so long as loans are secured by real estate. This was certainly true until the collapse of the bubble in the 1990s. Many banks solicited loans to customers by providing information on real estate investment opportunities. During the bubble period, even an ordinary salaried worker living in Tokyo could easily borrow up to 100 million yen for any purposes at long-term prime rate if his house can be used as collateral. Thus, financial liberalization created a perfect environment for asset price bubble where firms and households can easily acquire real estate with borrowed money in the 1980s.

The financial intermediation by banks expanded significantly in the 1980s. The bank lending-GDP ratio rose from 70 percent of GDP in late 1970s to 108 percent by 1990. The composition of loan portfolio of Japanese banks also changed dramatically. The share of manufacturing sector in the loan portfolio declined from 25 percent in 1977 to less than 15 percent by the end of 1980s. On the other hand, the share of loans to real estate and financing companies rose sharply in the same period. Since lending to financing companies such as Jusen (housing loan companies) is often on-lent to real estate investment, the involvement of banks in real estate related lending was very large in the 1980s.

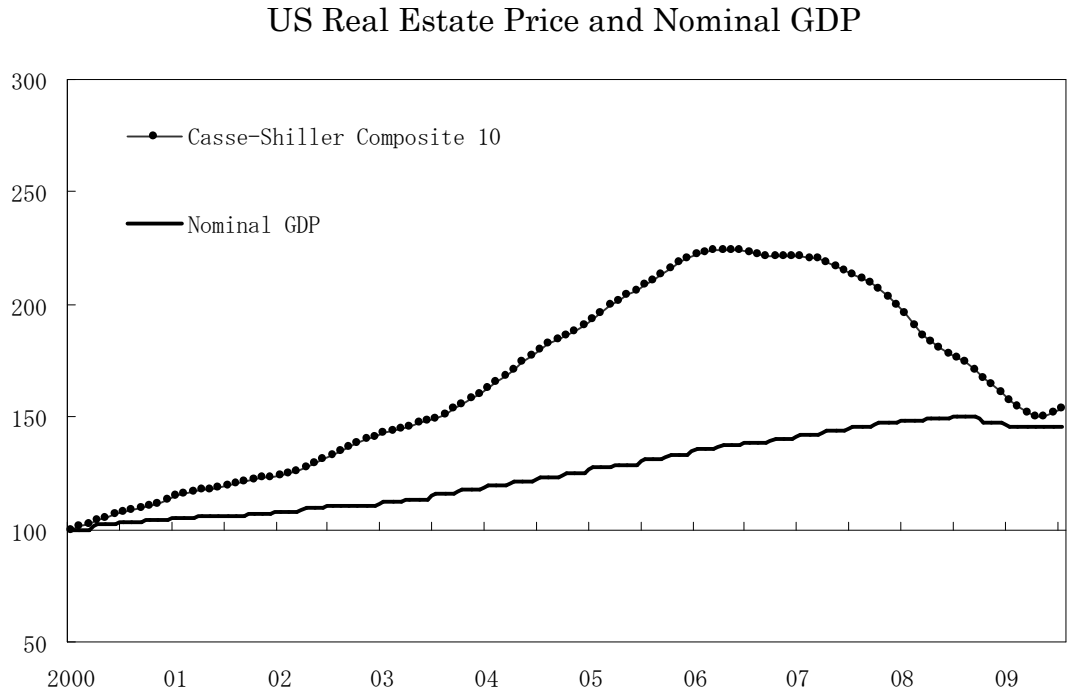
This time, the same mixture of factors created a big bubble in US residential real estate market. The Fed kept real interest rates at a very low level in the early 2000s in the face of real-estate boom and financial deregulations allowed very high leverages in securitization and derivative markets. Tax incentives induced consumers to spend equity in their residential real estates. This environment created twin bubbles; sub-prime mortgage market and derivatives market including CDS. The risky assets are distributed globally through the increasingly integrated financial markets.

Chart 3



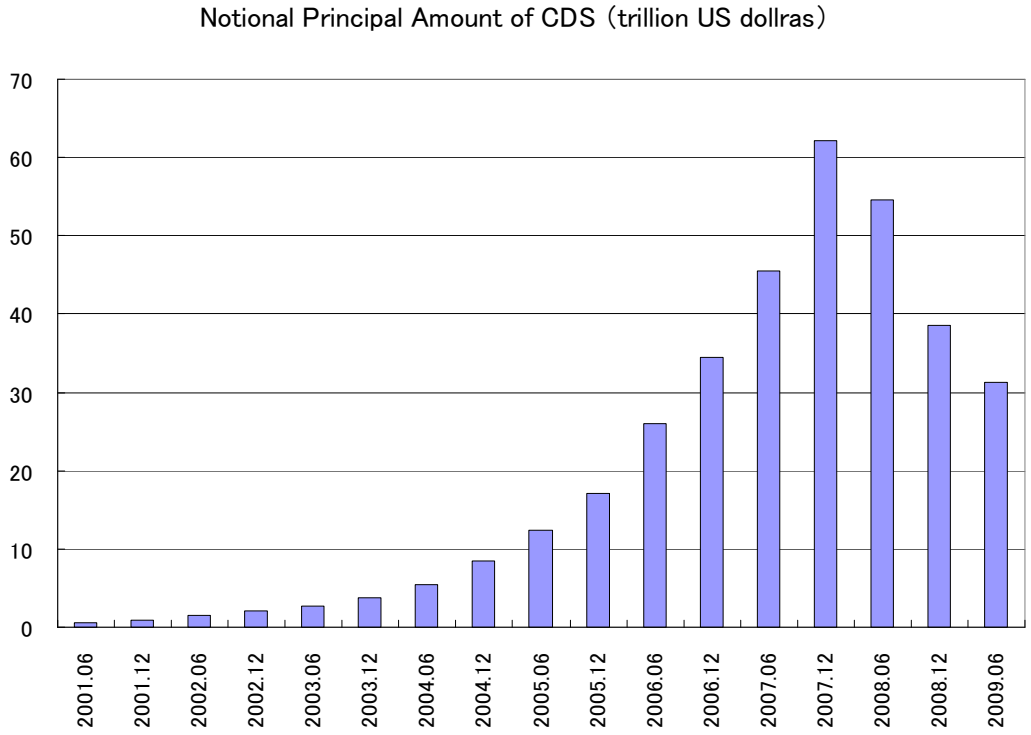
Data source: Standard & Poor's web site.

Chart 4



Data Source: Standard & Poor's web site.

Chart 5



Data source: International Swap and Derivative Association web site.

3. The Financial Crisis in Japan

This financial crisis emerged in weak links of the market by the spring of 2007 but the real crisis was triggered by the failure of Lehman Brothers on September 15, 2008. US government made a big mistake by allowing a systemically important financial institution to file a protection under Chapter 11 of US bankruptcy law. The unexpected failure of fourth largest investment bank created a chaos in the world financial markets. The failure of AIG, a giant AA rated US insurance company, on the next day due to its excessive risk taking in the CDS market exacerbated the crisis. These events started a genuine credit crunch in US and European financial markets. From the view point of Tokyo, this was a déjà vu of Japanese financial crisis in 1997 triggered by the failure of two security companies and one major bank.

In November 1997, the failure of Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities sharply increased financial instability. These events generated a severe credit crunch in the Japanese financial market, inducing an extremely serious recession. Then what has caused this enormous problem for Japan?

In my opinion, there are two factors behind this financial crisis.

One is the crash of the stock and real estate market bubble in the 1990s. The second is the lost confidence in the accounting and auditing system in Japan. We note that the actual amount of bad loans discovered at failed financial institutions has been far larger than the amount published prior to the failure. The Hokkaido Takushoku Bank was forced into bankruptcy even though it posted profits and paid dividends for the year to March 1997. Financial statements for that year reported Yen 0.3 trillion in capital; inspections after the failure found a negative equity of Yen 1.2 trillion as of March 31, 1998. This indicates a window-dressing of almost Yen 1.5 trillion.

Likewise, Yamaichi Securities was hiding Yen 260 billion of losses on securities investments--worth more than one-half of its equity capital--which neither Ministry of Finance inspections nor Bank of Japan examinations were reportedly able to uncover.

Depositors and investors of bank debentures issued by long-term credit banks imposed some market discipline. Deposits flew out of banks with low credit ratings because depositors feared that they would not be able to withdraw deposit quickly if their banks were closed. Long-Term Credit Bank of Japan and Nippon Credit Banks faced a rapid early redemption of their debentures because debentures are not covered deposit insurance system explicitly. Stock prices of weaker banks fell sharply and triggered mild bank runs in some cases.

These financial-institution failures have exacerbated suspicions both at home and abroad regarding the financial statements and regulatory supervision of Japanese financial institutions. It was this mistrust of financial statements that widened the "Japan premium" charged in overseas markets, blocked the domestic call market (which is used for short-term inter-bank loans), and multiplied the number of cash-pressed financial institutions turning to the Bank of Japan for loans. Japanese financial markets clearly experienced a kind of credit crunch because of a rash of failures, declining asset prices, and growing mistrust of financial statements and regulators. This credit crunch in turn cut into corporate investment and hiring, increased bankruptcy rates, and reduced consumption and housing investments because workers feared for losing their jobs. That resulted in a further contraction of credit in what became a vicious cycle. In other words, unreliable financial statements had proved a serious impediment to the functioning of a market economy.

The contraction was somewhat abated by the Emergency Economic Package announced by the Liberal Democratic Party and Ministry of Finance at the end of 1997. The government prepared Yen 13 trillion for the capital injection to solvent banks and Yen 17 trillion for the protection depositors of failed banks. The Ministry of Finance should have used the fund effectively: by forcing banks to write off all the bad loans, the financial institutions and the financial oversight by the government could have regained the public confidence. However, most of the money was left unused. Only Yen 1.8 trillion of Yen 13 trillion was thinly injected to 21 large banks at the end of March 1998 without any complete examination or comprehensive cleanup of bank balance sheets.

The failure of the capital injection became apparent only a few months later. In the summer of 1998, the stock price of Long-Term Credit Bank of Japan (LTCB) fell sharply when Sumitomo Trust and Banking effectively refused the merger with LTCB. LTCB was a big bank with Yen 26.2 trillion of asset at the end of March 1998. In October 1998, just before the Long Term Credit Bank of Japan went bankrupt, Financial Revitalization Act and Bank Recapitalization Act were enacted in disorderly atmosphere. This time, the government prepared Yen 60 trillion, about 12 percent of GDP: Yen 25 trillion for the capital injection into solvent banks under Bank Recapitalization Act, Yen 18 trillion for the resolution of failing banks under Financial Revitalization Act such as the capital injection into rescue banks, bridge banks, and the disposition of bad loans, and Yen 17 trillion for the protection of depositors by Deposit Insurance Corporation.

Table 1

Capital in the Japanse banking sector

(trillion yen)

	Market value of shares held by banks A	Book value of shares held by banks B	Capital account (Core capital) C	Deferred tax asset D	Estimated Under-reserving E	Equity capital held by the government F	Net capital Account C+(A-B)×0.6-D-E-F	Nikkei225 Index
Mar-91	77.7	33.1	30.2	0.0	NA	0.0	57.0	26292
Mar-92	56.4	34.5	31.3	0.0	NA	0.0	44.4	19346
Mar-93	56.4	34.5	31.8	0.0	NA	0.0	44.9	18591
Mar-94	61.9	36.5	32.3	0.0	NA	0.0	47.5	19112
Mar-95	52.0	39.8	32.3	0.0	NA	0.0	39.6	15140
Mar-96	64.3	43.0	27.9	0.0	NA	0.0	40.7	21407
Mar-97	54.1	42.9	28.5	0.0	15.0	0.0	20.2	18003
Mar-98	50.8	45.7	24.3	0.0	4.9	0.3	22.2	16527
Mar-99	47.1	42.7	33.7	8.4	4.0	6.3	17.7	15837
Mar-00	54.5	44.4	35.6	8.2	5.8	6.9	20.8	20337
Mar-01	44.5	44.3	37.6	7.1	7.5	7.1	16.0	13000
Mar-02	34.4	34.4	30.2	10.6	6.8	7.2	5.6	11025
Mar-03	23.2	23.2	24.8	10.6	5.4	7.3	1.5	7973
Mar-04	28.5	28.5	29.0	7.2	5.7	8.9	7.2	11715
Mar-05	27.7	27.7	31.4	5.7	6.9	8.1	10.8	11688
Mar-06	33.2	33.2	37.3	2.3	8.3	5.2	21.5	17059
Mar-07	33.9	33.9	39.7	1.3	9.3	3.5	25.7	17287
Mar-08	25.6	25.6	34.8	3.6	10.2	3.1	17.9	12525
Mar-09	18.4	18.4	29.0	5.1	10.2	2.5	11.2	8109

Source of data: Federation of Bankers Associations of Japan, "Analysis of Bank Financial Statements," various issues.

Note: The table represents the banking accounts of all banks in Japan.
Estimated required loan loss reserves is defined as follows:
1% of category I loan + 20% of category II loan + 70% of category III +100% of category IV loan
Since FSA terminated to disclose classified loan figures from March 2003, the classified loan figures and the required loan loss reserves were estimated from the disclosed bad loan figures.

Prepared by the author with Japan Center for Economic Research (2009).

Under Financial Revitalization Act, LTCB and Nippon Credit Bank were nationalized in October and December 1998. Under Bank Recapitalization Act, Yen 7.5 trillion of capital was injected to 15 major banks at the end of March 1999. Unlike the former attempt, this program was much better designed, succeeding to eliminate persistent Japan premium that started in late 1997. The gradual recovery of the Japanese economy and the announcements of big mergers among major banks have also contributed to calm the public concern over the financial system.

In May 2000, Deposit Insurance Law was amended so as to prepare the permanent resolution scheme for failing banks because Financial Revitalization Act and Bank Recapitalization Act will expire at the end of March 2001. In this amendment, bridge bank scheme and a procedure of systemic exception from the minimum cost principle became a permanent feature of the system. The introduction of the application of Yen 10 million cap on the deposit insurance coverage was postponed for one year from the end of March 2001. Moreover, the full protection of liquid deposits was extended until the end of March 2003. Yen 10 trillion was added to the Yen 17 trillion fund for the protection of depositors.

Table 2

Profitability of Japanese Banking Sector

Trillion yen

Financial Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Lending Margin (A)	7.1	8.9	9.8	9.2	9.7	10.8	10.7	10.0	9.6	9.7	9.4	9.8	9.4	9.0	8.7	8.7	8.5	8.6	8.7
Other Revenue (B)	2.6	2.2	2.5	2.8	2.1	3.3	3.7	3.6	3.1	2.5	3.0	3.1	3.6	4.3	4.6	5.2	4.3	3.4	2.7
Operating Costs (C)	7.1	7.5	7.7	7.7	7.8	7.8	8.0	8.0	7.5	7.3	7.1	7.0	7.0	6.7	6.4	6.5	6.5	6.7	6.9
Salaries and Wages	3.7	3.9	4.0	4.0	4.0	4.0	4.0	4.0	3.6	3.5	3.4	3.2	2.8	3.1	2.8	2.8	2.6	2.7	2.9
Gross Profit (D)=(A)+(B)-(C)	2.6	3.5	4.5	4.3	4.0	6.3	6.4	5.6	5.2	4.9	5.3	5.9	6.0	6.6	6.9	7.4	6.2	5.3	4.5
Loan Loss (E)	0.8	1.0	2.0	4.6	6.2	13.3	7.3	13.5	13.5	6.3	6.6	9.4	7.0	6.1	4.2	2.0	1.7	2.0	3.6
Net Operating Profit (F)=(D)-(E)	1.8	2.5	2.5	-0.4	-2.2	-7.0	-1.0	-7.9	-8.3	-1.4	-1.3	-3.5	-1.0	0.5	2.7	5.4	4.5	3.3	0.9
Realized Capital Gains (G)	2.0	0.7	0.0	2.0	3.2	4.4	1.2	3.6	1.4	3.8	1.4	-2.4	-4.1	0.6	-0.1	0.5	0.2	0.1	-1.9
Net Profit (F)+(G)	3.8	3.3	2.5	1.7	1.0	-2.6	0.2	-4.2	-6.9	2.3	0.1	-5.9	-5.1	1.1	2.6	5.9	4.7	3.4	-1.0
Asset	927.6	914.4	859.5	849.8	845.0	847.1	858.4	845.0	762.5	741.9	806.0	772.1	739.0	750.0	748.3	770.2	764.5	782.0	806.9
Outstanding loans	522.0	537.0	542.4	539.1	538.5	553.6	563.3	536.4	492.4	475.9	474.1	464.5	435.0	422.5	414.0	428.1	435.9	446.0	466.0

Note: Financial Statement of All Commercial Banks.
Other revenue (B) includes all the other profit such as dealing profits and fees but excludes realized capital gains of stocks and real estates.
Realized capital gains includes gains of stocks and real estates.
Source: Japan Center for Economic Research (2009)

4. Financial Crisis in the United States

In the current financial crisis, major US investment banks were hit hardest by the turmoil in the securitized mortgage markets. Several reasons were documented in most analyses of the current crisis:

(1) SEC weakened capital requirements on five major investment banks in 2004. SEC replaced traditional hair-cut rules with VAR based capital requirements.

(2) Increasing highly leveraged investment strategies with derivatives and securitization. Increasing popularity of CDS (Credit Default Swaps) and securitization of sub-prime loans with SPCs and SPVs

(3) Increasing use of prime brokerage service of investment banks by hedge funds. In this service, investment banks could use deposited assets of its customers to raise their funds. As a result, customers' assets are not separated form its own assets. In the case of Lehman Brothers, customers could not recover their deposited securities after the failure.

In my view, the mismanagement of Lehman failure by the US government and the Fed exacerbated the crisis. After rescuing Bear Sterns, the fifth largest investment bank, in March 2008 with public money of the Fed, the government allowed Lehman Brothers, the fourth largest, to file Chapter 11 in September of the same year. This failure was unexpected in the financial market and shook public confidence in major financial institutions. Moreover, the value of Lehman senior debt fell to only 9 cents for 1 dollar in about one month after the failure. This extremely low market value for a supposedly liquid security company was very shocking for many observers.

Table 3

Timeline of the Global Financial Crisis

June 2007: Two hedge funds of the Bear Stearns announced big losses due to their extensive investments in mortgage-backed securities.

October 2007: A number of US financial institutions, including City group, reports large amounts of heavy losses.

January 2008: The Bank of America acquires Countrywide Financial in a deal that rescues the country's biggest mortgage lender.

February 2008: The U.S. Congress approves a 150-billion-dollar spending package to stimulate the economy.

March 2008: Struggling Bear Stearns is sold at the fire-sale price of 236 million dollars to JP Morgan Chase, in a deal engineered by the Federal Reserve.

September 7, 2008: The US Treasury takes over Freddie Mac and Fannie Mae and injects capital to stabilize the two pillars of US mortgage market.

September 15, 2008:
- Lehman Brothers files for bankruptcy protection after the US government refuses to bail it out.
- Merrill Lynch hastily arranges to be swallowed up by Bank of America for 50 billion dollars.
- Credit rating agencies downgrade the debt of American International Group (AIG),

September 16, 2008:
- The US government rescued AIG with an 85-billion-dollar loan.
- The Reserve Primary Fund, a $64 billion money market fund, and two smaller, related funds, revealed that they would pay investors no more than 97 cents on the dollar because it had bought Lehman commercial paper.

September 17, 2008:
- The Securities and Exchange Commission (SEC) baned some short selling of financial shares.
- The credit markets had almost completely frozen up. Yields on short-term Treasury bills dropped close to zero. Morgan Stanley contacted Mitsubishi UFJ, Japan's biggest lender, hoping to raise additional capital.

September 19, 2008: US government announced a broad-based, 700-billion-dollar financial rescue plan.

October 3, 2008: The House of Representatives gave final approval on Friday to the $700 billion bailout for the financial system.

October 10, 2008: G7 Finance Ministers and Central Bank Governors announced an action plan.

October 14, 2008: US Treasury announced to inject 250-billion-dollar capital to nine major US financial institutions.

December 16, 2008: Fed reduced target federal fund rate to 0-0.25 percent range.

Note: Based on New York Times and other news papers.

The bankruptcy of Lehman Brothers induced the following reaction in other important markets.

(1) Several MMFs could not maintain par-value due to losses of Lehman CPs. As a result, money moved from MMFs to other more secure assets such as TBs.

(2) Many funds withdrew assets from their prime broker investment banks such as Morgan Stanley. This was very similar to bank runs.

(3) Lehman Japan failed to deliver government bonds to its counter parties in their repo transactions. Scared Japanese financial institutions stopped repo transactions with most foreign financial institutions. As a result, foreign financial institutions could not raise funds even with JGB collateral.

On the next day of Lehman failure, AIG (American International Group), the biggest US insurance company, faced a severe liquidity problem and asked the Fed and the US government for help. AIG was one of Forbs top ten US companies in 2007 and maintained AA rating. Its CPs kept the highest credit rating until this turmoil. AIG's near collapse was trigged by its derivative unit in London, AIG Financial Products. AIG financial products sold a massive amount of CDS protection and reported big profits for the group. However, as the housing bubble collapsed, some of the sub-prime related CDS protection went sour and AIG's credit rating was down graded. This triggered a collateral requirements for its CDS liabilities to its counterparties. AIG asked the government to lend them a massive amount of cash that can function as collateral for its CDS transactions.

AIG sold a massive amount of CDS protection on bond with high credit ratings and reported massive profit before the crisis. Because AIG sold protection on senior ABS of sub-prime loans, it incurred heavy losses after the sub-prime loan problem became serious. In effect, AIG underestimated the future cost of sold CDS protections. Theoretically speaking, the NPV of CDS fees is equal to the NPV of CDS protection cost. Therefore, AIG should have kept most of the CDS fees as reserves against the future cost. However, AIG recognized most of the fees as profit.

This AIG episode also indicates that profits on derivative transactions may be overstated on the financial statements of many market players. If all the derivative

transactions are evaluated by the unified evaluation scheme, all the NPVs of derivative transactions should add to zero because derivative transactions are a zero-sum game:

CDS protection seller's profit/loss + CDS protection buyer's profit/loss = 0

AIG case implies that the aggregated value of CDS positions of all the market participants may be positive rather than zero.

Warren Buffett, the chairman of Berkshire Hathaway, pointed out this problem in early 2003.[2] Berkshire Hathaway bought General Re, a reinsurance company. This company had a derivative subsidiary, General Re Securities. In the unwinding process of General Re securities, Buffett found large undervaluation of derivative liabilities and overvaluation of derivative assets. By the time Buffett found out these hidden losses, CEOs and traders of General Re Securities have left the company after getting bonuses. Buffett pointed out that the valuation of derivative portfolio is not market based but model based. These models can be easily manipulated to show profit in the short run. Therefore, Buffett wrote "In extreme cases, mark-to-model degenerates into what I would call mark-to-myth."

5. Similarity of Japanese and the Global financial Crisis

From the above accounts of Japanese and US financial crises in section 3 and 4, it would be clear that these crises are very similar each other. First factor is the lost confidence in the soundness in major financial institutions. In Japan, the public confidence in the financial institutions evaporated in the face of the successive failures of Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities in the fall of 1997. In the United States, the successive failures of Lehman Brothers and AIG in September 2008 created a similar environment.

The causes of failures of major financial institutions were also similar. In Japan, real estate loans of banks and hidden losses in forward security transactions of Yamaichi Securities. Large losses were hidden in unconsolidated subsidiaries of failed banks. In the United States, losses in securitized sub-prime mortgages, hidden losses in CDS transactions and unconsolidated SPVs caused failures.

Policy reactions were also similar: Repeated capital injections to major

[2] See Warren Buffet (2003)

financial institutions, mergers of large financial institutions, expansion of deposit insurance coverage, increased lending by central banks and government financial institutions.

Rapid response by major countries including capital injections to financial institutions, expansion of deposit insurance system and public lending activities stabilized financial market. Almost global zero-interest policy and expansionary fiscal policy limited the downward spiral of expenditures.

6. Conclusions

In this concluding section, I would like to propose some reforms to make future financial crisis less likely.

Firstly, it is necessary to change the conduct of monetary policy. Although core consumer price inflation should be the main target of monetary policy, central banks should pay attention to asset price movements including real estates, stock prices, and prices of credit risks. One way to achieve this dual target policy with one instrument, policy interest rate, is to use the room for maneuver of monetary policy under an inflation band target. If the target inflation band is between 2 to 4 percent of core CPI, a central bank can use its room for maneuver of 2 points to try to stabilize asset prices. Since inflation objective is the primary target, a central bank has to achieve inflation band and it would be impossible to fully stabilize asset prices. However, if asset prices are excessively high or are rising too fast, this central bank should hit the lower bound of inflation target, 2 percent. If asset prices are excessively low or are falling too rapidly, this central bank should hit the upper bound, 4 percent.[3]

Secondly, in order to regain confidence of the public in the soundness of financial institutions, the cause of the very high loss-ratio (91%) of Lehman Brothers debt should be investigated and the result should be released to the public.[4] Some of the loss-ratios (=estimated negative equity/gross debt before the failure) of failed Japanese financial institutions are as follows:

Yamaichi Securities: 3% loss rate

[3] I am advocating to set a lexicographic utility function for central banks.
[4] The value of senior debt of Lehman Brothers at the auction for the settlements of CDS transactions linked to the Lehman failure.

Kizu Credit Union: 77% (the worst loss-ratio case in Japan.)
Nippon Saiken Shinyo Bank: 29% loss rate
Long-term credit bank of Japan: 12% loss rate.

These ratios are estimated by the Japanese Deposit Insurance Corporation of subsidies to the failed deposit-taking financial institutions and the loss incurred by the Bank of Japan to protect all creditors of Yamaichi Securities. Compared with the loss ratio of Japanese institutions, Lehman's loss rate is extremely high. The governments of major countries should establish a high degree of transparency on the financial statement of major financial institutions. In doing so, full consolidation of all the related parties that a vital for the reputation of the group should be carried out.

Thirdly, financial regulations should be adjusted to avoid excessive levels of leverages. The practice of primary brokerage should be banned and the customers' assets should be strictly separated from those of security companies.

Fourthly, the valuation of OTC derivatives should be made symmetric between two counterparties; the value of winning side and losing side should add to zero. In order to achieve this objective, the model-based values of derivative transactions should be exchanged between the counterparties periodically and they should be reconciled. If the two parties cannot agree on the values, the gaps should be disclosed for major financial institutions.

Executive compensations of listed companies should be decided by shareholders meetings not by the compensation committees. The Treasury proposal of non-binding vote on executive compensation by shareholders is not effective.[5] Since the directors of a listed companies are the agents of shareholders. It does not make sense to allow the agents to decide their own compensation.

[5] Department of The Treasury (2009, p. 73).

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Eight Lessons from Japan on Bank Recapitalization

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In the paper "Will the U.S. Bank Recapitalization Succeed? Eight Lessons from Japan," we have reviewed the Japanese responses to its financial crisis in the late 1990s and derived eight lessons. The paper is available for download at NBER (http://www.nber.org/papers/w14401) and at SSRN (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448103). Here we provide a very brief summary of our findings.

The paper points out a surprising number of other similarities between the U.S. financial crisis and the Japanese crisis a decade ago. Especially remarkable is the similarity in the variety of tools that the governments used to rehabilitate the financial system. Many of those strategies that the U.S. government has tried were also used in Japan (with mixed effectiveness) in the 1990s. For example, buying up troubled assets from the banking sector and injecting public funds into undercapitalized banks, two ideas repeatedly discussed and implemented in the U.S., were both tried in Japan. The Japanese policies were only partially successful in reviving the financial system in Japan until a more drastic set of measures was imposed to force the removal of non-performing loans from the banks' balance sheets and the economy finally started to recover in 2003.

From these overall unsuccessful attempts in Japan, we derive eight lessons. First, financial firms may refuse public funds, as we observed for the 1998 recapitalization program in Japan. In the Japanese case, the problem was solved by all major banks asking for the same amount of public funds, which turned out to be too small to resolve the capital shortage for most banks.

Many programs, including the 1998 recapitalization and many asset purchase programs, were too small. For example, the Cooperative Credit Purchasing Corporation (CCPC), the largest of all the asset management companies tried in the Japanese crisis in terms of the size of its purchase, removed only ¥15 trillion of non-performing loans during more than seven years of its existence. This number is far smaller than the total amount of loan losses that the banking sector incurred over the years between 1992 and 2003 (¥88 trillion), for example. Even the most comprehensive of the recapitalization programs, under the Prompt Recapitalization Act, injected only ¥8.7 trillion in the spring of 1999, which was about 1 percent of total bank assets (and less than 2% of total loans). Thus, the second lesson that the Japanese experience suggests is that programs of asset purchase and recapitalization must be big enough.

A third, more fundamental lesson is that buying troubled assets alone is not likely to solve the capital shortage. It is possible that a much bigger, comprehensive program might have eliminated the uncertainty of the value of assets that remained on banks' balance sheets and allowed them to find willing investors to contribute new capital. But, because none of the Japanese AMCs were designed to overpay for the bad loans, just removing some of the assets did not rebuild capital. The Japanese experience suggests that a recapitalization program is necessary in addition to an assets purchase program in order to solve the capital shortage.

Fourth, recapitalization programs must be preceded by rigorous inspection to determine the size of the problem. The 1998 recapitalization program just distributed capital to major banks without any inspections, in part to induce the banks to accept the public capital without stigma. As a result of the banks' hesitation to appear needy, the size of the program ended up too small. The 1999 recapitalization was better in that it followed inspections of those banks, but the regulators did not force the banks to clean up their non-performing loans. Instead they were allowed to operate even with huge amounts of non-performing loans on their books. The amount of non-performing loans (disclosed by banks) actually increased from ¥29.6 trillion (March 1999) to ¥42.0 trillion (March 2002), and started to decline only after rigorous inspections under the Takenaka plan introduced in the fall of 2002.

Fifth, troubled assets purchased by AMCs need to be put back into the private sector or restructured swiftly in order to prevent further deterioration of the value of those assets. Especially in early years, the Japanese AMCs were slow in selling off the loans they purchased and just functioned as warehouses of bad loans. Land prices were still falling and they presumably did not want to realize capital losses. Not until the early 2000s, did they begin attempting to restructure the loans and rehabilitate the underlying borrowers thus addressing the source of the bad loan problem.

Sixth, nationalization can be useful to wind down systemically important banks. Japan passed the Financial Revitalization Act in the fall of 1998, which gave the government a scheme to resolve failed large banks through nationalization. The scheme was applied to the Long-Term Credit Bank of Japan and Nippon Credit Bank in late 1998. It is important to note that both LTCB and NCB had international counterparties. So the winding down of these institutions was not just a purely domestic matter. As part of the nationalization, the international transactions were guaranteed and the resolution process did not create much turmoil in the financial markets.

Seventh, targeting total lending or lending to specific sectors can be counter-productive. In the recapitalization program of 1999, the Japanese government required the recapitalized banks to increase their loans to small and medium enterprises which were supposedly suffered from credit crunch. Many of those loans to small and medium enterprises, however, ended up hurting the health of the banks. As we show in the full version of our paper, the nature of non-performing loan problem changed in the early 2000s. The loans to small and medium enterprises became the central problem rather than the real estate related loans.

Finally, recapitalization was ultimately driven by macroeconomic recovery. Since macroeconomic recovery also depends on a healthy functioning of the financial system, the causality runs two ways. In the Japanese case, export expansion to large and growing economies,

especially China and the U.S., contributed to the macroeconomic recovery in the mid-2000s independent of the recovery of the financial system. To the extent that macroeconomic policy can successfully stimulate the recovery that will also help recapitalization.

In light of these lessons from Japan, how do we evaluate the U.S. responses so far? In assessing U.S. policies during the crisis it is essential to realize that there are some noteworthy respects in which the U.S. and Japanese crises differed. Most importantly, the problems in the U.S. regarding the breakdown of securitization and the collapse of the "shadow banking system" were not an issue in Japan. Hence, many of the bold and most controversial programs instituted in the U.S. have no parallels in Japan. Accordingly, we limit our evaluation to the areas where Japan's experience could be informative.

There are at least three of the eight Japanese lessons that were either not heeded or had to be relearned. Most obvious was the hesitation of the banks to admit publicly their need for government assistance. Some of the original TARP 9 institutions were adamant in their insistence that they did not need public support. Soon after receiving TARP money in October, both Citigroup and Bank of America ended up needing much more assistance. Though the case of Bank of America may be explained by surprisingly large capital shortage caused by the acquisition of Merrill Lynch, Merrill was also one of the TARP 9 and it was not transparent about its capital needs.

The initial TARP capital purchases were also done without rigorous audits and inspections. It is an interesting counter-factual to think about how the AIG, Citigroup and Bank of America bailouts would have been structured if more accurate information had been available at the time the funds were committed.

The third area where the Japanese history seems to have been ignored regards the willingness to nationalize an institution and wind it down. At least at the time of the second Citigroup intervention, the government could have tried to buy a controlling stake in the firm and pushed the company into bankruptcy. The government has discussed a longer term plan to split Citigroup into two parts. Even if this eventually happens, however, this will not force the long-term debt holders of Citigroup to bear losses, whereas a bankruptcy would have.

A major constraint on the government throughout the crisis has been the lack of a resolution procedure that could work for a complex financial holding company. To take one example, existing law makes it impossible for the government to take over a company and continue to run its swap contracts. This makes the resolution cost much higher than if the government could assume the contracts and continue making and receiving payments, rather than having to close them out. Had the U.S. tried to buy Citigroup and push it through bankruptcy using the existing law it would have been operating in uncharted territory.

In contrast, in Japan a major piece of the legislation was enacted during the crisis precisely to make it possible to fail major financial institutions. The Japanese government also used this authority in at least two very visible cases. Federal Reserve and Treasury officials have repeatedly asked Congress to pass a bill creating the authority to resolve a large, complex

financial institution. With two years having passed since the start of the crisis, the lack of any movement on this front suggests that the Japanese experience was ignored.

Ultimately, the U.S. did pursue the stress tests and the initial market reactions once the results were announced were quite favorable. It is too early to tell whether they will be deemed a long run success.

Two of the major lessons from Japan involved the use and design of asset management companies. The U.S. record in this regard is mixed. The U.S. has avoided the Japanese mistake of trying to do small asset purchases to solve a serious capital shortage problem.

The ambiguity comes because even though essentially no money has been spent, the U.S. government has spent a lot time trying to design asset purchase plans and made various public announcements suggesting that asset purchases were impending. The two publicly discussed cases involve the original TARP plan, which was abandoned, and the PPIP which has been very slow to start and appears destined to be only a small part of the overall U.S. spending on the crisis. In addition, many press reports suggest that during the period between President Obama's election and his inauguration, considerable planning to create an aggregator bank was undertaken.

These efforts have been costly in tying up Treasury and Federal Reserve staff and management on programs which were not critical. More importantly, they have created some confusion with the public and politicians over the intended government response. The various stops and starts have left doubts about the government's commitment to remove non-performing assets from the financial system. This in turn has left doubts about why so much emphasis was placed on asset purchases if they are not needed.

In the meantime, the troubled assets still remain on most institutions' balance sheets. This leads to three ongoing problems. First, the management of the banks must continue to devote effort and capital to monitoring the risks associated with holding these assets. Some commentary from regulators suggests that this diversion of attention is costly.

Second, to the extent that any of the major banks are still seriously undercapitalized, the presence of the assets creates an incentive to gamble for reclamation. For a clearly solvent bank, the decision to hang on or dispose of the assets would be based on a profit-maximizing motive. For a bank that is close to insolvent, the incentive to remove the risk is much lower. If the assets lose value and drive the bank into insolvency then the inability to resolve such an institution could create a zombie bank.

Lastly, the presence of the impaired banks that are filled with hard to value securities can distort the incentives of other healthy institutions. As modeled by Diamond and Rajan (2009), if the troubled banks could wind up being forced to sell the assets quickly so that prices are depressed below fundamentals, other potential buyers of the assets (i.e. the healthy banks) would choose to avoid making loans that tie up their capital. The presence of the banks that they dub the "walking wounded" can, therefore, create a credit crunch.

Collectively these three considerations suggest that there are costs to leaving the toxic assets on the balance sheets. But notice that the costs are greatly reduced if the banks are well-capitalized. Well-capitalized banks have no incentive to gamble for reclamation. A well-capitalized bank that finds that the assets are diverting attention can afford to sell them, and if many banks are clearly solvent there would be plenty of potential buyers so that the fire-sale would be much less likely. Hence, we see the uncertainty over asset quality being intimately tied to the size of the capital shortage.

Finally, on the big question of how much sustained macroeconomic growth will help the bank recapitalization, it is too early to tell. On the one hand, in Japan export growth was a driver of macroeconomic growth in the mid-2000s. Given the size of the exports in the U.S. economy, it is unlikely that a pure export boom would enough to lift bank profitability on a sustained basis if the domestic economy remains weak.

On the other hand, U.S. macroeconomic policy has also been very different than in Japan. The Federal Reserve cut the policy rate almost down to zero and has been trying various non-traditional means to stimulate the economy. Massive fiscal stimulus package was also applied within 18 months of the onset of the crisis. If these policies deliver growth, the prospects for bank recapitalization in the U.S. will be much brighter.

Finally, the U.S. scores well on avoiding policies that force the banks to have lending targets either in aggregate or to specific sectors. Perhaps the closest policy in this respect is the funding to the auto industry. The support given to General Motors Acceptance Corporation is at risk for being used to support purchases that might temporarily prop up one of the troubled auto companies. But thus far the banking problems have not spilled over to create a set of non-financial zombie companies.

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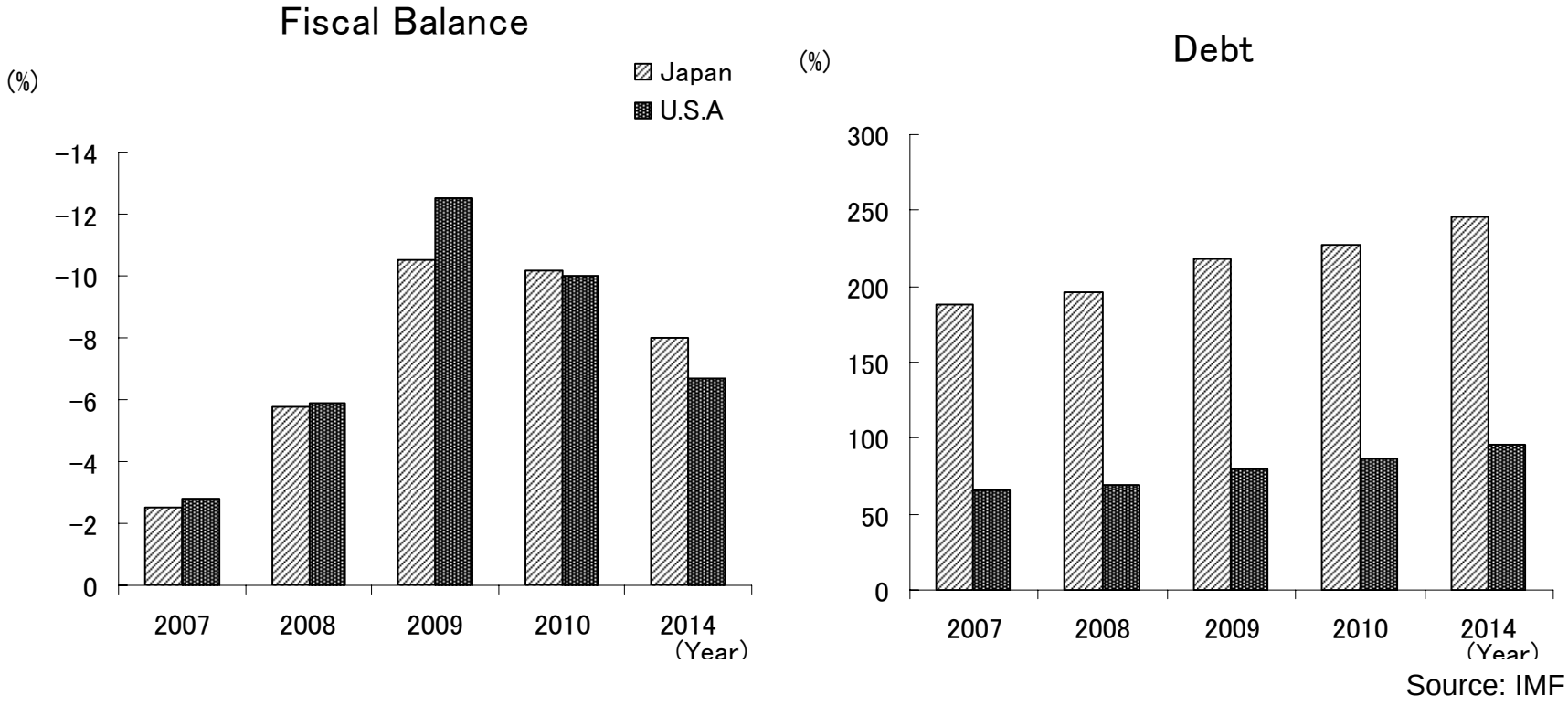
Fiscal Exit Policy

- Lessons from Japanese Experience -

Mikio Kajikawa

Minister, Embassy of Japan

Current Fiscal Situation and Forecast



Source: IMF

Japan	・The "Three-stage rocket" of economic countermeasures(08-12/2009)	Total Amount : ¥75 trillion Fiscal measures : ¥12 trillion
	・Policy Package to Address Economic Crisis	Total Amount : ¥56.8 trillion Fiscal measures : ¥15.4 trillion
U.S.A	・Emergency Economic Stabilization Act of 2008	$700 billion
	・American Recovery and Reinvestment Act 2009	$787 billion

SEPTEMBER 24 – 25 2009

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- We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way, maintaining our commitment to fiscal responsibility.

- We recognize that the process to ensure more balanced global growth must be undertaken in an orderly manner. All G-20 members agree to address the respective weaknesses of their economies.

  • G-20 members with sustained, significant external deficits pledge to undertake policies to support private savings and undertake fiscal consolidation while maintaining open markets and strengthening export sectors.

  • G-20 members with sustained, significant external surpluses pledge to strengthen domestic sources of growth. According to national circumstances this could include increasing investment, reducing financial markets distortions, boosting productivity in service sectors, improving social safety nets, and lifting constraints on demand growth.

Exit Strategy – Fiscal Policy & Monetary Policy –

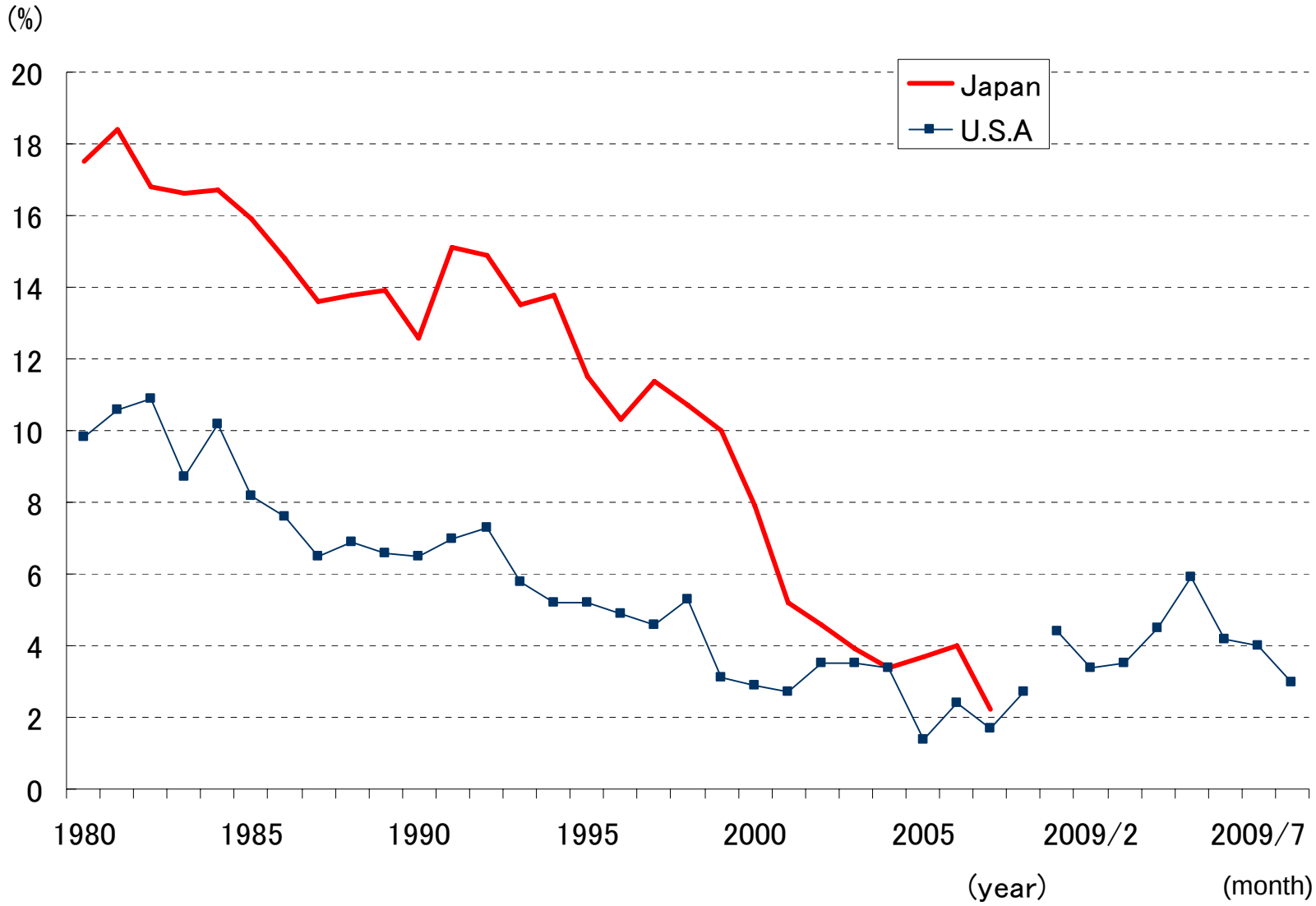
	Fiscal Policy	Monetary Policy
Current Situation	[Fiscal Deficit] Japan: −2.5% (2007) ⇒ −10.5% (2009) U.S.A: −2.8% (2007) ⇒ −12.5% (2009)	[Interest rate] Japan (O/N Call rate): 0.5% (2007) ⇒ 0.1% (2009) U.S.A (FF rate): 5.25% (2007) ⇒ 0 – 0.25% (2009)
Exit Strategy	Fiscal Consolidation (Increasing Tax Revenue, Reduction of Expenditure)	Normalization of Interest rates
Decision Maker	Exective and Legislative Branch of the Government (Political Process)	Central Bank
Term Requied for Implementation	Years ?	Weeks ?
Short-term Effect	Government Expenditure ↓ Consumption ↓ Exchange rate ↓	Investment ↓ Housing /Automobile ↓ Exchange rate ↑
Outcome Without Exit	Fiscal Bankruptcy	Inflation

Fiscal Exit Policy in 90s in Japan

			GDP	
			Outlook *	Actual
1994	Nov.	Tax Reform Bill Passed the Diet. (Scheduled Consumption Tax Increase and Temporary Income Tax Cut)	2.4	1.5
1995			2.8	2.3
1996	Oct.	General Election (The Ruling Party Won.)	2.5	2.9
1997	Apr. July Nov.	Termination of Income Tax Cut (↑ \2trillion) Consumption Tax Increase (↑ \5trillion) Healthcare Reform (↑ \2trillion) Asian Financial Crisis Sanyo Sec., Hokutaku Bank and Yamaichi Sec. failed.	1.9	-0.0

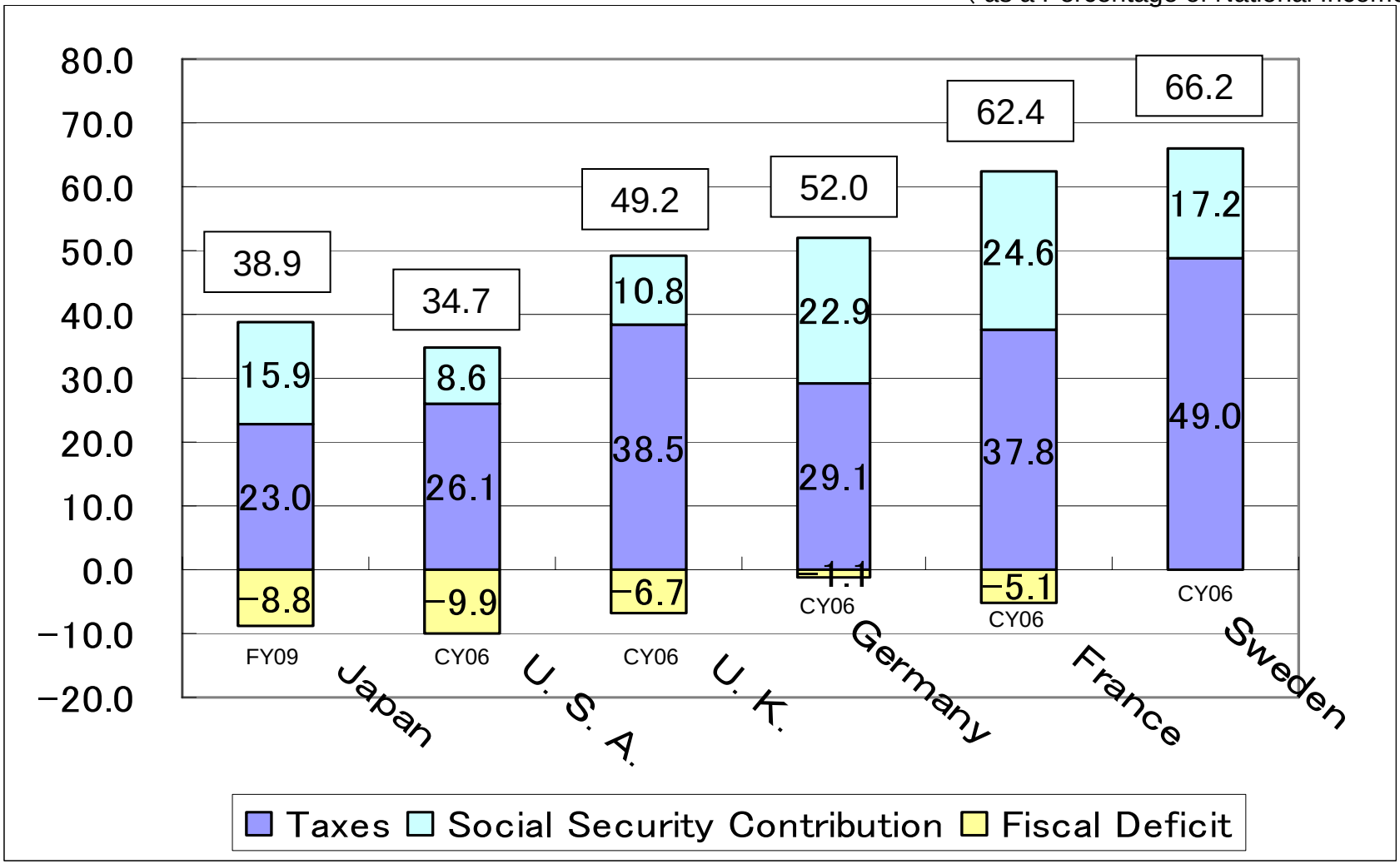
* Government Economic Outlook Announced in the Previous Year

US＆Japanese Saving rate



National Burden Ratio and Fiscal Deficit

（ as a Percentage of National Income ）



Source: MOF, Japan

- Fiscal exit policy
  - must pass through tough political process
  - requires long time to be implemented.

- It might be
  - inconsistent with business cycles
  - inconsistent with the staging in the international framework.

- A stable strategy
  - with long-term perspective
  - internationally coordinated
  - corresponding domestic situation in each nation is needed.

Macro Alert

FIM RESEARCH 02 October 2009

Lessons from Japanese Banking Crisis

Summary

The difference between Japan's experience of financial crisis and present U.S. market turmoil lies in the size and asset class types but the seriousness is equal.

The impact of the financial crisis on real economy lasted for a long time as commercial banks were extremely hesitant in credit creation to give higher priority for disposing non-performing loans. This put significant deflationary pressure on the overall economy.

Yet, the BOJ's Quantitative Easing Policy and Zero Interest Rate Policy well supported banks' disposal of non-performing loans.

However, "lost decade" in Japan means lost national wealth, household financial assets in particular, due to Zero Interest Rate policy which brought prolonged recession to the country.

(1) Major characteristics of Japanese Banking Crisis

Excessive Liquidity with Extremely Accommodative Monetary Policy

As stated in the history of how it evolved, one of the roots causes of why bubble economy took place and collapsed lied in monetary policy and financial administration. Japanese financial institutions at those times were heavily protected under "convoy system" and increased too much of financial risks than they should. The result created by the competition of asset size rather than profitability was an increase in the amount of loans that turned into massive amount of non-performing loans later. Thus the Japan's financial crisis was created by both mismanagement of both macroeconomic policies from monetary policy side and micro-based financial administration side.

Lack in Political Leadership

Another factor that delayed and further complicated the response to the problem was lacking in leadership in politics. Each Prime Minister's administrations could not hold long due to sharp economic downturn brought by the burst of the bubble economy and the financial crisis was almost left alone all the while. If we could define the start of the financial crisis, that could be in August 1992 when the Ministry of Finance first acknowledged the non-performing loans problem and Finance Minister Kiichi MIYAZAWA stated that the government is not hesitant to use public funds to address the issue. Yet, it was actually realized in only 1997 when large-scale bankruptcies frequently happen.

Defining that the problem started in August 1992, it took 10 years before the government started to take serious measures by creating "Financial Recovery Program" under KOIZUMI's era. Considering that the problem saw a steady way of improving after the creation of the program, it will not be difficult to realize what an important role politics will play in dealing with this kind of financial crisis.

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Thus it was PM KOIZUMI, who took office in April 2001, and his cabinet, especially Financial Services Minister Heizo TAKENAKA that started seriously dealing with the financial crisis. It was then TAKENAKA that created the "Financial Recovery Program" in October 2002 that was a broad-based solution including concrete timeline and numbers to be achieved.

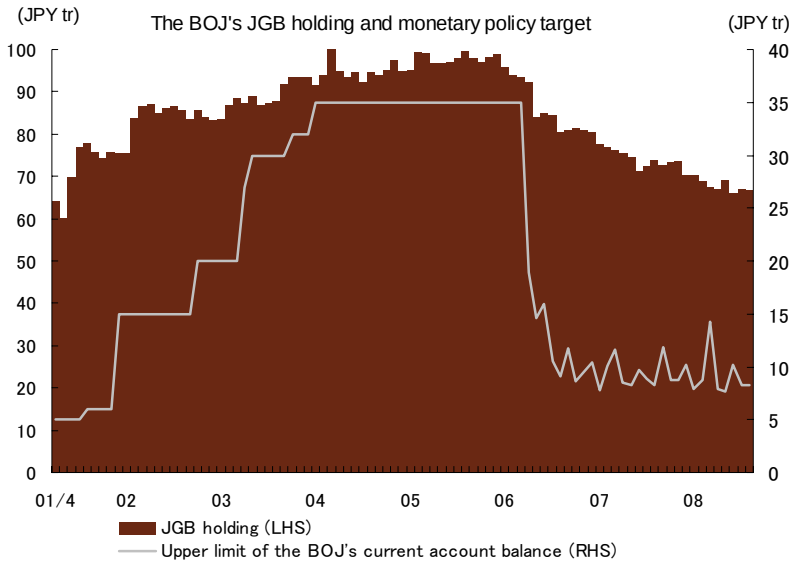
The program was most effective in the case of nationalizing Resona Bank by injecting public funds into the bank's balance sheet. If it had not happened, steady recovery to normalization that followed thereafter would not have been realized. This should be another aspect of how politics are important in times of financial crisis.

What Did BOJ Do All the While?

The role played by the BOJ during financial crisis can be divided into two types, i) indirect assistance to deal with the problem and ii) monetary policy responses. Type i) responses included indirect assistance as to disposal of non-performing loans through special lending facility under Bank of Japan Law and loans made to Deposit Insurance Corporation. Type ii) response is the implement of the Zero Interest Rate Policy. Although the policy sacrificed depositors' interest incomes (JPY 380 tr.) in favour for wider profit margins taken by commercial banks, the policy, supplemented by Quantitative Easing Policy, helped to set the model that the BOJ would help those troubled financial institutions' funding by purchasing the assets on their balance sheets.

The amount of the BOJ's Current Account balance target was 5 trillion yen at the start of the Quantitative Easing Policy in March 2001 but it was finally raised to as much as JPY 35 trillion. In order to create such amount of excess reserves, the BOJ decided to purchase commercial papers, and **asset-backed securities** (decided in June 2003) in addition to usual operations of buying JGBs. The amount bought in the purchasing operations of JGB is raised to JPY 300 billion per operation and conducted 4 times a month. Furthermore, the BOJ also decided to purchase stocks held by banks (18th September 2002.)

The BOJ's JGB holding and monetary policy

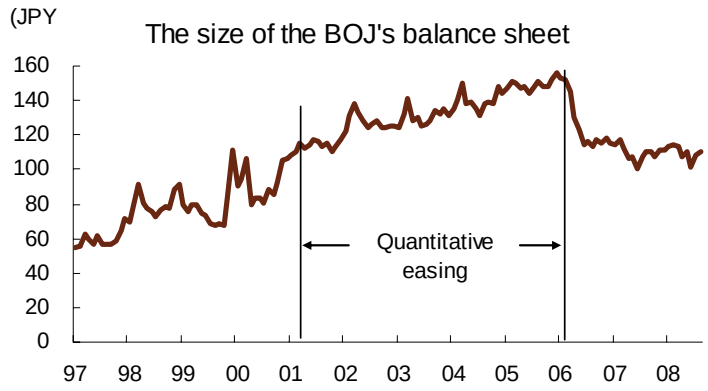


Source: Bank of Japan

As a result of those innovative ways of purchasing operations, the size of the BOJ's balance sheet amounted to JPY 155.6 trillion at peak in December 2005 as compared to JPY 40.5 trillion in March 2001 (start of the Quantitative Easing Policy) and that is a more than JPY 90 trillion increase compared to the end of 1997 when the financial crisis was increasingly realized. The BOJ exited from the

quantitative easing policy in March 2006 but the size of its balance sheet yet stands at JPY 110 trillion as of the end of August 2008, before Lehman shock.

The size of the BOJ's balance sheet during the crisis

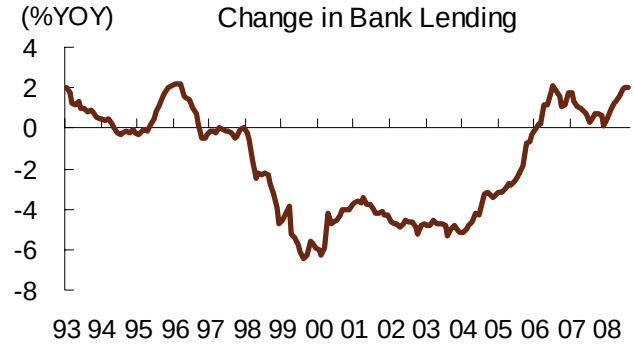


Source: Bank of Japan

Deflationary Pressure Due to restricting Loans

On the other hand, commercial banks were required to accelerate the disposal of non-performing loans and they quickly collected funds. As a result, there were increasing numbers of corporate bankruptcies putting strong deflationary pressure on the Japan's economy as a whole. Thus those banks were shifting those funds away from corporate loans to JGB market.

Change in bank lending



Source: Bank of Japan

(2) Implications

Different Use of Public Funds in Japan and U.S

Public funds played an essential role in the settlement of financial crisis in Japan. The Resolution and Collection Corporation (RCC), consisting of the Resolution Collection Bank (RCB) and the Housing-loan Administration Corporation "JYUKAN KIKO", has been collecting non-performing loans even today. In Japan, public funds were used even in banks which were not yet financially struggling – it was important to sort out non-performing loans promptly before getting into more trouble. It took a long time to finally come to

the decision to inject public funds. Formal governmental financial support began with the "Financial Reconstruction Law" in October 1998. Yet, the financial struggle continued over the next **five years** until the Resona Bank was nationalized in May 2003.

It could be summarised that Japan's use of public funds focused more on the **reinforcement of capital** rather than purchasing of non-performing loans. This is because most of the institutions' balance sheets were already weak and unable to help each other. Although it might be possible for a larger and more open markets like U.S. to rely on funds among private or even foreign institutions, Japanese market in those days were a lot smaller and closed, making it necessary to rely on the public funds.

As the financial stability act currently argued by U.S. policy authorities is yet to be clarified, they cannot be simply compared with the Japanese policies. Nevertheless, the act appears to include setting an institution under the U.S. Treasury with USD 700 billion of public funds that are intended to be used for purchasing securitised products and credit products through price competition. It has been reported that the expenses will be divided into three instalments and there will be a reduction in the remuneration of the executive members of financial institutions that will take part in the price competitions. The establishment of a third party institution is also being considered for the purpose of surveillance. However, the important point of the program is that the program is there to purchase deteriorated assets and it differs in the use of public funds in Japanese case where they were used in pre-emptive manner in order to reinforce capital size.

We presume that the main feature of U.S. financial stability act is to **recover the market function** and then facilitate the separation of deteriorated assets from balance sheets. On the other hand, Japan's case focused more on the selling of real estates that were collateral for loans in order to facilitate the collection of deteriorated loans. Hence for Japan's case, direct intervention into the financial market was limited to the BOJ's purchase of stocks that were held by banks. This is a critical difference between the cases in U.S. and Japan.

Moreover, while nationalization of private financial institutions was an option, and actually done, in Japan, it has been not the case in the US. Although Fannie Mae and Freddie Mac came under the governmental control, they were public institutions in nature and AIG was not nationalized. Thus the intention of the U.S. government will be to avoid helping private institutions by using tax.

While the impact of non-performing loans problem was limited within Japan, another crucial difference is that the U.S. case is globally related though the possessions of its securities. The U.S. approach of making a priority on the recovery of financial market is thus perhaps the most important policy in order to stabilized global financial turmoil. If the Japanese approach was applied to the U.S. case, while it may be possible to rescue the US economy, problems that spread around the world would persist.

Role Played By the Bank of Japan

Following are the policies made by the Bank of Japan in order to help settling down the repayments of non-performing loans.

① Interest rate to zero. Also, prepared the excess reserves maximum of JPY 30 billion as a part of the Quantitative Easing Policy.

② Increased the amount of JGB to buy in purchasing operations to JPY 1.2 trillion per month and also increased the number of operations to 4 times per months.

③ As a result, the yield curve steepened, making profit margin for commercial banks wider and they used for disposal of non-performing loans.

④ Moreover, the BOJ purchased asset-backed securities and stocks held by financial institutions for the purpose of helping funding issues and revitalizing risk asset markets.

Zero interest rate policy made a great achievement in dramatic drop down in the cost of borrowing and hence wider margin for commercial banks. However,

it did not stimulate the real economy effectively. This is because ①the nominal interest rates cannot go below zero and therefore the real interest rates stayed positive ② liquidity preference meant that liquidity was held more in cash and excess liquidity actually got out of the banking system and ③ the "lost" interest income amounts to more than JPY 100 trillion and lower asset return during the period drove many of pension funds getting out of the business.

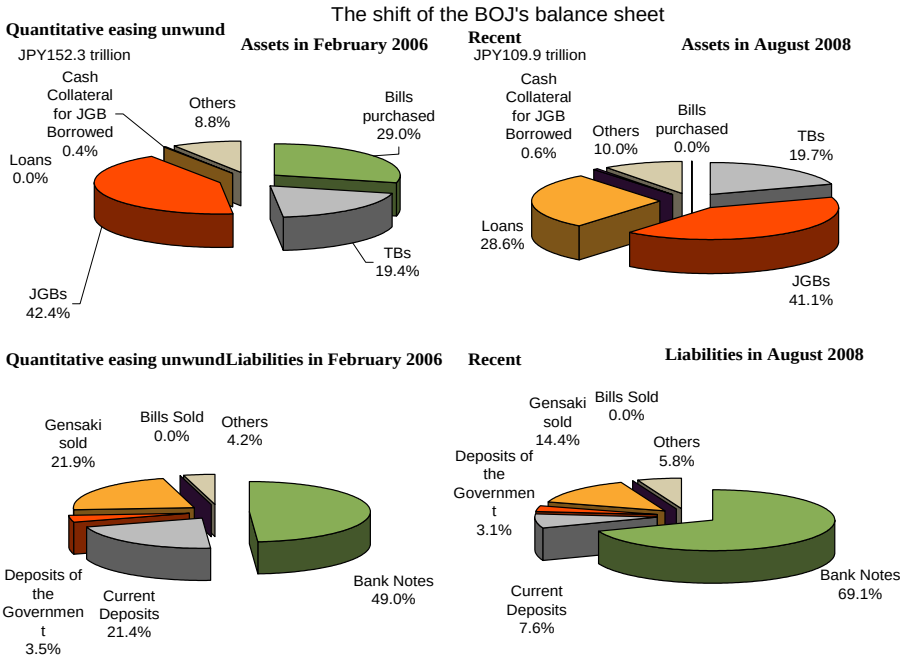
From the macro point of view, nevertheless, zero interest rate policy had a concrete meaning. The yen depreciated as a result of "**yen carry trade**" on the back of the BOJ's policy and resulting massive capital outflow. Then yen depreciated to a level of extreme undervaluation in terms of purchasing power parity or amounts of foreign assets Japan owns, which worked positively for exporting industries. If we include this indirect impact of unprecedented accommodative monetary policy by the BOJ, it contributed a great deal to solve the problem.

But the problem is when and how the BOJ should withdraw from the intervention of financial markets. Especially this should be considered carefully as to when the BOJ stop or at least decrease the **purchasing operations** that the BOJ conducts 4 times a months with JPY 300 billion size each. Although the role the purchasing operation plays has already come to an end as the Japan's financial crisis faded away, even a small amount of decrease in purchasing operation could pose a great instability in the bond market.

Although the global financial market turmoil that is now taking place should mean that the BOJ has less incentive to stop buying operations that supply liquidity into markets, there will come a time when the BOJ needs to compress its balance sheet size. It should be well remembered that the size of the BOJ's balance sheet still surpasses JPY 110 trillion as of today.

Although it is difficult to discuss what would be the appropriate size of the BoJ's balance sheet, we expect that around JPY 80 trillion should be enough with JPY 70 trillion for bank notes, JPY 6 trillion for legal and special reserves, and a couple of trillions yen for governmental deposit. Therefore, there will be a need for cutting the size by JPY 20 trillion in the future if the balance sheet were to be compressed. If this is the case, the consequences will be more than the collection of loans.

Shift of composition of the BOJ's balance sheet



Source: Bank of Japan

Collection of Public Funds

Today, the injected public funds are still being collected. Some institutions have recovered its financial ability strong enough to pay back the debt while for others RCC is collecting those. **So far, by the end of March 2008, JPY 24.6741 trillion has been collected** with JPY 10.2194 trillion returned voluntarily while JPY 9.5960 trillion collected by RCC and JPY 4.8587 trillion repaid in other ways. **This amount is about 52.7% of the overall amount of the public funds**, JPY 46.8 trillion. As the public funds of JPY 18.6111 trillion that were injected in 2002 will not be collected, the effective collection rate stands at 87.5%.

While the effort of collection will continue, we expect that the total loss will be about JPY 20 trillion. In one sense, the loss of JPY 20 trillion made by public sector could be evaluated as a significant cost for dealing with a financial crisis. However, whether the loss, namely 4% of nominal GDP or JPY 170 thousand burdened per capita, was truly painful or not will depend on how those commercial banks will recover as financial intermediaries.

Financial assistance by public fund and recovery

Financial Assistance by public fund and recovery

(JPY bn)	Financial Assistance	Recoveries	Rate of recovery
①Grants	18,611	0	0.0%
②Purchase of assets	9,776	9,596	98.2%
of which from failed financial institutions	6,366	7,143	112.2%
of which from healthy financial institutions	3,410	2,453	71.9%
③Capital injection	12,427	10,219	82.2%
by former Financial Function Stabilization Law	1,816	1,653	91.0%
by Early Strengthening Law	8,605	8,556	99.4%
by Financial Revitalization Program	2,007	11	0.6%
④Others	5,989	4,859	81.1%
⑤Total	46,804	24,674	52.7%

Source: FSA

(3) Lessons from the "Lost Decade"

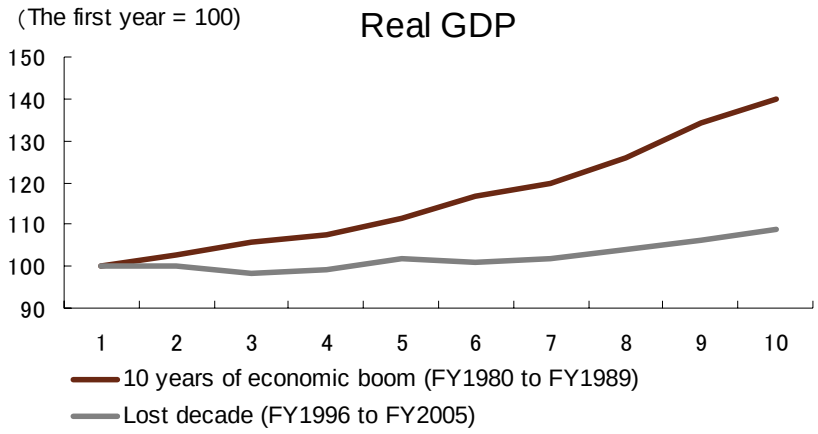
So, what has been really lost during the "Lost Decade?" Many of things were lost including Japan's economic power, household assets, economic growth, employment and, though invisible, confidence. Among those visible, there were times when the size of the Japanese economy contracted with negative real GDP growth.

Japanese households are estimated to lose JPY 106 trillion of interest rate income on deposits between 1996 and 2005 due to the BOJ's Zero Interest Rate policy, and lost amount of employees' compensation is estimated to be JPY 276 trillion during the same 10 years due to cut in employment and wages. Thus **Japanese households lost as much as JPY 382 trillion of wealth**.

Although Japan's economy is getting back on track, the pains experienced during the while have been still weighing on the economy with delayed response from policy authorities exacerbating the problem. Yet, one of the important lesson from the experience should be that government and the BOJ's purchase of those deteriorated assets further intensified deflationary pressure through massive discount of those assets rather than supporting the asset prices. We suspect that what will happen to the U.S. market will somewhat similar to the experience.

That is perhaps temporarily though, intensify deflationary pressure. The important management of monetary policies will be that those policies will be conducted in a way to avoid further deflationary pressure as monetary policy becomes almost powerless once the economy gets into deflationary economy with even low level of policy interest rate not having much stimulative effects.

Economic growth track during the lost decade



Source: Cabinet Office

Certification

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Susumu Kato

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The Japan Fallacy

Today's U.S. Financial Crisis Is Not Like Tokyo's "Lost Decade"

By Richard Katz

From *Foreign Affairs* , March/April 2009

Summary: The financial crisis of 2008 need not usher in a replay of Japan's "lost decade" of the 1990s. The current crisis is the result of correctable policy mistakes rather than deep structural flaws in the economy.

Richard Katz is Editor in Chief of The Oriental Economist Alert and the author of Japanese Phoenix: The Long Road to Economic Revival.

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In periods of crisis, pundits and policymakers tend to scramble for historical analogies. This time, many have seized on Japan's notorious "lost decade," the decade of stagnation that followed a mammoth property bubble in the late 1980s. But this comparison is wrong. In Japan, the primary problem was pervasive dysfunction in the economy, which caused a banking crisis. In the United States, pervasive dysfunction in the financial sector has caused a deep recession in the economy as a whole. This financial dysfunction is not the result of structural flaws, as in Japan, but of grave policy mistakes. It is now being compounded by widespread investor panic.

The consequences of the 2008 U.S. financial crisis will be different from Japan's slump in the 1990s for three reasons: the cause of the current crisis is fundamentally different, its scope is far smaller, and the response of policymakers has been quicker and more effective.

Japan's malaise was woven into the very fabric of its political economy. The country has a thin social safety net, and so in order to protect jobs, weak domestic firms and industries were sheltered from competition by a host of regulations and collusion among companies. Ultimately, that system limited productivity and potential growth. The problem was compounded by built-in economic anorexia. Personal consumption lagged, not because people refused to spend but because the same structural flaws caused real household income to keep falling as a share of real GDP. To make up for the shortfall in demand, the government used low interest rates as a steroid to pump up business investment. The result was a mountain of money-losing capital stock and bad debt.

Japan's crisis pervaded virtually its entire corporate world. In sector after sector, debt levels and excess capacity ballooned and profitability remained low. White-elephant projects, from office buildings to auto plants, were built on borrowed money under the assumption that if times got tough, the government and banks would bail out the debtors. But the banks were too poorly capitalized to write off bad loans. And for every bad loan, there was a bad borrower whose products were not worth the cost to make them. The cumulative total of bank losses on bad debt between 1993 and 2005 added up to nearly 20 percent of GDP.

Policy mistakes -- from Japan's mismanaged fiscal and monetary policy to the government's failure to address the loan crisis -- made a bad situation even worse. But even if policymakers had done everything right, Japan's economy still would have stagnated until Tokyo addressed its more fundamental flaws.

DEREGULATION NATION

The United States' subprime mortgage fiasco of 2007-8, in contrast, was primarily the result of discrete, correctable mistakes brought on by ideological excess and the power of financial-industry lobbyists rather than intractable structural problems.

The first mistake was the U.S. government's refusal to regulate subprime mortgages. Traditional banking regulations forbid banks from lending to people with no down payment or proof that they can repay a loan. However, no such rule applied to nonbank lenders, even after they became the country's biggest mortgage originators. That left new mortgage institutions with little incentive to ensure that their loans could be repaid; no

sooner had they issued these so-called liar loans than they resold them to investment banks for a profit. The investment banks then sliced and diced the loans into securities embossed with AAA ratings despite the dubious creditworthiness of the original borrowers. A single statistic makes clear how damaging this lack of regulation was: by the third quarter of 2008, 22 percent of subprime, adjustable-rate mortgages were in foreclosure; by contrast, the foreclosure rate for prime, fixed-rate mortgages -- 60 percent of all mortgages -- was still less than one percent.

There were plenty of warnings. In 1994, a bipartisan coalition in Congress passed the Home Ownership and Equity Protection Act, which enabled the Federal Reserve to force all mortgage lenders to follow traditional banking standards. But Federal Reserve Chair Alan Greenspan refused to use these powers, claiming that the financial markets were self-correcting. When Democrats and Republicans in the next Congress tried to require that the Fed enforce these rules, House Majority Leader Tom DeLay (R-Tex.) quashed the effort.

The second policy blunder was the U.S. government's failure to regulate the compensation of chief executive officers (CEOs) -- a system that in its current form gives executives incentives to take outrageous risks with other people's money. When CEOs are paid primarily in stock options, as is the case today at many firms, they suffer little punishment for failure. If CEOs gamble big with the company's money and succeed, they can gain hundreds of millions of dollars in bonuses; if their gambling fails, they do not suffer losses, just a smaller reward. Even CEOs who have caused their firms to collapse, such as Merrill Lynch's Stan O'Neal, have still walked away with enormous severance packages. This system is a critical factor in the behavior that led to today's crisis. Studies show that extraordinary losses are much more common at firms where the majority of CEO compensation comes from stock options, rather than cash or outright stock.

The third error was the virtual nonregulation of the derivatives market. Derivatives should serve as a kind of insurance to lessen risk. Corn futures, for example, stabilize farmers' incomes, inducing them to plant more, which gives consumers more food at cheaper prices. Today's financial derivatives often turn the insurance principle on its head, causing shocks to be amplified and transforming derivatives into what the investor Warren Buffett has called "financial weapons of mass destruction." If an investor buys a share of General Electric from Merrill Lynch, that share retains its value even if Merrill goes bankrupt. But unlike corn futures or stocks, most financial derivatives are traded not on exchanges but in bilateral deals. If an investor's trading partner (counterparty) fails, the investor takes the loss. The collapse of the investment bank Lehman Brothers caused the insurance company AIG to lose big in so-called credit default swaps, undermining trust in all counterparties and causing a run on the entire derivatives and securitization markets. Rather than frightened depositors banging on bank doors, the result was investors furiously clicking away at their keyboards as their money disappeared. In the end, the impact was the same: perfectly solid companies suddenly found themselves unable to issue commercial paper, and creditworthy homeowners found it hard to get car or student loans. It took an intervention by the Federal Reserve to forestall a more serious meltdown.

This run on the shadow banking system is the real cause of the severe post-September credit crunch that transformed a mild recession into something far worse. Banks have actually increased their extension of credit by six percent since September, but they are having a hard time securitizing those loans in the capital markets. That means that they can no longer use the proceeds to make further loans, which would allow them to use the initial dollar over and over again.

If powerful financial lobbyists waving the banner of faith in markets had not thwarted commonsense regulation, much of this would never have occurred. Democratic and Republican policymakers alike, from Treasury Secretaries Robert Rubin and Lawrence Summers to Federal Reserve Chair Greenspan, blocked attempts at reform in 1998. Then, in 2000, Senator Phil Gramm (R-Tex.) went so far as to virtually outlaw the monitoring and regulation of many types of derivatives by initiating the Commodity Futures Modernization Act. Just as deposit insurance now prevents massive runs on banks, the regulation of derivatives could have made this crisis less severe.

A TALE OF TWO BUBBLES

The scope of the Japanese crisis and the scope of the U.S. crisis are also fundamentally different. From 1981 to 1991, commercial land prices in Japan's six biggest cities rose by 500 percent. The subsequent bust brought prices down to a level well below that of 1981; as of 2007, they were still 83 percent below the 1991 peak. In the United States, the real estate bubble was not as inflated, and the bust has been less severe. From 1996 through the 2006

peak, housing prices in the 20 biggest U.S. cities rose by 200 percent. Most forecasters think prices will drop by 30-40 percent from the peak levels before bottoming out in 2009 or 2010. No one is suggesting that prices will fall below the level of 1996.

Most of the United States' nonfinancial corporations are still healthy. Whereas the debt of Japanese corporations was several times their net worth, in the United States, corporate debt amounts to only half of companies' net worth, the same level that has prevailed for decades. The ratio of nonperforming loans among nonfinancial companies is only 1.6 percent, and productivity growth remains solid.

In October 2008, the International Monetary Fund's Global Financial Stability Report predicted that the losses on all U.S.-originated unsecuritized loans (including home mortgages) would amount to $425 billion, about three percent of U.S. GDP. This estimate will likely rise, but even then it would not come close to the 20 percent ratio that Japan experienced.

The biggest financial losses are coming not in loans taken out by household or business borrowers but in the shadow banking system. Because of the leverage inherent in financial derivatives -- which are designed so that a one percent hike in real estate prices can create a much larger gain in asset-backed securities -- a small loss in the value of the underlying assets can be multiplied several times over. Far more significant is the psychological factor: by mid-December 2008, pure panic had pushed the value of AAA-rated commercial-mortgage-backed securities (CMBS) down to 68 percent of their face value, despite a commercial-mortgage delinquency rate of only one percent.

That 32 percent loss has reverberated throughout the financial system due to mark-to-market accounting rules, which require securities to be valued at their current market price, even in markets where there is little trading and prices fluctuate wildly. As a result of these rules, all investors holding CMBS have had to write down their holdings by 32 percent, even if the underlying mortgages are being paid on time. That, in turn, has led prices to decline even more and investors to write off more capital, further tightening the credit crunch.

The International Monetary Fund predicts that this vicious cycle will cause $1 trillion in mark-to-market losses, as much as seven percent of U.S. GDP. If this is correct, most financial losses suffered since the onset of the crisis will have come not from genuine defaults in the real economy but from problems generated within the shadow banking system. Applying normally beneficial mark-to-market rules in today's abnormal markets without any adjustment is doing more harm than good. By the time the economy recovers and those marked-down securities are marked back up, the credit crunch will have led to a host of corporate bankruptcies, millions of layoffs, and countless families losing their homes.

A PROGRAM OF ACTION

The Japanese and U.S. crises differ in many ways, but the starkest contrast is in the response of policymakers. Denial, dithering, and delay were the hallmarks in Tokyo. It took the Bank of Japan nearly nine years to bring the overnight interest rate from its 1991 peak of eight percent down to zero. The U.S. Federal Reserve did that within 16 months of declaring a financial emergency, which it did in August 2007. It has also applied all sorts of unconventional measures to keep credit from drying up.

It took Tokyo eight years to use public money to recapitalize the banks; Washington began to do so in less than a year. Worse yet, Tokyo used government money to help the banks keep lending to insolvent borrowers; U.S. banks have been rapidly writing off their bad debt. Although Tokyo did eventually apply many fiscal stimulus measures, it did so too late and too erratically to have a sufficient impact. The U.S. government, by contrast, has already applied fiscal stimulus, and the Obama administration is proposing a multiyear program totaling as much as five to six percent of U.S. GDP. When it comes to crisis management, it is far better to do too much than too little.

Policymakers can draw many lessons from this comparison. First, the current U.S. crisis -- like the Asian financial crisis of 1997-98 -- has proved that even an economy with sound fundamentals can be thrashed when financial markets go haywire. However, the Asian crisis provides a more promising message: once financial markets are calmed and policy mistakes are reversed, economies recover.

Second, whereas Japan needed a thorough overhaul of its political and economic institutions and practices, a process that continues today, the United States simply needs aggressive reform of its financial architecture and

process that continues today, the United States simply needs aggressive reform of its financial architecture and CEO compensation system. President Barack Obama clearly understands the need for better regulation, and there is reason to hope that his economic advisers, many of whom are alumni of the Clinton administration, have learned from their mistakes. In October, former Treasury Secretary Summers, now director of the National Economic Council, wrote in the Financial Times, "The pendulum will swing -- and should swing -- towards an enhanced role for government in saving the market system from its excesses and inadequacies."

Third, fiscal policy works, but only in connection with other measures. Many commentators believe that Japan's lost decade proves the uselessness of fiscal stimulus. They are wrong. When Tokyo stepped on the fiscal gas, the Japanese economy did better. When it took its foot off the pedal or, worse yet, applied the brakes -- such as when it raised taxes in 1997 -- the economy faltered. Equally important, it is hard for fiscal and monetary stimuli to be effective when the financial system is broken.

Finally, markets only work when undergirded by proper regulatory institutions that enforce genuine checks and balances on corporate executives, corporate boards, financiers, accountants, rating agencies, and regulators. Better rules make it safe to have freer markets.

There is, of course, one way in which the United States' crisis is much worse than Japan's: its global ripple effects. Getting through today's recession will be neither quick nor easy. But there is absolutely no need for fatalism or talk of an upcoming "lost decade" in the United States. The first step is to recognize, as Obama has repeatedly stressed, that this crisis is not a once-in-a-century unforeseeable disaster. Bad policies created this mess. Better policies can fix it.

How the U.S. Should Respond to the Financial Crisis: Lessons from Japan

1. Summary of Japan's Response to its Financial Crisis

Japan's response to its financial crisis of the 90's can be summarized as follows;

◆The three-step strategy to encourage disposal of bad loans led to the successful stabilization of the financial system

①Accurate understanding of the bad loans (through the introduction of self-assessment frameworks and the problem asset disclosures as determined by a standardized method)

②Ultimate clean-up of the banks' balance sheets (from FY1993 to FY2004, Japanese major banks disposed of bad loans totaling 95 trillion Yen, 85 trillion Yen of which was completely eliminated from the balance sheets)

③Removing the concerns over potential bank capital shortages through injection of public funds mainly to the major banks (1.8 trillion Yen in March '98 and 7.5 trillion Yen in March '99 were injected into major banks)

◆It should be noted that it was not as if Japan had extensive experience of financial crisis management previously, and the experience seemed like we were trying to find our way in the dark.. This meant the path to designing and realizing the above framework for crisis response was long, with many twists and turns, requiring considerable amount of time and effort. For example, even though the bubble had burst in 1991, it was not until 1998 – 7 years later – that the concern over major banks' capital shortage was addressed through the first-round of public capital injection. And even then, it did not sufficiently alleviate the capital shortage concerns, and the second-round of funds were injected in 1999, followed again by a third-round injection in 2003 to protect some banks from then growing deflationary pressure.

2. Lessons from Japan's Financial Crisis Management

Based on the above Japanese experience, we believe the following four key points should be addressed in striving towards the normalization of the US financial system.

①Establish a Clear Rule for Valuation of Problem Assets

・ The delay, in Japan, in setting up the standardized framework by which the banks could accurately evaluate their problem assets, and write down or provision accordingly, resulted in worsening of the problems. This would also be the case for the securitized credit products that

caused the current financial crisis. It is essential that clear common rules, such as rules regarding the valuation of assets whose market liquidity is significantly reduced, be established so that the accurate assessment of the problem assets can be made.

②Promoting Elmination of Bad Assets from the Banks' Balance Sheets

- After the second-round of capital injection to major banks in 1999, combined with the worldwide IT bubble, Japanese financial system managed to temporarily pull out of the financial crisis. But the deflationary pressure and the economic slump soon pulled its financial system back into a deepening crisis. The U.S., while on its way to recovery from its crisis, the possibility that the U.S. economy could follow the "W" shaped "double-dip" path similar to Japan cannot be denied. This means for U.S. banks, that there remains an ongoing concern of potentially huge losses not only from the securitized credit products that are kept on their balance sheets but also from the deterioration of their traditional lending portfolio. In order for banks to minimize these risks going forward, further dedicated efforts to clean up bad assets from their balance sheets will be essential.
- It goes without saying that each bank should be individually committed to cleaning up their balance sheet. However, from the financial system stabilization point of view, setting common objectives and deadlines for cleanup or target levels of bad assets by major banks on an industry-wide basis, as was the case in Japan, is likely to be more effective. To that end, the Public Private Investment Program (PPIP) which was created under TARP should play an important role.

③Continued Public Capital Injection to Banks and Financial Support for the Deposit Insurance Fund

- U.S. injected public capital to banks within a month or two from the Lehman Brothers' collapse in September of last year. This was significantly faster and larger in size compared to the response by the Japanese government in the 1990's.
- Taking Japan's experience into consideration, however, it is important to note that the injection of public capital is not enough to dismiss concerns of capital shortage for individual banks', nor enough to stabilize the overall financial system, unless the bad assets are accurately identified and eliminated from the balance sheets. Given the fact that regional banks are facing growing losses from their loan portfolios including commercial real estate loans, and the Deposit Insurance Fund is drying up, the U.S. should promptly and proactively address these issues, including public fund injections into the Deposit Insurance Fund.

④Improving the Mid and Small-sized Banks' Financial Health

- The Japanese government did not impose deadlines for the bad assets cleanup on its regional banks, for reasons such as concerns for the fragile regional economy. However, this less stringent stance toward regional banks, compared to the major banks, resulted in the delay of their recovery to financial health, eventually leading to the need for the establishment of the framework for proactive public capital injection to banks (mainly the regional ones) as a temporary legislation (i.e. The Act on Special Measures for Promotion of Organizational Restructuring of Financial Institutions: Apr. 2003～Jul. 2004, The Act on Special Measures for Strengthening Financial Functions: Aug. 2004～Mar. 2008 <revised law enacted on Dec. 2008>).
- These facts suggest the need to pay attention to the mid and small-sized banks in U.S. as well. Although their relative weakness in management resources and financial base compared to the major banks should be carefully considered, establishment and enforcement of less strict but nonetheless explicit targets for mid and small-sized banks to deal with bad assets will be necessary to achieve financial stability.

3. Preventing Recurrent Crises in the Future by Establishing an Efficient and Effective Bank Regulatory/Supervisory Framework

- The current financial crisis can be described as "21st Century model" in that the evolution of financial technology, including securitization, led to the risk being spread throughout the global markets and resulting in a threat to the global financial system and the real economy. The regulatory/supervisory reform to prevent future recurrence of such a financial crisis is being discussed not only in the U.S. but in the international arena.
- The elements of the regulatory framework for the banking system are manifold: regulatory capital requirements; disclosure rules; prompt corrective action as a proactive measure; deposit insurance and bank dissolution mechanisms as reactive measures; and more. In Japan's experience in dealing with the crisis, the comprehensive framework of crisis management was promoted taking into account all of these elements. It would be worth pointing out, however, that the entire process never had to resort to the discussion of raising minimum regulatory capital requirements.
- Nevertheless, current arguments with respect to reforming the international regulatory/supervisory framework are too focused on the quantity and the quality of capital, requiring banks to beef up their capital base significantly through issuing of common stock and/or retaining earnings. Requiring banks to raise too much capital could strain the capacity of the equity capital market, possibly leading to future inability to meet urgent and real capital

needs, which in turn could result in further financial crisis. Also, if banks around the world were to simultaneously slash their assets to meet enhanced capital requirements, the world could be left without adequate supply of growth money. When discussing regulatory/supervisory reform intended to prevent future financial crises, it is important to discuss how the various rules and regulations on the banking system should be composed as a holistic package.

- The current crisis highlighted the importance of liquidity risk. Whether the bank has a stable funding base turned out to be a crucial issue for the bank management. It is important, therefore, rather than to simply raise capital requirements across the board, to consider the differences in the liquidity risk among different banks, including the degree of reliance on the market based funding, when we discuss the issue of the regulatory capital reform.

What's Wrong with Corporate Governance in America? Lessons from the Financial Crisis

Article contributed by: Arthur M. Mitchell, White & Case LLP

Corporate governance needs to be considered in the context of the financial crisis that is gripping the world today. The reason is that there are important links between good governance and economic performance. The financial crisis has caused banks and other financial institutions to tighten or cut off credit to individuals and corporations in the real economy, causing lay-offs, down-sizing and bankruptcies. The real economy cannot recover until stability and confidence returns to the market place and the global financial system is restructured. How that is done will have consequences for the economy at large. While this article does not describe every aspect of the financial crisis,[1] it does outline some of the major contributing factors, discuss some of the weaknesses of the present system and considers what the likely outcome will be.

Causes of the Financial Crisis

Excessive greed and mismanagement have damaged the real economy, destroyed pension accounts and threatened American national security.[2] But this was not an accident nor was it planned by anyone. It was the natural consequence of the mind-set that existed until the onset of the crisis, the opportunity presented by excess liquidity in the world financial system and specific actions of company management, regulators and investors.

The mind-set had its origins in the fall of the Berlin Wall and the triumph of Western economic models, which placed excessive faith in the ability of markets to produce prosperity with limited government intervention. As noted by Alan Greenspan, the assumption was that financial institutions would not incur excessive risk as that would be against the interests of their shareholders.[3] In other words, the system would cause the players to regulate themselves in an appropriate manner.

A second factor was global current account imbalances. Following the Asian financial crisis (1997-98), a tremendous amount of surplus dollars were saved by China, Japan and countries in the Middle East. This liquidity was recycled to American financial institutions which needed to reemploy those funds. This led to extremely low interest rates, which fueled the extraordinary demand for credit. Pension funds and other investors needed to find higher yielding (but riskier) investments in order to provide satisfactory returns to their clients. However, it should be clear that China and Japan did not create the crisis. The lack of a sufficient domestic demand in China and Japan merely created the opportunity for American financial institutions to mismanage their portfolios. Also, never before have so many American households saved so little and borrowed so much.

The third contributing factor was the tremendous growth of derivatives, securitization, and the ever-increasing role of leverage to support high investment returns.[4] It is important to realize that traditional banking became subordinate to what is sometimes called the "shadow banking system" or the "near-banking system". Traditional banking functions involves "maturity transformation", i.e. accepting deposits from the public on a short term basis then lending them to corporations and individuals on a long term basis. Traditional banks are subject to close regulation and supervision in order to mitigate the risk that all of the depositors will withdraw their money at the same time. Hedge funds, private equity funds and structured investment vehicles (SIVs), the latter being off-balance sheet vehicles owned by banks, formed the core of the "near-banking system" and were not heavily regulated or even regulated at all. These were the institutions that created most of the sub-prime mortgage and other risky financial products that led to the financial crisis.

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Finally, the crisis became global in nature because these securitized investment products were traded globally. For example, it has been estimated that approximately half of the sub-prime mortgage products created in the U.S. were bought by European investors. But it would be a mistake to think that this problem was solely caused by the U.S. Indeed, loose credit standards and faulty assumptions, such as the idea that credit would continue to be cheap and plentiful and that real estate values would continue to rise, existed in both the U.S. and Europe.

In sum, what developed was a situation in which all of the market participants—the financial institutions, the rating agencies, the regulators, investors and homeowners—found themselves in an environment of excess cash, unrealistic assumptions, inappropriate understanding of systemic risk or the risk inherent in certain products, and lax regulation. Hindsight is 20–20 but the fact of the matter is that no one person, institution or government regulator seemed to have a complete picture as to how the global financial system was operating. Some commentators and economists issued warnings well before the summer of 2007, but these views were not given sufficient weight because good governance was not operating properly.

Corporate Governance Failure

Good corporate governance depends upon having the right balance between incentives and disincentives or rewards and penalties. An appropriate balance must also be struck between the interests of shareholders, customers and management as well as employees. A number of factors that came to light as a consequence of the financial crisis indicate that the right balance has not been struck.

According to an analysis prepared by the Senior Supervisor's Group[5], top regulators from five countries, senior management at many of the financial institutions:

- Did not properly develop and enforce controls which would balance the desire to do business with their appetite for risk;
- Did not properly identify risks and take steps to mitigate those risks;
- Did not surmount organizational structures which prevented information from following up the management chain; and
- Did not provide cross-disciplinary methods for discussion and communication of insights into relevant risks across the firm.

As noted before, all the market participants share some of the blame, but there should be no doubt that top management of many financial firms were not doing a proper job.

Also, much has been made of the way in which incentives for top management were misaligned by compensation policies which rewarded executives when their companies stock price rose regardless of the risk profile that their firms where taking. As a result, managers were rewarded even as they pursued policies which caused their institutions to fail. Further, although companies are required under the Sarbanes-Oxley Act to file reports on internal controls for submission to the board of directors, it appears many of the board of directors at failed institutions failed to intervene or act appropriately.

Next, various regulatory and accounting changes allowed the banks and the near banks to incur a tremendous amount of debt and use that to underwrite risky financial products. When the market is rising, debt enhances the return on equity but in a down-market, it magnifies the losses. Regulators allowed financial institutions to borrow up to 30 times or more than the equity that they had in their firms. [6]

When the U.S. housing market began to crash, the value of the sub-prime mortgages, which were often purchased with large amounts of debt, began to weaken the credit standing of the financial

institutions which held these investments. Thus, the machine which created vast profits went into reverse.

The rating agencies also share some of the responsibility for the way in which they became involved in the structuring of many of the riskier securitized products. Traditionally, the role of these agencies was to estimate the likelihood that a particular bond might go into default. Over time, their role morphed into that of an advisor to financial institutions that were structuring products for sale into the market. This was a clear conflict of interest.

Many financial institutions also lowered their credit standards to allow borrowers to qualify for home mortgage loans that they would not have qualified for under normal circumstances. This was, in part, an effort to increase home ownership but these loans were structured so that they could only be repaid if the market value of the properties went up and the borrowers refinanced their loans, thus creating new fees for the financiers. In the worst cases, borrowers were not required to give evidence of their incomes or whether they had existing jobs. These were called "Ninja loans" because the borrowers had "no income" and "no job". In some cases, there was outright fraud by the borrowers. At the same time, some unsuspecting borrowers were misled as to the consequences that they would encounter with these financial products.

Reforming the System

All of the forgoing acts were taken purposefully but without the intent to destroy the financial system. Nevertheless, good intentions will not help us avoid disaster. Given the problems described above, here are a few of the reforms that are likely to take place:

- Financial firms will certainly not be allowed to use as much leverage as in the past even though the consequence may be lower returns for some investors.
- Systematically important firms may continue to exist but many will question whether any firm should be allowed to be "too big to fail".
- Shareholders are likely to exert more influence over executive compensation.
- Innovation in financial products will continue to be important but there will be recognition that not all innovations are useful.
- Some traditional bank functions, such as the payment system, may be split off into "public utility" type organizations, in order to protect the system from future bank failures.
- All institutions, markets and financial products will be subject to some form of regulation in order to mitigate systemic risk.
- Accounting firms and rating agencies may come under pressure to reform their compensation systems in order to avoid being captives of their clients and to avoid conflicts of interest.
- Practical steps need to be taken to reform financial systems but we need to start from where we are. Solutions need to be global in nature but a wholesale restructuring is not likely to be practical. In other words, the focus should be on harmonizing national frameworks on a global basis in order to avoid "regulatory arbitrage".

The long-awaited G-20 meeting in April 2009 has now ended and its communiqué issued. While the press has made much ado about the differences among the leaders over how much fiscal stimulus versus how much regulation may be needed, no one has focused on the fact that our leaders failed to address corporate governance reforms within each country[7]. The right kind of corporate governance by itself may not have avoided the crisis but it should be clear that in the future, the regulators will not be able to properly regulate if the right governance reforms are not put in place. In other words, corporate governance and regulatory reforms should go together to form a new "smart regulatory framework".

A “smart regulatory framework” is one that promotes transparency and accountability, encourages useful innovation, punishes fraud and corruption and supports the orderly development of the real economy. Undoubtedly we will not see the end of financial shocks, but a smart regulatory framework, which restores the proper balance, is the beginning of the way forward.

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[1] An excellent overview on this subject is a speech given by Adair Turner, the Chairman of the U.K. Financial Services Agency, on 21 January 2009. http://www.fsa.gov.uk

[2] The Director of National Intelligence, Dennis C. Blair, recently told the U.S. Congress that instability in countries around the world caused by the current global economic crisis, rather than terrorism, is the primary near-term security threat to the United States. http://obama.wsj.com

[3] In testimony before the U.S. Congress on 23 October 2008, the former Federal Reserve Bank Chairman Alan Greenspan said, “Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief”.

[4] A simple yet comprehensive description of how derivatives and securitization worked in this context can be found in a paper by Professor Douglas W. Arner - “The Global Credit Crisis of 2008; Causes and Consequences”. http://www.ALLFL.com

[5] Senior Supervisors Group; Observations on Risk Management Practices during the Recent Market Turbulence, 6 March 2008.

[6] John C. Coffee, Analyzing the credit crisis; was the SEC missing in action? *New York Law Journal*, 5 December 2008.

[7] The nine page communiqué mentioned the word “governance” only once and that was in the context of reforming the IMF and other international financial institutions.

How should the U.S. Respond to the Financial Crisis: Lessons from Japan

Naoko Nemoto
Managing Director, Standard & Poor's　Financial Institutions Ratings
Rating Services

1) The Japanese experience suggests that capital injections and liquidity support to banks alone do not resolve a credit crunch. It is vital to take effective measures to address fundamental problems such as how to improve the health of the corporate sector and individual borrowers.

- The outstanding loan balance of Japanese banks did not trend upward until 2005, seven years after the injection of public funds. S&P conducted research targeting the top 20 regional banks in Japan during 1999-2004. We found that the correlation between the absolute capital ratio and loan growth is very low, while the correlation between credit costs and loan growth is higher.
- In Japan, the government did not take prompt action to address the industrial and financial sector. After a slight recovery during 1999-2000, Japanese banks suffered from the resurgence of bad loans brought about by prolonged deflation. It was only later that action was taken to purchase NPLs from healthy banks and to establish the Industrial Revitalization Corp. of Japan.
- In Korea the banks recovered swiftly after the Asian Banking crisis compared to Japan. The Korean government and private sector took harmonized action to promote the revitalization of the business sector and create employment. For instance, the government provided favorable tax plans for venture companies and various training programs for those who lost their jobs.

2) In Japan, it took almost 12 years for the banking industry to restore the health of balance sheet, which constrained the recovery of economy. Banks have a tendency to defer drastic reform and the disposal of legacy assets. The regulatory authority should continuously put pressure on banks to improve transparency and remove NPLs from their balance sheets.

- In Japan, it took a long time for investors to regain a reasonable level of confidence in banks' disclosed figures. In general, banks applied generous standards in assessing their balance sheets in order to avoid reporting large losses, reputational damage, and

government intervention. In 2002, proposals were raised to inject more public funds into the banks. However, the government and the banks were reluctant to take additional action.

- In 2002, Mr. Heizo Takenaka was appointed as the financial services minister and launched the financial Revitalization program, which was based on three principals;
  - Stringent assessment of assets:
  - Reinforcement of capitalization; and
  - Enhancement of corporate governance.

Under this program, the banks could finally resolve the bad loan issue and improve their financial profile. Major banks were obliged to lower their NPL ratios by 50% in 2 years, which prompted drastic action and efforts to cut costs and expand revenue sources. Meanwhile, Japan's FSA prompted the transparency of banks disclosed figures by applying fair value accounting, quarterly disclosure and expansion of the definition of NPL.

- The stringent assessment of loans could have put negative pressure on .the highly leveraged corporates. In order to mitigate deflationary pressure, the government provided specific aid to the SME sector, expanded the function of government banks and prepared the legal system to support the work-out process more smoothly.

-The recovery in 2004 was largely supported by the better external environment. However, it was the measures taken by the government, the BOJ, and efforts by the private sector that enabled the banking industry to take advantage of the recovery.

3) It is a positive development for G 20 countries to review the current regulatory framework and strengthen it. On the other hand, regulatory changes could bring new risks to the banking industry. It is prudent to conduct sufficient due process and consider the impact on the industry.

- In Japan, the banking industry experienced an economic bubble during the late 80s and subsequently burst. During 1986-1989 the Nikkei stock index and land prices jumped threefold. Meanwhile, real estate loans extended by banks increased 150%. This was the period when the Japanese regulators introduced Basel I. Japanese banks were afraid that the new regulation would lower their earnings, which motivated them to focus on risky but lucrative real estate loans. Japanese banks also actively used affiliated nonbanks as the vehicle to expand

real estate loans as the assets of those affiliates were not counted as regulatory risk assets.

- Currently, the governments of G 20 countries are considering setting up new standards for banking regulations and supervision. It is positive moment to reconsider the weakness of the current system, though it should be kept in mind that regulatory changes could alter the banks' behavior and encourage them to take risks in unexpected areas.
- In addition, the regulator's approach to measure the risk assets of banks could cause loopholes and regulatory arbitrage even if the method is refined. The enhanced regulatory framework is not a panacea. It is critical to strengthen the motivation of financial institutions to take prudent risk management and to take a long-term approach in making business decisions. .

SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:
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Capital Markets in Japan

- Recent Developments and Policy Changes

Yoshio Okubo
Senior Managing Director
Japan Securities Dealers Association

JSDA
Japan Securities Dealers Association

Stock Market part 1

Nikkei 225 (From Jan 1985)



NIKKEI 225

Source: Yahoo Finance

Stock Market part 2

Major Stock Index (From Sep 15, 2008)



NIKKEI 225

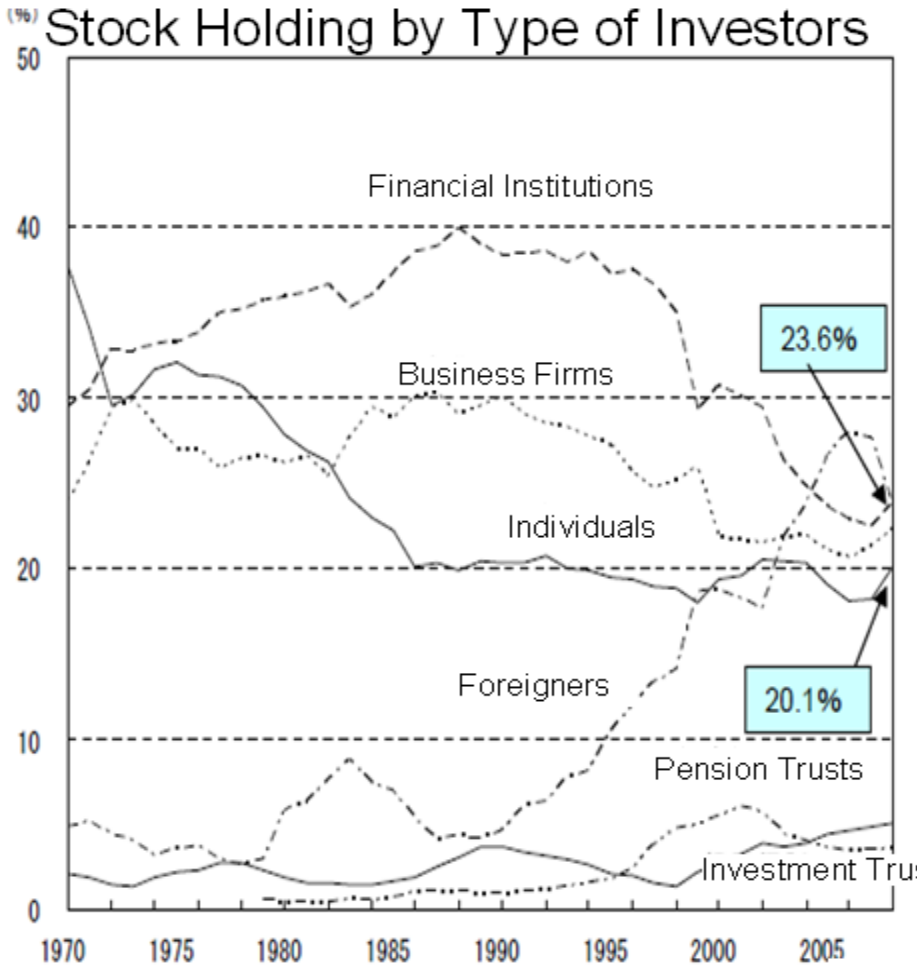
SSE Composite Index

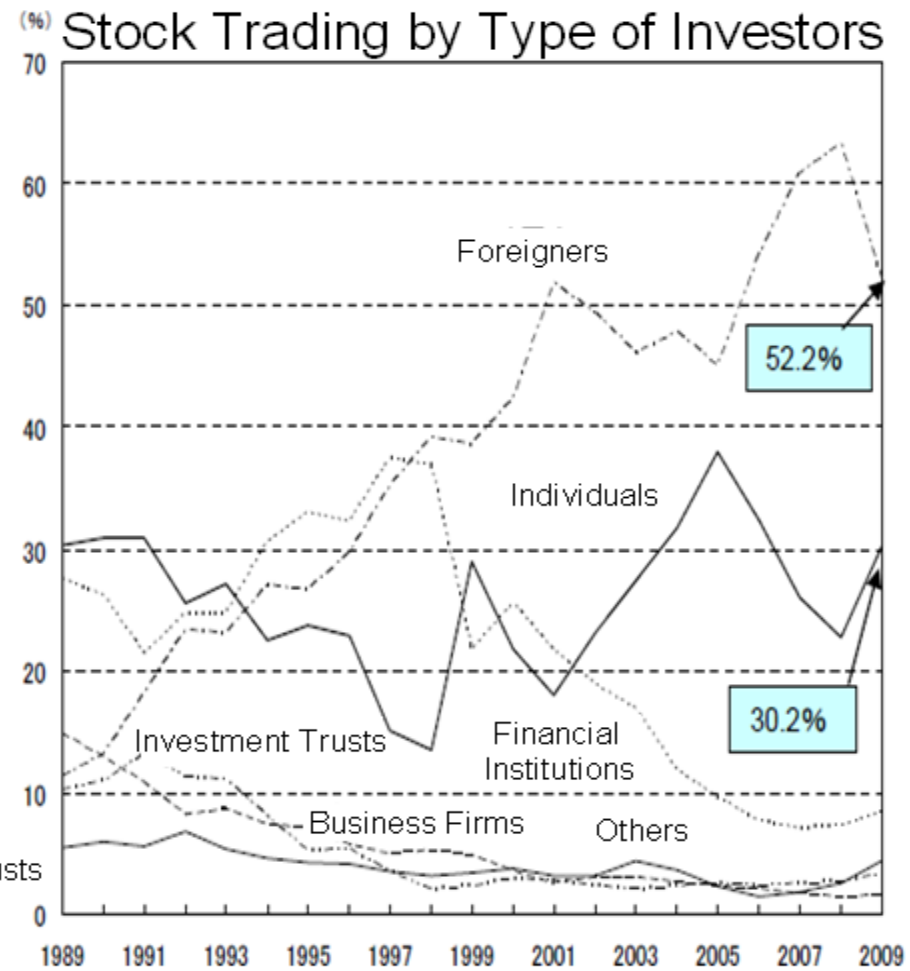
Dow Jones Industrial Average

FTSE 100

Source: Yahoo Finance

Stock Holding and Trading by Type of Investors





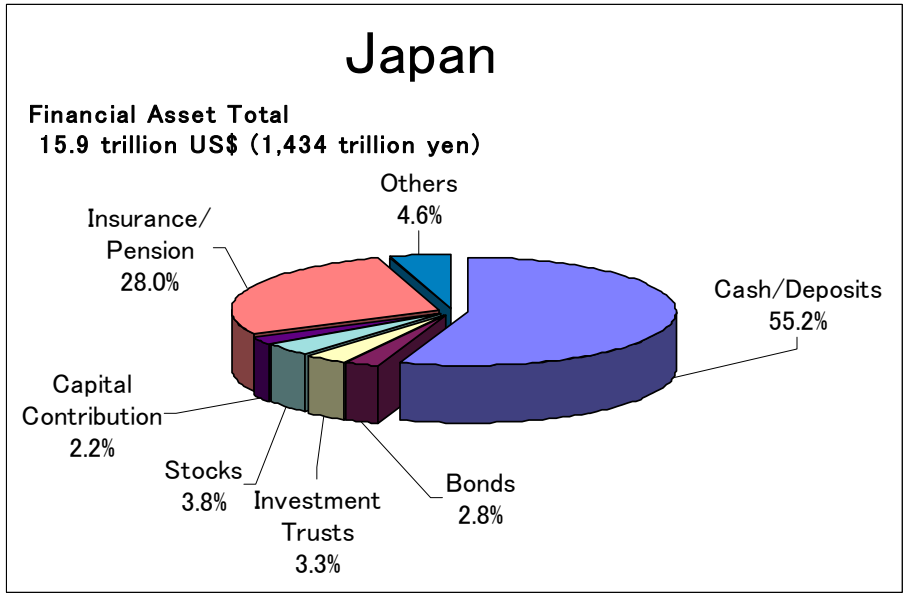
* Up to end of FY 2008
* “Financial Institutions” don’t include Investment trusts and Pension Trusts.
  However, before 1978, it includes Pension Trusts

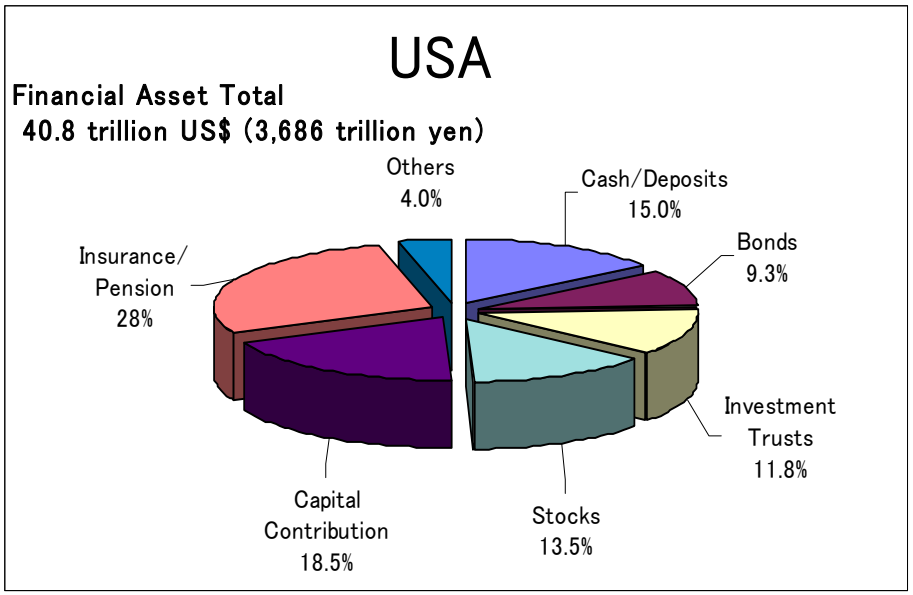
Source: Tokyo, Osaka, Nagoya, Fukuoka and Sapporo Stock Exchange

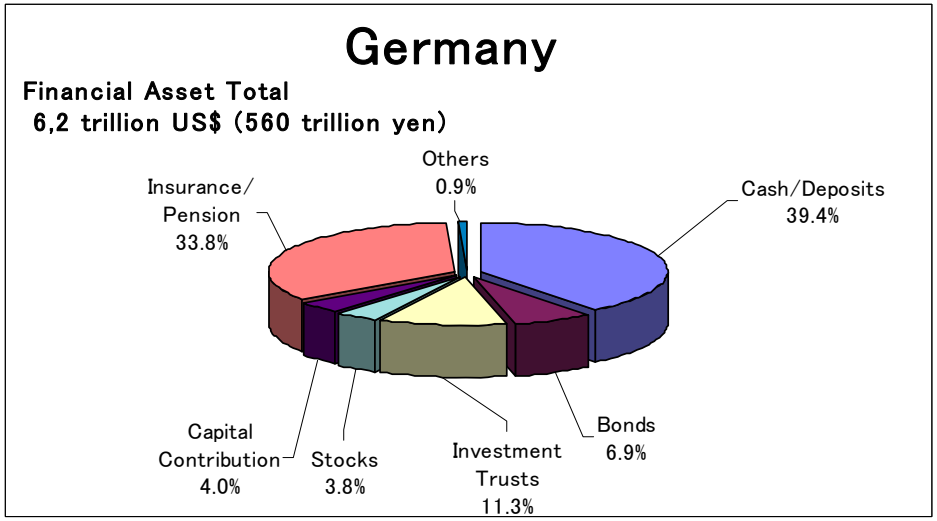
* Up to the forth week of July in 2009
* “Financial Institutions” consists of Insurance Companies, City Banks, Regional Banks and Trust Banks
* Market participants with more than 3 billion yen capitalization in three markets (Tokyo, Osaka and Nagoya) are surveyed

Source: Tokyo Stock Exchange

Composition of Household Financial Assets





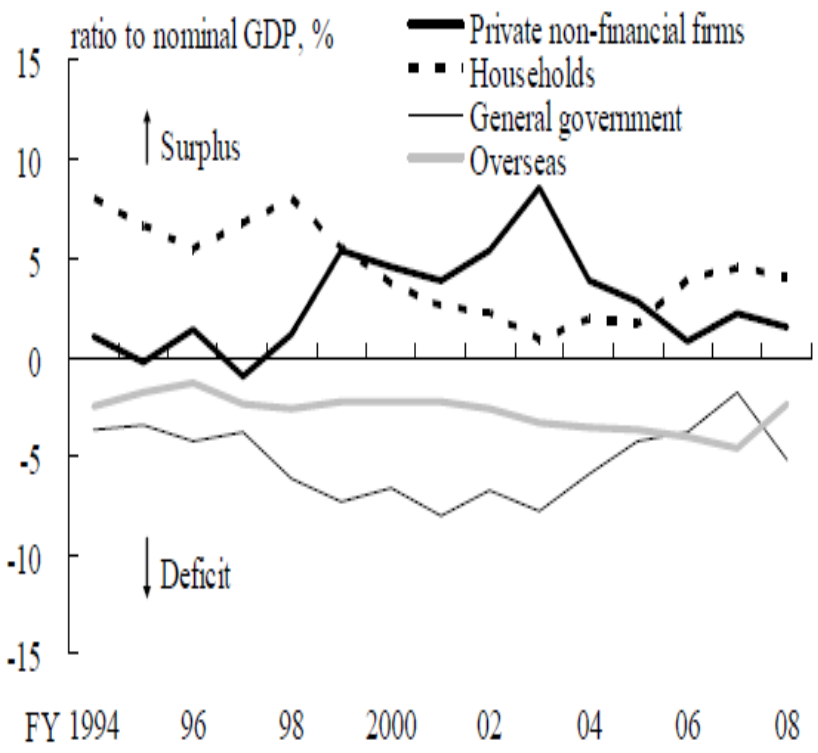


As of end of CY 2008

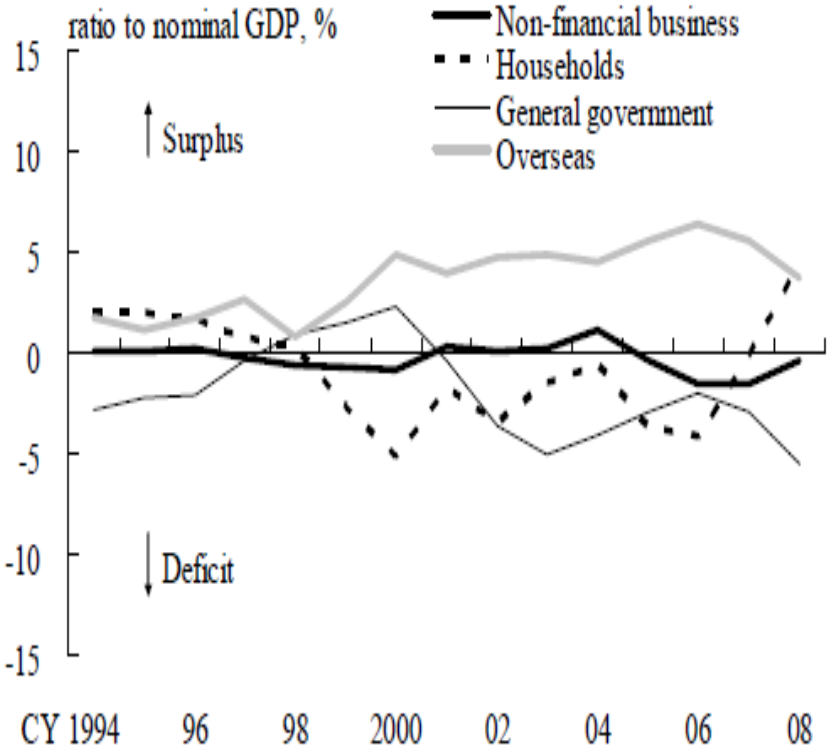
Source: Bank of Japan, FRB and Deutsche Bundesbank

Sectoral Financial Surplus/Deficit

Japan



USA

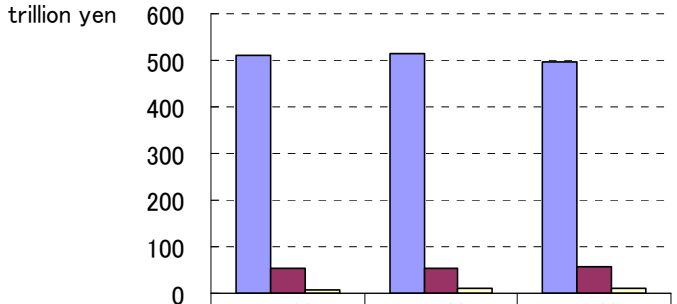


Source: Bank of Japan

Corporate Bond Market in Japan and USA part 1

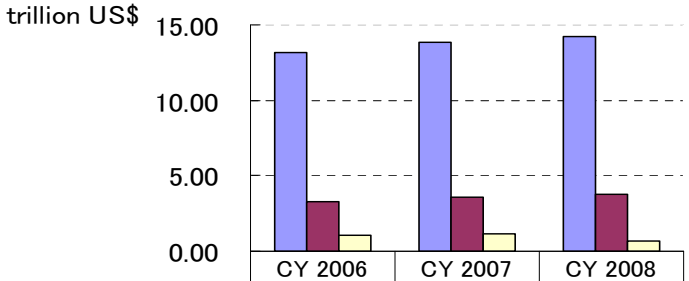
1. GDP and Corporate Bond

Japan



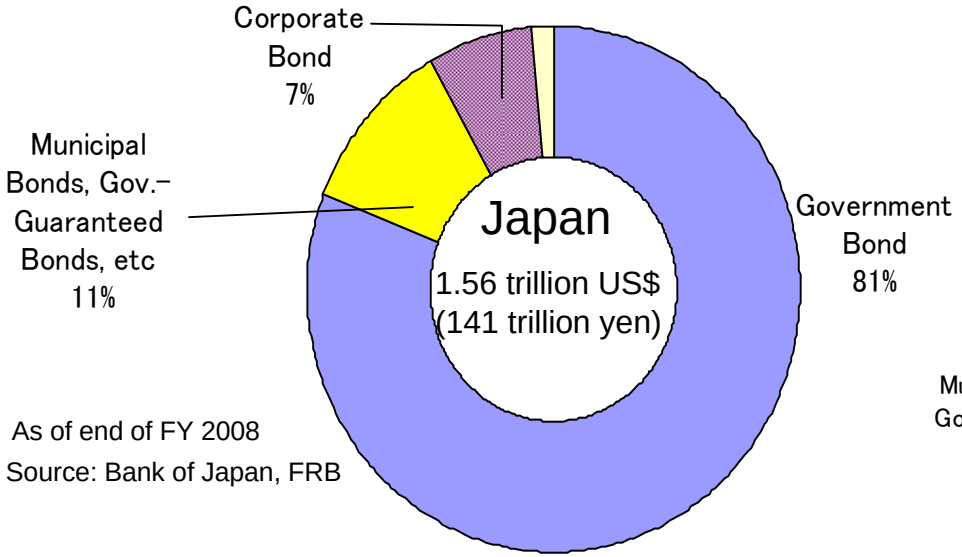
	FY 2006	FY 2007	FY 2008
GDP	510.90	515.82	497.42
Outstanding Amount	51.87	54.42	56.10
Issuing Amount	6.83	9.40	9.60

USA



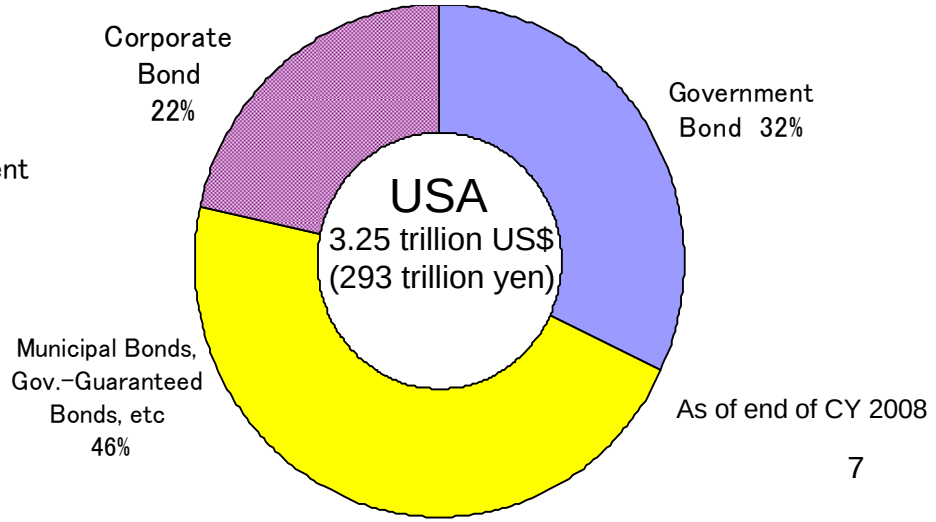
	CY 2006	CY 2007	CY 2008
GDP	13.18	13.81	14.26
Outstanding Amount	3.25	3.56	3.76
Issuing Amount	1.06	1.13	0.71

2. Composition of Bond Issuance



As of end of FY 2008

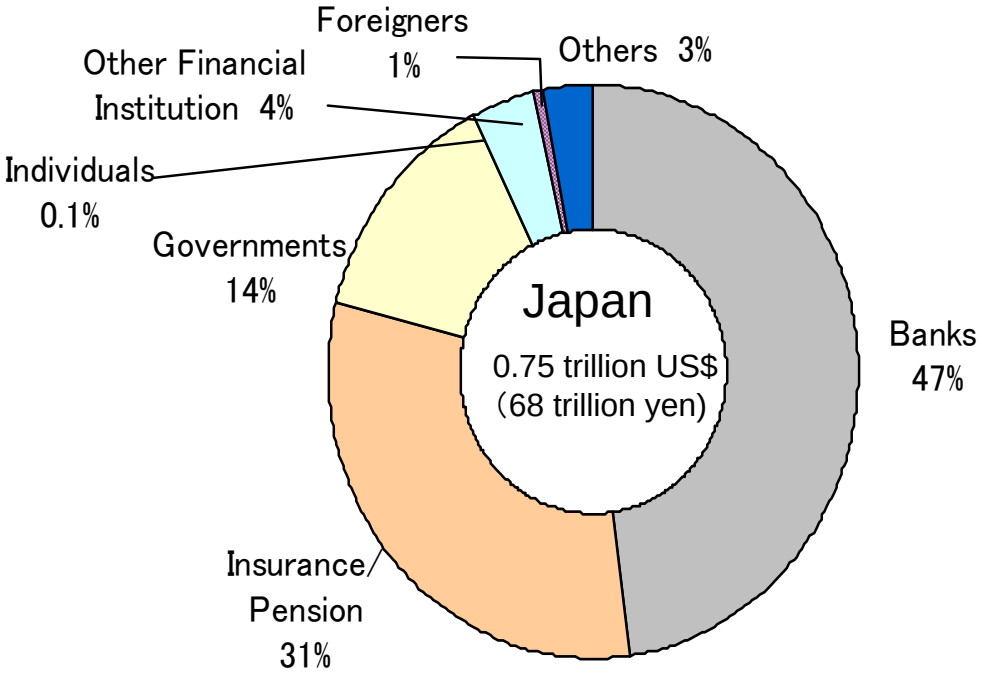
Source: Bank of Japan, FRB



As of end of CY 2008

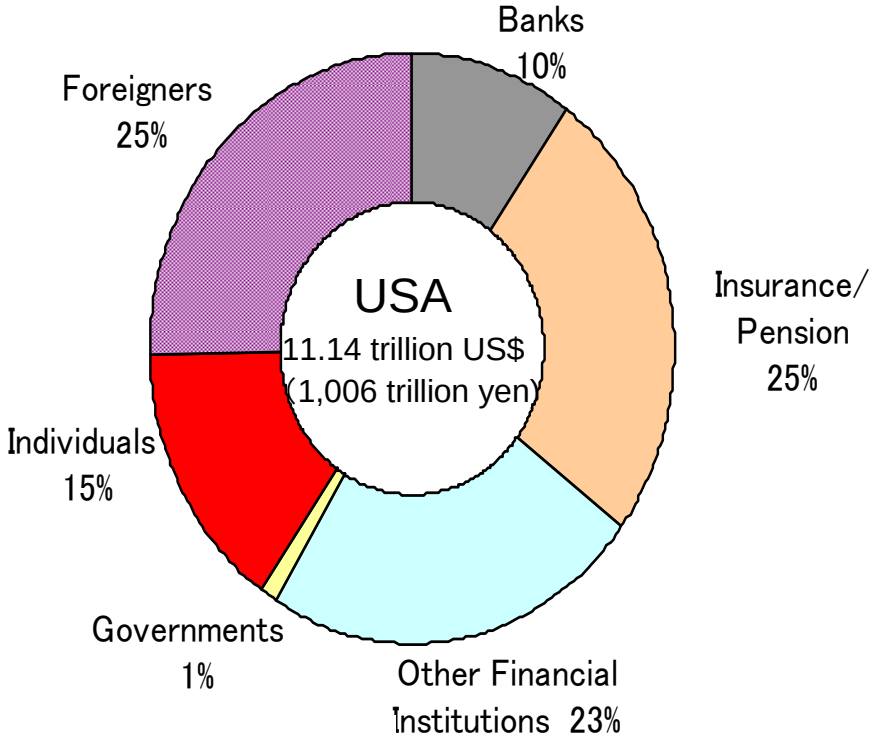
Corporate Bond Market in Japan and USA part 2

3. Bond Holding by Type of Investors



As of end of FY 2008

Source: Bank of Japan



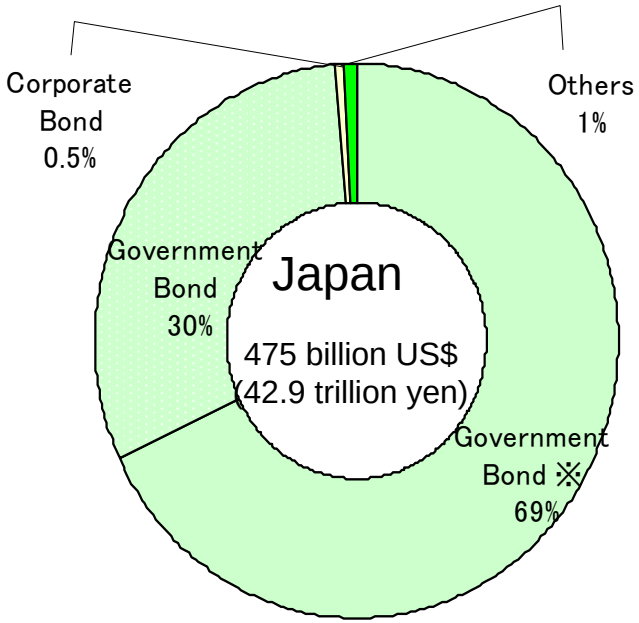
As of end of CY 2008

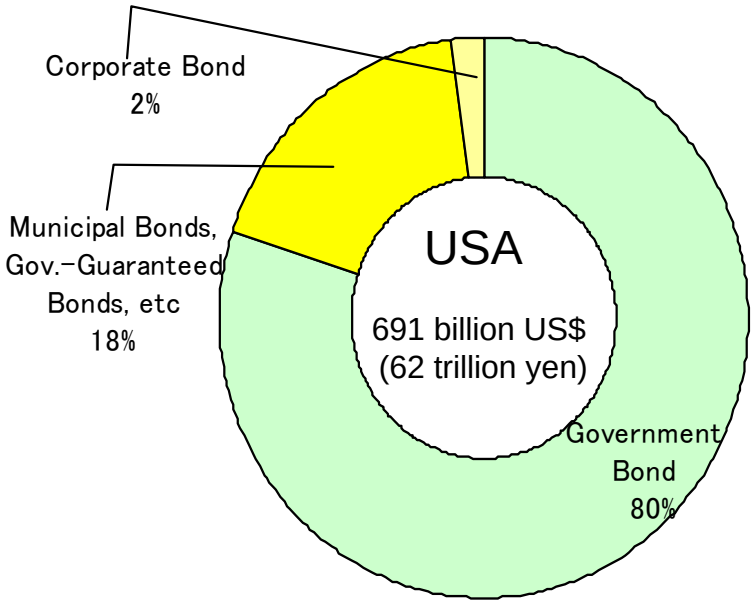
*Including overseas issuance by U.S. Firms

Source: FRB

Corporate Bond Market in Japan and USA part 3

4. Daily Bond Trading Volume





As of end of FY 2008

As of end of CY 2008

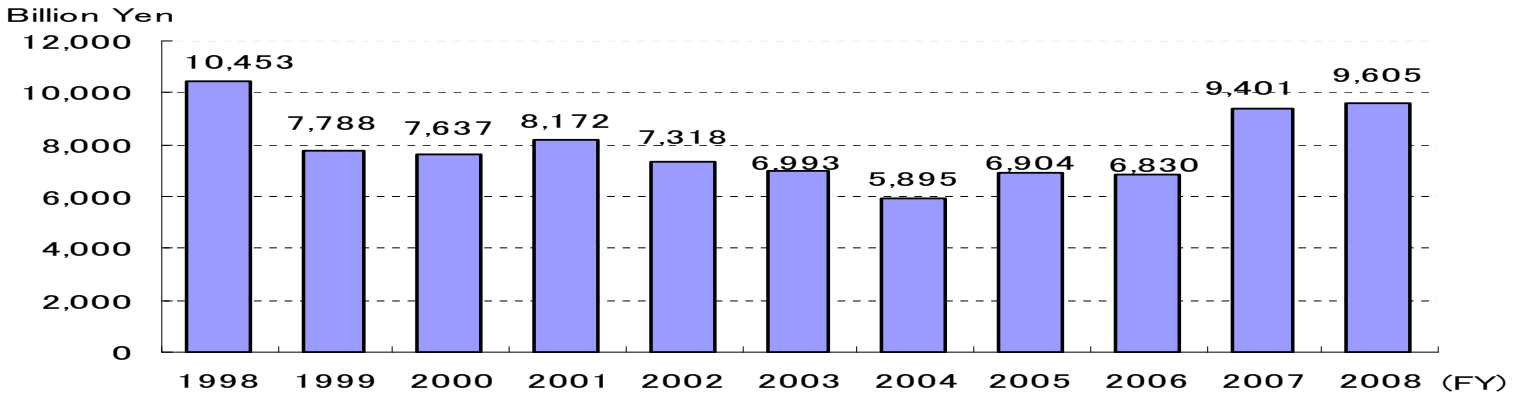
Source: FRB

* This figure shows trading volume of Gensaki Trading (transactions with repurchase agreements).

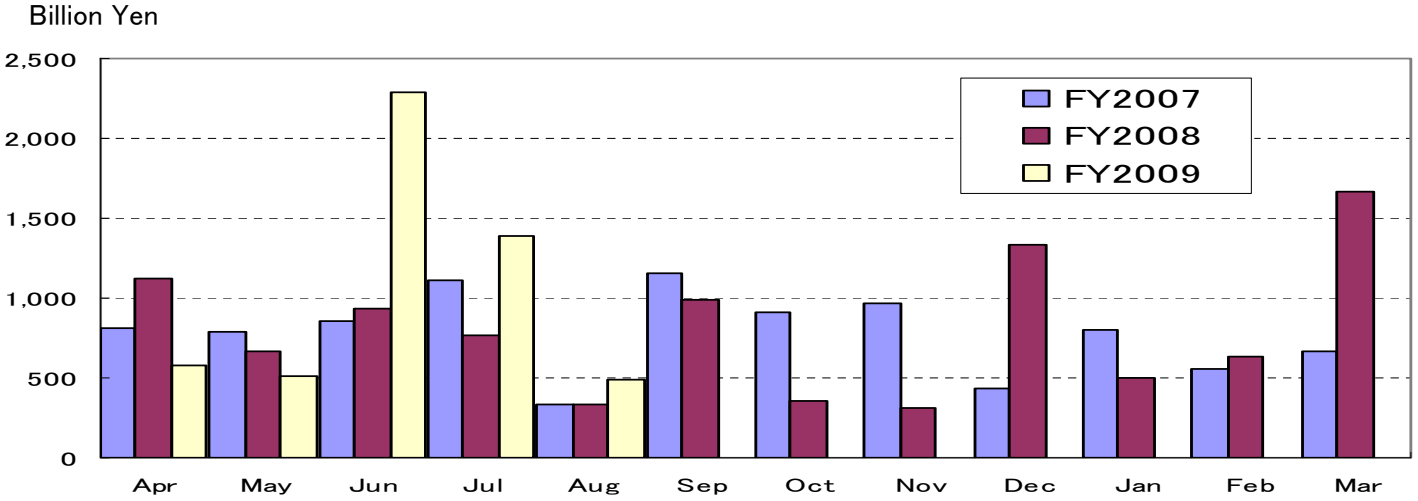
Source: JSDA

Corporate Bond Issuance in Japan

Amount of Corporate Bond Issuance in Japan



Monthly Amount of Corporate Bond Issuance in Japan



Current Policy Issues in Japanese Market

1.Corporate Bond Market

- To Activate Corporate Bond Market in Japan, Setting up Task Force in JSDA and Working on Various Related Issues (see next page)

2.Review of the Role of Self-Regulation

- Review of the Existing Rules
- Principle-Based Approach

3.Claim Intermediation

- ADR（Alternative Dispute Resolution）
- Close Cooperation with Other SROs, Filling the Regulatory Gaps

4.New Regulation for Financial Products

- Securitized Product - Transparency Initiative (Self-Regulatory Rule Implemented in June 2009)
- ”Ahead of the Curve” Initiative
  - Contracts for Difference
  - Unlisted Stocks

5.Strengthened Customer Diligence

-Prevention of Insider Trading
-Dealing with Suspicious Customers

Corporate Bond Market Task Force in JSDA

1. Increasing and diversifying Corporate Bond Issuers and Market Players

(1) Primary Market

- Issuers
- Investors
- Role of Rating Agencies and Analysts
- Securities Firms (Intermediary Function)

(2) Secondary Market

- Improving Basic Date concerning Corporate Bond Market and Information for Market Players and Investors
- Market Price, Reference Statistical Prices [Yields] for Transactions *

* It is published and calculated by JSDA on the basis of reports from its members

- Establishing Corporate Bond RP Market

2. Securitization (Products, Transaction)

- Ensuring Disclosure and Transparency of Products and Transactions
- Improvement of Statistical and Price Data
- Laws, Self-Regulatory Rules, Inspection
- Rating
- Credit Guarantee
- Secondary Market

3. Derivative Market
4. Settlement System
5. Taxation System and Accounting Standard

Response to Global Financial Crisis

- Enhancing Risk Management

- Regulations on Credit Rating Agencies

- OTC markets Contracts for Difference (CFDs)

- Infrastructure for clearing and settlement of OTC derivatives

- Review of rules and practices regarding failed deliveries in bond transactions

- New structure for Alternative Dispute Resolution (ADR) in financial markets

- Measures for strengthening the safety-net for deposit-taking institutions

About IOSCO/SROCC

IOSCO / Self-Regulatory Organization Consultative Committee

- Established in 1989 as a part of IOSCO body

- Comprising a total of 64 IOSCO affiliate members, Self-Regulatory Organizations.

- Contributing to regulatory policy development through the expertise as self-regulatory organizations.

- JSDA has chaired this committee since June 2006
  - Mr. Tatsuo Watanabe, Former Vice Chairman of JSDA, and subsequently Mr. Yoshio Okubo, Senior Managing Director of JSDA, have been acting as the chairperson on this committee

Japan's Deep Recession and Prolonged Recovery

Hugh Patrick
Center on Japanese Economy and Business
Columbia Business School

What a year! Since my previous essay a year ago, the world has been engulfed in financial crises and Japan, the U.S., and the world economy went into their worst recessions in the postwar period. Furthermore, the Democratic Party of Japan's election victory means a new era in Japanese politics has begun.

While Japan escaped severe direct effects of the global financial crisis, it was hard-hit by global declines in demand as its exports suddenly collapsed in fall 2008. What began as mild declines in Japanese GDP in the second and third quarters of 2008 turned into a debacle in the fourth quarter and continued into the first quarter of 2009, with GDP falling at an annual rate of about 12% during those six months. Japan's decline has been more severe than those of the United States and Europe. However, Japan bottomed sooner - in spring 2009. The government's first estimate of April-June 2009 GDP growth was an annual rate of 3.7%, just revised down to 2.3%. But a rebound is not a recovery. Discouragingly, Japan has returned to mild but persistent deflation after a temporary return to price stability in 2008, due essentially to the global oil and commodity price boom.

As Japan proceeds in its ongoing fundamental transformation from the earlier postwar system era, economic policy thinking has to deal with three fundamental realities.

First, Japan is a high income, high tech, sophisticated, and mature economy. This means that, like other advanced industrial economies, long-run potential GDP growth per capita is on the order of 2% a year, once cyclical recovery is achieved.

Second, Japan, sooner than other countries, is in the advanced stage of demographic transition. An increasingly large share of the population is over 65, those

of work-force age have been decreasing for more than a decade, and the total population is beginning a slow decline.

Third, Japan's most important macroeconomic problem for the past 15 years, and certainly for the next several, is lack of domestic demand growth, particularly consumption. Inadequate domestic demand is more than a cyclical problem; it is structural. Japan is not short of labor. For almost two decades labor has been in surplus because Japan has been unable to achieve sustained, full employment growth.

What the current recession vividly demonstrates is that Japan's overwhelming macroeconomic problem is the combination of lack of aggregate demand and its unbalanced structure. There was great reliance on growth of exports and domestic business investment. Relatedly, mild but persistent deflation is a significant concern. The big question continues to be: where will sufficient aggregate demand come from to bring about a real recovery and sustained growth?

Japanese public discourse on the economy is replete with false facts and misleading clichés. Rapid growth in the 1980s was not miraculous; it is explained by standard economic factors. The 1990s were not a "lost decade"; economic growth was mediocre, but a host of institutional, political, and social changes took place. The main source of increases in income inequality are not Prime Minister Junichiro Koizumi's economic structural reforms; failure to achieve full employment is. Fiscal policy in the 1990s was not a failure; it was a success when it was allowed to work. Its inadequacies were because fiscal stimulus was too little, too late, too ad hoc, and too uncertain; and when successful, it was prematurely terminated in 1997.

I am less optimistic than in previous years about the near and medium term. In the sections that follow, the focus is on Japan's macroeconomic challenges and policy choices. I consider the August elections, the incomplete 2002-07 recovery, recent economic performance, the economy's near-term future, the aggregate demand conundrum, Japan's international economic relations, and growth in the longer run.

The New Political Ballgame

The Democratic Party of Japan (DPJ) won an overwhelming victory in the House of Representatives election held August 30, and DPJ president Yukio Hatoyama became prime minister on September 16. Aside from an 11-month period in 1993, this is the first time since 1955 that the Liberal Democratic Party (LDP) has been out of power. But the election reflected less a commitment to the DPJ than a great dissatisfaction with poor LDP performance and a strong desire for change. The DPJ's victory gives the party both a surge of energy and a sense of urgency. But it is a new government, inexperienced and untested. Not only is this the DPJ's first government, almost half its lower-house members (143 of 308) are serving first terms.

Policy change is in the air – economic, political, government administration, foreign relations. But specifically what will change, how much, and to what degree is far from certain. The DPJ is characterized as slightly left of center, and the LDP slightly right of center, but both parties encompass a broad political spectrum. DPJ Diet members range from moderately conservative to socialist, and some were once LDP members. Still, despite a great deal of rhetoric, significant change is unlikely to come quickly.

In addressing both immediate and longer-run issues, the debates in coming months will be shaped by preparation for the House of Councillors election in July 2010. The DPJ currently controls the upper house in coalition. Depending on how its performance during its first 10 months is perceived, the DPJ could gain complete control then. But it could also face backlash that weakens DPJ control of the government, or even gives the LDP an upper house majority, although that seems unlikely. In any case, the DPJ is here to stay - lower house elections do not need to be held until 2013.

The DPJ's economic philosophy is not oriented toward efficiency-enhancing structural economic reform. Rather, it is to reject what it considers market-liberalization excesses, especially in labor markets, although it is not anti-market. The DPJ has stated it will pursue three major economic policy objectives.

The first is switching government expenditures from public infrastructure to household consumption. The centerpieces of this is providing annual payments for each

child of ¥312,000 ($3,284 at 95 yen per dollar) through middle school (age 15), educational payments to reduce senior high school education fees and costs, and income transfers to farmers. These new expenditures are projected to rise to about 3 percent of GDP, to be financed by cutting other expenditures.

The second is fiscal moderation. The DPJ will not depend upon deficit financing more than the LDP did in its 2009 government budget; it will not engage in further deficit financing (government bond issue) to finance the new social welfare expenditure programs. While in the 2010 budget the DPJ will utilize government special account reserves as well as cutting out some infrastructure projects, in the longer run other expenditures will be cut and revenue adjustments made, such as eliminating family deductions for income taxes. The DPJ has promised not to raise the consumption tax in the next four years.

The third objective is to create a new, powerful, politician-dominated policy-making apparatus, in order to reduce significantly the power of the central government bureaucracy and its long-standing, cozy relationships with the LDP. This will be a new National Strategy Bureau, reporting directly to the prime minister, consisting of 30 or so knowledgeable policy advisors drawn from the private sector, Diet members, and some bureaucrats. It will be led by Naoto Kan, a former head of the DPJ, who will concurrently serve as deputy prime minister. The DPJ is determined to impose stronger political control over the bureaucracy and to the extent it succeeds it will bring about basic change in the way Japan is governed. But the DPJ cannot rule without the cooperation of the bureaucracy so pragmatism will lead it to some kind of accommodation with the bureaucracy.

The immediate policy battleground will be the Diet deliberations starting in October on the budget for fiscal 2010 (which begins April 1, 2010), as well as a revision of the LDP 2009 supplementary budget. The transfers for children will be addressed, and probably begun next April, but for the first year at half the amount planned for subsequent years.

A key political issue is whether the DPJ can increase social welfare expenditures without having to increase total expenditures and thus further increase the deficit. It can find the revenues for fiscal 2010, but for fiscal 2011 and beyond that will be difficult. My expectation is that the government will delay new expenditure programs in order to prevent further deficit financing, unless the current recovery seriously falters. The DPJ apparently does not feel a need to seriously change the LDP economic recovery policy. It has not articulated a comprehensive longer-run growth strategy. That too will be an important issue in the economic policy debates in coming months and years.

The Incomplete 2002-07 Recovery

It is important to place Japan's current economic condition in the context of the 2002-07 incomplete recovery from the difficulties of the 1990s. From 2002 to 2007 Japanese GDP increased 11%, about 2% annually, in both total and per capita terms since population was flat. In per capita terms Japan grew slightly faster than the United States, though from a greater initial output gap.

Companies were able to eliminate their three excesses: too much debt, too much capacity, and too much labor. The main drivers of growth during 2002-07 were exports and business fixed investment. Exports increased a remarkable 58%, and rose impressively as a share of GDP from 10.9% in real terms (11.3% in current prices) in 2002 to 17.4% (17.6%) in 2007. Business fixed investment, already high at 13.7% of real GDP in 2002 (13.5% in current prices) rose by 30% to a 16.0% share (also 16.0% in current prices) in 2007. Consumption spending was little help, increasing only 5%. Already a low 57.5% (56.5%) of GDP in 2002, the consumption share fell to 54.8% (56.3%) in 2007. Public investment continued its decline, from 6.3% to 3.4% (6.3% to 4.0% in current prices).

Japan benefited from surging Chinese development, combined with good growth in the United States and the rest of Asia. Exports also benefited from the weak yen, due to low Japanese interest rates, the carry trade, and other Japanese capital outflows.

Japan's comparative advantage was and is in automobiles, electronic goods, and machinery, all of which respond strongly to rises in foreign demand and, as the last year has demonstrated, also to declines. Most of the increase in manufacturing capacity and industrial production during the period was to provide exports.

Growth from the 2002 trough to the 2007 peak was good, but not good enough. Recovery was incomplete: full employment was not achieved and domestic deflationary pressures were not brought to an end. Equally important, the structure of aggregate demand was unbalanced; growth depended primarily on extraordinarily high rates of growth of exports and business investment. Aggregate demand imbalances were not overcome by consumption growth because household income increases were low; and government policies of fiscal consolidation (reduced deficit spending) held back faster growth.

The core Consumer Price Index (CPI) fell slightly or was flat during 2002-07. Only in late 2007 did prices begin to rise, and then only due to the global oil and commodity price boom. CPI inflation increased to a peak monthly rate of 2.4% in July 2008 before rapidly declining to zero by the beginning of 2009. The Bank of Japan was not able to raise its basic interest beyond 0.5% (from zero), which meant a more normal level of market interest rates could not be achieved.

Unemployment declined from a monthly peak of 5.5% in early 2003 to 3.8% by the end of 2007. Labor markets became more efficient; but without strong GDP growth and demand for labor, many workers were adversely affected. Non-regular workers continued their dramatic rise as a share of the labor force - from a fifth in 1990 to a third in 2009. The part-time, contract, subcontract, and temporary workers that make up this group receive weak employment commitments, lower wages, and fewer benefits. For some, non-regular status reflects a lifestyle choice, but large numbers, especially young people, unsuccessfully have sought regular, full-time employment.

Firms have benefited doubly; they can replace retiring regular workers with low-cost non-regular workers, and in times of economic downturn the non-regulars can be

laid off easily. Thus, even as unemployment was reduced, the economy's wage bill fell over the period, and disposable household income as a share of GDP declined.

Labor market developments in a micro sense increased efficiency and benefited companies, but retarded total demand. This has contributed to the public view that income inequality has become a significant social problem, a dramatic change from the 1980s when more than 90% of the Japanese considered themselves to be middle class (or middle mass, the Japanese phrase used to avoid the concept of class). Income inequality in fact has increased somewhat from the 1980s. The distribution is slightly less equal than the OECD median, but still considerably more equal than in the United States. The incomplete recovery, with its failure to achieve full employment, has been a main source of the increased inequality.

Recent Economic Performance

A year ago the emerging recession was seen as halting the recovery but otherwise was not expected to be severe. Instead, Japan has gone through its longest and deepest postwar decline in GDP. The economy turned around in the second quarter of 2009, but GDP in summer 2009 is still 6.4% below its peak.

However, in aggregate, the adverse economic effects of recession have been relatively modest. GDP per capita in 2009 in purchasing power parity terms is estimated to be about $32,300, a decline to slightly above the 2006 level. Consumption has fallen only slightly. Unemployment has rather sharply increased, from a monthly low of 3.8% in October 2008 to an unprecedented 5.7% in July 2009, but remains far below Western levels. Housing ownership has remained stable, and foreclosures are not a problem. Unlike the 1973-74 oil crisis, there is no inflation or widespread sense of panic, no fears of import embargoes or shortages. However, the recession has hurt the already vulnerable, including part-time and temporary workers and those soon entering the labor force. Japan's unemployment insurance programs are not well developed.

GDP plunged 3.2% in fiscal 2008 (ending March 31, 2009). This was triggered by a 10.2% decline in exports and a 9.6% decline in business fixed investment; together they accounted for more than the total drop in GDP. The annual data smooth out what were stunning quarterly slumps. Compared to a year earlier, exports fell 12.6% in the 2008 fourth quarter and by 36.4% in 2009 first quarter; business fixed investment dropped 11.8% and 20.5%, respectively. Consumption held up fairly well over the year, declining only 1.5%.

The good news in late summer 2009 is that GDP has stopped dropping and has begun to rise. The less good news is that the turnaround in the second quarter was due more than entirely to foreign trade. Exports rose sharply, industrial production increased, and imports dropped; together that increased demand by 6.5%, far more than the initial estimate of an annualized 3.7% GDP increase. The government's revised second quarter growth estimate on September 11 of only 2.3% was a surprise. It was not such bad news however, since most of the further decline in domestic demand was even larger reductions in company inventories, which in coming months will be reversed and provide more stimulus. Nonetheless, domestic demand declined by 4.2% in the second quarter at an annual rate, as slowdowns in business fixed and inventory investment and housing investment more than offset a substantial rise in public investment and some consumption growth.

Japan's financial system has so far weathered the crises and recession reasonably well, in large part because in the late 1990s it went through its own crisis, consolidation, and reform. The regulatory system was overhauled and the Financial Services Agency (FSA) was established. The FSA's problem is not lack of regulatory authority but lack of staff, budget, and better market oversight information technology. In fall 2008 the Bank of Japan effectively stepped in to prevent the freezing of domestic financial markets by actively purchasing commercial paper and corporate bonds and taking other temporary measures to avoid a credit crunch.

The Tokyo stock market dropped to 7055 (Nikkei index) on March 10, 2009, its lowest level since the market bubble burst in 1990. Foreign holders reduced their share of the market by 4.0 percentage points to 23.6% as of March 30, 2009.

Japanese major banks have large corporate shareholding positions for client relationship purposes. Banks took substantial book losses on the decreased mark-to-market value of their holdings of stock and other securities in fiscal 2008, and have hustled to raise new capital. However, given limited exposure to US subprime loans and related derivatives, the banks were not otherwise directly hit hard by the global financial crisis and recession. The ratio of non-performing loans did not increase. At the end of March 2009 it was only 1.9% for major banks and 3.0% for the entire banking system, though some small local institutions continue to be in real trouble.

The stock market has rebounded; on September 11 the Nikkei was 10,444. Stock market volatility is a source of banking vulnerability, but for competitive reasons, no individual bank can reduce specific-company holdings. A government policy to restrict bank equity holdings by half, or more, from the current 100% limit relative to bank Tier 2 capital makes sense.

While the pace of mergers and acquisitions has slowed somewhat in Japan as elsewhere, it has continued with greater participation by Japanese firms, both domestically and internationally. Some parent companies such as Hitachi are buying listed profitable subsidiaries at below book value. The number of management buy-outs of small companies continues to rise, albeit from very low levels. The strategic decisions of major Japanese to acquire foreign companies are an important trend.

With population declining, companies in markets where economies of scale are important face saturated domestic markets. Managements do not want to reduce firm size and distribute proceeds to shareholders and employees. Domestic merger with a competitor is increasingly taking place, but is not easy. Successful diversification into new fields or industries is not easy either, as the 1980s and 1990s demonstrated. The current surge of Japanese company expansion abroad, usually by acquisition, will persist. This will pose difficult human resource management and institutional challenges

for these firms, especially for non-manufactures, as they enter unfamiliar foreign environments.

Small and medium enterprises (SMEs) have been particularly hard hit by the recession. SMEs comprise a large share of output and, more importantly, employment. The government has taken a range of steps to ensure that SMEs do not suffer a credit crunch. Regulations for lending institutions were eased, such as not counting rescheduled loans as non-performing or special attention loans if the SME borrower had a viable restructuring plan. Importantly, the government in October 2008 provided ¥20 trillion ($211 billion) to back 100% loan-loss guarantees through local credit guarantee corporations, rather than requiring lending banks to bear a portion of the losses. By February 2009, some ¥8.8 trillion in loan guarantees had been utilized.

Bank of Japan (BoJ) policy has been good, but its ability to combat the recession has been severely constrained. During the 2002-07 recovery it was not able to raise its basic overnight call rate above 0.5% (reached in 2006). The BoJ lowered its rate to 0.3% on October 31, 2008, and to 0.1% on December 19, but, not surprisingly, the effects were small.

The main failure of monetary policy has been its inability to halt deflation, even to the BoJ's own conservative implicit range of an annual core CPI increase of 0 to 1%. (I think the range, explicit or implicit, should be 1% to 2%, similar to the European Central Bank and the U.S. Federal Reserve System.) As a consequence of booming world and Japanese import commodity prices, core CPI rose to a peak of 2.4% in summer 2008, but as commodity prices plummeted, the CPI dropped to 0 in January 2009 and to minus 2.2% in July.

Deflation has a wide range of bad effects. It discourages investment, borrowing, and current purchase of durable goods. It makes traditional monetary policy ineffective. And, also important for Japan, it has an adverse fiscal policy effect. Deflation reduces government tax revenues, in addition to the revenue declines from slowed real GDP growth. Japan's GDP price deflator has been negative consistently, if modestly, since

1998, so GDP changes in current prices are lower than in real terms. The GDP deflator declined by 0.3% in fiscal 2008.

As the economy suddenly declined precipitously, in spring 2009 the LDP government dramatically abandoned its fiscal consolidation policy of the previous several years. While it kept the conservative 2009 budget intact, once it was enacted the government immediately announced a huge supplementary budget stimulus package, passed May 29, of ¥13.9 trillion ($146.3 billion), about 3% of current price GDP. About half is direct expenditure. This one-shot boost is now having an impact on consumption and public investment which will continue, albeit diminishing, through the first half of 2010.

Unemployment is a lagging measure of an economy's performance. Japan's rate rose from a low of 3.8% in October 2008 to 5.7% in July 2009, surpassing the former peak of 5.4% in April 2003. Despite the current recovery of output, unemployment is projected to continue to rise to about 6.0% before beginning to decline in the first half of 2010.

Japanese increases in unemployment have been less severe than elsewhere, in part because companies shortened work hours and shared reduced workloads, thereby retaining regular workers. Importantly the government now pays two-thirds or more of the wages of some 2.4 million regular workers deemed surplus in more than 83 thousand firms; they comprise 3.6% of the total labor force. Accordingly, quarterly measures of output and productivity per worker have temporarily plummeted. Japan continues to rely on a company-based employment welfare system rather than direct unemployment compensation for unemployed workers.

Bifurcation in labor markets has become more important as non-regular workers have increased. Full-time regular employees are protected both by company permanent employment commitments and by laws that make it difficult to lay them off. Those losing jobs are usually temporary workers, subcontractors, and those whose contracts expire.

The Japanese system of wage payments has significantly greater downward flexibility than in the United States or Europe. It is not only a matter of replacing retiring regular workers with non-regular workers, though that has been important. A major source of downward wage cuts is reduction of the semiannual bonuses that virtually all employees receive. The norm is for winter and summer bonuses to be about 4 months of regular monthly wages, depending on the industry and firm size. Profitability is an important factor, so bonuses can vary significantly from year to year and firm to firm. Surveys estimate the summer 2009 bonuses of large firms will be lower by about 17% from a year ago, the first absolute decrease since 2002. Export-oriented manufacturing firms are cutting bonuses even more. The decline for non-manufacturing firms is a modest 2%, the first time in five years their bonus payments will be larger on average than manufacturers.

The combination of these forces – increases in non-regular workers, reduced overtime, and lower bonuses – meant that total cash earnings of all employees in Japan decreased by 0.7% in fiscal 2007, 1.1% in fiscal 2008, and an unprecedented 4.7% in the second quarter of 2009. It is not surprising that household income as a share of GDP has stagnated, that the household saving rate is now a low 3% to 4%, and that the consumption share of GDP continued to be low, 57.8% of GDP in current prices (55.5% in real terms) in fiscal 2008.

Labor market flexibility makes for greater efficiencies in a full employment economy, but the widening inequalities of income distribution, unemployment, and underemployment have generated a political backlash. Thus, dissatisfaction with changes in the labor market are deemed one factor in the DPJ's election victory.

The Near-Term Outlook

I am not optimistic about Japan's near- to medium-term economic performance. Japan will not achieve full recovery until GDP grows at 2% or better for long enough to eliminate the output gap and full employment is achieved. I do not foresee that

happening soon. The economy is beginning to recover, but it is likely to be a slow process, importantly dependent on DPJ policy initiatives and an increase in exports.

I expect the DPJ fiscal 2010 budget to signal fiscal caution. New welfare expenditures will be financed by other expenditure cuts and use of reserve funds. As part of this, the DPJ has indicated it will quickly enact a second 2009 supplementary budget with reductions of ¥3 trillion or so by freezing or eliminating projects already identified as low priority. Export success depends not only on how rapidly China, the other Asian economies, and the United States recover and grow, but the extent to which they shift demand more to domestic consumption and investment and less to foreign trade.

Growth in the second half of 2009 may be about the same as the revised second quarter estimates. Exports will increase, but at a less dramatic rate as foreign inventory adjustments are completed. Consumption and public investment will continue to do reasonably well due to the 2009 supplementary budget, and Japanese inventory restocking will begin. Overall, year-on-year GDP growth forecasts see a 5% to 6% downturn for calendar 2009, but a negative 3% or so for fiscal 2009 - the fiscal year does not include the terrible January-March 2009 quarter.

The prospects for 2010 do not look very good: around 1% GDP growth, a still huge output gap, and relatively high unemployment. Although negative CPI growth will bottom in the fourth quarter of 2009, deflation will not end for several more years unless a new global oil and commodity boom develops. The CPI change will be about minus 1% in 2010.

The economy will continue slow recovery into 2011, at perhaps a 1.5% rate. Full employment seems at least several years away. Mild deflation will persist with small negative values of core CPI changes through 2011 and beyond.

It is more difficult to forecast Japanese economic performance for the 3-5 year period, and I may be too cautious. Some analysts I respect are more positive. The IMF optimistically forecast in spring 2009 that Japan's growth will accelerate to a peak of 3.2% in 2012 and will still be a very good 2.5% in 2014, mainly as a consequence of

renewed world GDP and trade growth. It will be wonderful if this proves correct. It could mean that, after more than two decades Japan will finally be achieving full employment growth.

A modest rebound the rest of 2009 and growth of 1% or so in 2010 is not very good news for the DPJ, but not terrible news either. The economy could perform even better if the world economy and trade recover rapidly and Japanese investors and consumers become more optimistic. It would be bad news if Japan were to suffer a double-dip recession in early 2010. If so, and if recovery prospects looked dim, I would not be surprised if the DPJ were to pas a major stimulus supplementary budget in spring 2010, as the LDP did in spring 2009.

Japan's Aggregate Demand Conundrum

In the long run, Japan's growth of GDP per capita depends fundamentally on improvements in labor productivity through innovation, technological change, education, institutional and organizational improvements – all the factors that make the economy more efficient and increase aggregate supply capacity. However, in the near to intermediate period, Japan's major macroeconomic problem will continue to be the persistence of inadequate aggregate demand.

More particularly, business fixed investment is too high a share of GDP, and household consumption is too low a share. Japan's business fixed investment share of 15% is greater than the US share, but the US economy grows more rapidly. Japan's business incremental capital/output ratio, an inverse measure of capital efficiency, is triple the U.S. Given Japan's demographic reality of a declining labor force, in equilibrium the economy requires business investment of, at most, 11% to 12% of GDP, a reduction of 3 to 4 percentage points.

The average returns on business investment and on assets in Japan are significantly below Western companies and industries, and have been for two decades. It is not just that interest rates have been extraordinarily low, or that exports have

boomed. Most listed companies are controlled by their management, and smaller firms by their owners. Their basic objective is to ensure the company survives, and if possible thrives. Management retains cash flow and profits in order to invest; dividend payout ratios are low. New investment increases productivity, expands capacity, and maintains jobs, including those of managers. (Japan has no labor market for senior corporate executives, unlike the United States.) Over time the share of domestic investment to GDP will probably decrease as market pressures strengthen and population declines. Instead firms will invest abroad as they seek markets.

A good domestic demand structure implies that, rather than 55% of GDP, consumption should be somewhere between 60% and 65%. How to achieve this is a conundrum. Consumption depends mainly on household income, and to a lesser degree on household assets. In aggregate the household savings rate is now low, and dissaving by the elderly as they spend assets is constrained by the skewed wealth distribution. Pensions are lower than wages when workers retire. Household income depends on employment and wage payments; both are determined by demand for labor, which is dependent on GDP growth. For consumption to rise significantly, wages have to increase significantly. But that will occur only in a growing economy already having achieved full employment.

The other major demand component is the government sector. The 1990s were a period of great fiscal expansion, significantly due to tax shortfalls and mandated welfare transfer payments. Consequently the gross government debt to GDP ratio rose sharply, and is now 172%. From 2002 until early 2009 the government pursued fiscal consolidation in an unrealistic effort to achieve primary balance by 2011. In the face of recession, in June 2009 the LDP government's goal to achieve primary balance was postponed for a decade or so; and on the condition that the consumption tax, currently 5%, be gradually increased to 10% or 12%. A further condition is that prices rise sufficiently that a 3% GDP growth in current prices, and hence government tax revenues, be achieved.

To provide adequate domestic demand growth, another strong fiscal stimulus package in 2010 may well be necessary. I have argued for several years that Japan needs strong, temporary fiscal stimulus to jump-start the economy, rather than a misguided policy of fiscal consolidation when labor and other resources are underemployed. However, the political reality is that sufficient fiscal stimulus is unlikely to be adopted.

Many Japanese policy makers, media, and the general public apparently do not sufficiently understand basic macroeconomic principles and analyses. Certainly the ratio of government debt to GDP is very high and should be reduced, but only once the output gap is eliminated and the economy is back on a sustainable full-employment GDP growth path.

The risks of the high gross debt to GDP ratio are exaggerated and overly feared; they are not catastrophic. About half the debt is owned by various government units and the Bank of Japan. Government net debt is about 90% of GDP, high but sustainable. Almost all the debt is owned domestically; foreign holdings are too small to create exchange rate or balance of payment difficulties, and Japan's foreign exchange reserves are an excessive $1.022 trillion.

Interest rates are extraordinarily low, and government interest payments on its debt are only 2% of GDP. Market long-term interest rates indicate that inflationary expectations are low for the foreseeable future. The government debt problem in the near to medium term is not as important as the problem of lack of domestic demand essential for economic recovery and growth. Japan's fiscal experience of the 1990s showed that stimulative fiscal policy works if managed correctly.

Unfortunately, most Japanese do not think this way. There is strong public concern that the government debt is too large and should not be increased significantly, even temporarily. There is insufficient appreciation of the high costs of inadequate aggregate demand. Hence the apparent fiscal conservatism of the DPJ as well as the LDP. Fiscal policy will be a key indicator of DPJ economic thinking.

Because increases in business investment, consumption, and government net spending will probably not be sufficient to propel the Japanese economy, export growth

and a strong current account surplus in the balance of payments will be the only possible major source of demand growth. To recover and grow, more than before Japan will depend on the growth of China, the rest of Asia, and the United States. Japanese manufacturers will have to become even more competitive and export oriented, and service-sector companies develop effective operations in foreign markets.

Given likely slow recovery, the Bank of Japan will have to continue its very low interest policy indefinitely. That suggests Japanese capital outflows will increase as interest rates return to normal in the United States and elsewhere, and as Japanese corporate strategies of foreign direct investment develop further. Temporary movements aside, this implies the yen will not strengthen significantly despite continuing lower inflation rates than in the US and EU.

The appropriate exit strategy from macroeconomic stimulus is certainly a key issue for Japan but in a somewhat different context than the U.S. and Europe. Japan is unlikely to face an inflationary surge in the foreseeable future. The Bank of Japan will be able to exit soon from its temporary measures to prevent a credit crunch but will sensibly maintain its low interest rate, easy monetary policy as long as necessary. My fear is that Japanese fiscal stimulus will end prematurely. However, perhaps the DPJ will enact an annual series of ad hoc supplementary budget stimulus measures. If so, I hope that, rather than muddling along, they will manage fiscal stimulus more efficiently and effectively than in the 1990s.

International Economic Relations

Japan has long been a major player in world trade and capital flows, actively involved in Europe, the U.S., and Asia – indeed everywhere. It is the fourth largest exporter, after Germany, China, and the United States. China is now Japan's largest trading partner, and that share will probably increase. Japan's trade with other Asian economies is becoming increasingly important. East Asia has been, and will continue to be, the world's most dynamic, rapidly growing region. In technology, economic achievement,

standard of living, and quality of the labor force, Japan is the East Asian leader, but China is a dominant force in terms of total GDP and growth.

East Asian economies have developed a high degree of trade integration, enhanced by regional supply-chain production systems. However East Asia has not developed a significant regional architecture for trading and financial relations, and it will not anytime soon. This is not surprising, given the major differences in size, levels of development, political systems, language, and histories. Effective participation in global economic institutions and policy-making will continue to be based more on the power of individual countries than on any region-wide consensus and supporting mechanisms. Keys to the future lie in the ambitions and prospective roles of Japan and China in dealing with each other and with the other East Asian economies.

China's development has benefited Japan economically, but it poses challenges for Japan's regional and global roles. China has responded positively to the global financial crisis and trade deterioration by pursuing strong domestic stimulative policies and quickly restoring rapid growth. China is an important global actor, but has yet to take the role of a global leader.

For the first time in history Japan and China are simultaneously regional powers. China is the largest economic and military power in East Asia, despite its very low per capita income. China's population is 10.5 times that of Japan, and its economy should be able to pursue rapid catch-up growth for many years.

The evolving strategy of many Japanese companies, given declining domestic population and slow market growth, is to actively expand abroad, particularly in Asia and Australia, through acquisition and other direct foreign investment. However, the Japanese government has rarely exercised a global or regional leadership role commensurate with its economic power.

Many in the United States and the EU see China, not Japan, as the most appropriate focus; perceptions of dynamism and growth trump stability and maturity. But this is too narrow and short-sighted a perspective. Even with subpar growth, Japan will be the fifth largest economy in the world 20 years from now, following the U.S., EU,

China and India; its GDP will continue to be substantially larger than other populous countries such as Brazil, Indonesia, and Russia.

In terms of economic well-being, Japan's already high standard of living will double every 48 years if GDP per capita growth is only 1.5%. If the advanced-economy long-run growth norm of 2% per capita growth is achieved, the standard of living will double in 36 years, and more than quadruple in the lifetime of a typical Japanese.

National economic power is often measured by total GDP, reflecting the combination of population size and labor productivity. Economic welfare is proxied by GDP per capita. In a listing of the top 20 economic entities ranked by GDP per capita in purchasing power terms, all but 2, the United States and the Netherlands, have populations smaller than New York City's 8.4 million.

Growth in the Longer Run

In the years after World War II to about 1990, Japan's growth challenge was on the supply side: to expand productivity capacity, production, and productivity as rapidly as possible. Exports were necessary to pay for required imports, not as a major source of demand. However, for the past two decades, Japan's major macroeconomic problem has been how to achieve sufficient aggregate demand. This problem will continue for at least several years. Nonetheless, in the longer run the supply side will determine Japan's potential growth rate.

Growth depends on changes in employment and in labor productivity. Long-run productivity growth per hour is determined by innovation, technological change, and education, as well as new investment. As with the United States and Europe, Japan's potential labor productivity growth per worker per hour is on the order of 2% to 2.5%. Japan's may be slightly higher than the US since its average productivity for the economy as a whole is only about three-quarters of the US level. Japanese manufacturing productivity is high but service sector productivity remains extraordinarily low.

Over the next 20 years the Japanese labor force will inevitably become smaller. As of February 2009, 82.0 million Japanese (64.2%) of the total population of 127.6 million were between 15 and 65 (that is, of working age), 28.5 million (22.3%) were 65 or older, and 17.1 million (13.4%) were under 15. Assuming no net immigration, Japan's population in 2030 is projected to be 117.6 million, of whom 69.6 million (59.2%) will be in the working age group, 34.8 million (29.6%) over 65, and 13.2 million (11.2%) under 15. This is a reduction of 12.4 million in the working age group, an annual average rate of decrease of 0.8%. Offsetting this is likely to be some rise in the female labor participation rate and continuing work by some of those over 65, so labor input may decline about 0.7% annually on average.

These projections of a rise in labor productivity but a decline in the labor force suggest that Japan's GDP potential growth rate will be on the order of 1.3% to 1.8%. That is based on many heroic assumptions. One is that, while Japan may import workers on a contract basis, net immigration will be negligible. Whether to encourage significant immigration, and by how much, will be one of the most important, and difficult, decisions Japan will eventually face. A further assumption is that labor productivity will increase as rapidly in an economy with a declining population and an aging work force as when there are growing populations and relatively young labor forces. We simply do not know.

Conclusion

Over its modern history, Japan has gone through a series of long-run major transformations in virtually every dimension – economically, politically, socially, and demographically. It is yet again in the midst of a new era. Since the early 1990s, the operative constraint on good economic performance has been lack of aggregate demand. A new dynamic of sustained full employment growth has yet to be achieved. The election of the DPJ government is a major step in the political transformation process. However, how long the DPJ will retain power, and indeed what the political

landscape will become, are substantial uncertainties. There are significant generational changes in values, or at least behavior. Fewer young people are getting married, and do so at a later age on average, though married couples have about as many children as couples did two decades ago.

While I am cautious, indeed concerned, about Japan's near-term economic performance and am anticipating only slow recovery, I am more optimistic about Japan's longer-run future. Japan has strong human and social resources. It is a stable society, peaceful and quite crime-free, and has an operating democracy as effective as most others. Japanese are intelligent, educated, pragmatic, hard-working, and ambitious. Over time Japan has demonstrated great flexibility and adaptability. Japan does eventually solve its problems. What I have been unable to discern is what kinds of future Japanese want for themselves and their nation.

September 14, 2009

How should the Banking Industry Respond to the Current Financial Crisis: Lessons from Japan

From late 1986 through the end of 1989, Japanese stock prices soared based on speculation. Land prices also spiraled through 1990. Then, this asset bubble collapsed, and real estate loans, both to individuals and corporations, became largely non-performing. These loan portfolios were not treated as mark-to-market assets by the banks. Therefore it took a long time for the banks to depreciate them.

Leading up to the current global financial crisis, sizable bank loan assets, including sub-prime loans, were securitized and sold to investors globally. These assets were revalued at market prices. Once the sub-prime bubble burst, the value of these assets started to deteriorate. Immediately, the negative impacts of this devaluation spread. Investors and financial institutions which held structured products based on these loans were in trouble. In addition, asset-backed securities (ABSs) were bought by structured investment vehicles (SIVs) using short-term funds in order to maximize their return. Once the value of ABSs started to fall, no one wanted to lend to SIVs. That exacerbated the liquidity shortage in the global money market.

At the beginning of Japan's financial crisis, in the early 1990's, some Japanese banks transferred their bad loans to subsidiaries at face value, rather than market value. This measure did not resolve the problem, as the Financial Services Agency pointed out at the time. The FSA was also concerned about the easy credit stance taken by some Japanese banks. Thus, the FSA became stricter in its inspection of bank loan assets.

At that time, more than 160 banks contributed capital to establish the Cooperative Credit Purchasing Company (CCPC) to purchase non-performing loans from the banks at market value. This CCPC did not work well because the banks could not fully support it and cover the secondary losses on the purchased loans. As a result, the government established the Resolution and Collection Corporation (RCC) to purchase the banks' non-performing loans at market value and injected capital into even the megabanks to stabilize the financial system. This government support preserved the system, but it took almost 10 years, Japan's "lost decade" for the banks to write off all of their bad loans. During this crisis, the banks and their staff lost credibility and trust. The banks which transferred their non-performing loans to subsidiaries at face value rather, than market value, have still not regained trust.

The current global financial and economic crisis has persisted for almost two years, with no end in sight. The worst seems to be over, but the way out of the woods is not clear. The crisis stemmed from complex causes, including global macroeconomic imbalances, loose credit conditions, dangerous over-trading in parts of the financial sector, overly clever risk management, pro-cyclical capital regimes and accounting standards, and compensation structures which have all too often been greedy and short term.

The result of all this is the worst recession in 70 years and a massive breakdown of trust: trust in the financial system, trust within the financial system; trust in bankers, trust in business, trust in the whole process of globalisation even. All have been severely damaged, in rich and in poor countries alike.

There is no question more important for us today than how to restore trust. It seems clear that financial regulatory regimes need reform. There are vitally important issues about the sustainable structure of an industry which is so critical to the overall health and stability of an economy that failures within it are a matter of national interest. There are issues about how regulators should supervise and control risk within financial institutions to limit the danger to the public purse. There

are also issues about the architecture and co-ordination of regulation – at the national level, and at the global level, in response to the G20 demand for a new international order to cope with the challenges of globalised markets.

There are questions for the accounting profession, for example, the effect of mark-to-market accounting when there is a total breakdown of market liquidity, and the need for an available-for-sale category of accounting alongside mark-to-market and accrual accounting.

Banks have been at the epicentre of public rage. The public standing of bankers is now at one of its lowest points in decades. Some bankers have received pay and bonuses in vast multiples of the remuneration of ordinary, hard-working and socially valuable people for indulging in an alchemy which has blown up in their faces and required huge bailouts at prodigious cost to taxpayers. This has ignited fury around the world.

As economies have turned down, businesses have failed, and unemployment has risen, banks, including those rescued by bailouts, have been seen to be tugging the rug from under people's livelihoods, causing pain and further anger. Even if the truth is more complex than the headlines, re-establishing confidence in, and respect for, the banking sector will be difficult, but necessary. In virtually any human endeavour – and certainly in financial services, which are the bloodstream of any modern economy – trust is essential. Trust has three core components.

First, relationships, because relationships affect the outcomes of interactions among human beings; second, confidence, because confidence enables people to risk entering into relationships; and third, values, because they are essential to making relationships constructive and sustainable.

Rebuilding trust is partly a matter of effective rules and guidance, and these are now quite properly under review in the public domain as far as external oversight is concerned. But we would all agree, I think, that the rules and guidelines can never be more than a necessary condition. They cannot be sufficient. True governance is always about more than just following the rules. Indeed, we have in recent years seen far too much of the attitude which says, in effect, "if there's a market, if it's legal and if I have a contract, then I don't need to ask any further questions."

Unless we think more widely about our responsibilities, we will not have sustainable business models, and indeed, we risk losing sight of the very *raison d'être* of banking. This narrow approach to responsibility has been too much in evidence in recent years, and the effect on public trust has been devastating.

Let's be clear what the *raison d'être* of banking is: it is to provide financial services to customers on a sustainably profitable basis.

All parts of that sentence are important, but customer relationships are all-important. Banking services extend beyond taking deposits and extending loans. In this age of markets which are interconnected across both geography and products, it is fantasy to believe that "narrow banking" is the way to predictability and stability. Customers need an increasingly wide range of services. To force them to go to different types of institution for different services – according to a resurrected Glass-Steagall model, if you will– would be totally unrealistic, as anyone would appreciate who thinks through the details of what it would mean in the era of derivatives. Financial institutions are systemically important in a way that other businesses are not, and thus, effective oversight by regulators is needed.

To go back to my one-sentence definition of the *raison d'être* of banking, it is the job of senior management, – it is their corporate and social responsibility – to oversee the provision of financial services, not just on a profitable basis but on a *sustainably profitable* basis.
Delivering on this over time is the secret of rebuilding trust, because it means focusing on long-term customer relationships, not just the next transaction. Because it implies ensuring responsibility in trading, ensuring that management tests the suitability and transparency of products that are sold or transactions undertaken, not just their profitability. Because it entails accepting that the risk in all trading activities must be properly measured, controlled and kept in true proportion to the business capital at risk.

The linking of compensation to revenue from high-risk transactions is a serious problem outside Japan, though its seriousness seems not to be widely enough appreciated.

There are other challenges in rebuilding confidence. In particular, in a time of great economic difficulty, we must respond appropriately to customer needs for finance. We need to accept as a matter of reality that many people in business, politics and the media will feel that banks are not doing enough. We all know the dilemmas and risks in providing financial services in a recessionary environment, and we know that the withdrawal of foreign participants from this market has led to a significant shrinkage in credit supply, particularly to certain sectors.

I want to make three observations on this topic:

- Firstly, one positive outcome of this crisis has been a much more serious, constructive and fact-based dialogue on the flow of credit between the industry and the authorities than was ever the case before. I sincerely hope this will continue after this recession is over, since it is required for the long-term health and balance of the economy.

- Secondly, sound economics in the provision of financial services are in the interest of sustainable profitability and are therefore in the public interest. This requires transparency, proper capital ratios and tough-minded, independent risk management.

- Thirdly, as an industry we need to communicate as openly as possible about the true cost of finance and explain why we take the actions we do. We need to explain clearly and transparently to our customers why the economy needs sound economics in finance.

We need to explain why a return to the excesses and false economics of two years ago or more is unsustainable, both for customers and for banks. We need to explain that, if sense and economics are allowed to prevail, we can avoid in the future the extreme fluctuations in risk appetite and lending capacity that we have witnessed in recent years. This also means eliminating various structured and complex products that had no real economic value.

How do boards ensure that all this is delivered, and confidence restored? Not by micro-managing their companies. Their role is oversight which seeks sustainable profitability over the long term and which, therefore, takes clear account of the public interest and is closely aligned with the regulatory process. Any business which values its brand and understands that its brand represents, or should represent, the essence of the company's self-understanding and *raison d'être* has to be able to ask, and give a satisfactory answer to, the question: how does the business we do contribute to the common good? Boards and senior management need to be able to answer this question and explain the answer convincingly to their own people. This is a requirement for understanding and sharing common values. It is not just a matter for straplines and sales manuals: it should be a central task of training and development programmes to help employees understand how they contribute.

I believe that, whilst banking has had much to answer for in recent years, it is an activity which is essential for sustainable economic development, in rich countries and poor. Strong, efficient, well-supervised banks with a drive to innovate and to provide suitable, profitable services, and staffed by people with integrity and commitment are a *sine qua non* of effective market economies and modern social development, the relief of poverty, and a reduction of carbon emissions.

Nurturing a company's ethics and values can never be an exact science, of course, but it is one of the most important tasks for any board. It should be an explicit subject at regular board discussions at any major company, not just banks. How the corporate culture has evolved; how it is contributing to shareholder value; how it can be nurtured for the good of future generations. There are no more important topics of conversation within a board.

Of course, values cannot be prescribed by edict from the centre. They have to run much deeper than that, and are bound up in the DNA of any organisation. But management can and must ensure that values are articulated and understood throughout the organisation, and that they are supported by policies and standards that encourage appropriate thinking and behaviour.

In summary, restoring trust requires persistence and hard work. The standing of the banking industry is very low, and despite some recent improvement, the economy is still a long way from a return to normal growth. Full and constructive debate on the future of the regulatory landscape must and will continue, but in the end, much of the responsibility to restore trust rests on each of us, as organisations and as individuals. We must lead change from within. Doing that successfully demands moving beyond the rulebook, for true governance is about much more than following the rules. It means investing in long-term relationships, it requires working with all our stakeholders to restore confidence, and it means living and breathing our values.

In conclusion, restoring trust means getting back to the *raison d'être* of banking.

Global Letter Paul Sheard

Lessons learned

US policymakers have learned the lessons from Japan: act quickly, forcefully and on all fronts.

There has been much talk in the current financial crisis about whether US policymakers have learned the lessons of Japan's "lost decade". But what are those lessons? There are three. First, crippled banking or financial systems need to be fixed quickly, and this requires strong government intervention; it is not wise to try to grow out of a banking crisis. Second, in a deflation or liquidity trap, fiscal policy must be the central policy and large-scale and sustained fiscal expansion is required. Third, the policy response of the government and the central bank should be forceful, determined and coordinated.

Japan broke all three of these rules. First, the cornerstone of banking system policy was forbearance, the opposite of a pro-active fix-it-quick strategy. The government announced in June 1995 that it would fully guarantee all bank deposits, thus heading off a run on, and a potential collapse of, the banking system; it then moved to put in a five-year financial stabilization plan. The premise of the plan was that the banks would be able to grow their way out of trouble without an injection of government funds. But there were problems with this approach: the scale of the underlying "stock" problem – the implicit hole in bank balance sheets – was too large for it to be solved by a multi-year accumulation of "flows". Furthermore, monetary policy operates through the banking system, which requires banks that are willing to lend and firms and households that are willing to borrow. To rely on monetary policy to fix a crippled banking system and corporate sector encumbered with bad assets and a debt overhang when together these stymied the effectiveness of monetary policy doomed the attempt to failure.

Japan's second policy error was to eschew the use of expansionary fiscal policy, worse still to make fiscal consolidation a prime policy goal. Fiscal policy acquired a bad name in Japan in the mid-1990s after a number of fiscal spending packages failed to turn the economy around and government debt continued to mount. The policy consensus inside Japan (but challenged by non-Japanese economists) became that expansionary fiscal policy had been tried, did not work and therefore should not, or could not, be used. In fact, by the time the Koizumi administration formed in April 2001, a policy camp arguing against the Keynesian logic that fiscal expansion could help to overcome deflation had gained primacy.

But none of these arguments made sense. Given the scale of the balance sheet problems and the macro de-leveraging that was under way, and the fact that Japan had entered deflation and a liquidity trap by the mid-1990s, the fiscal stimulus packages that were implemented were too small to turn the economy around. Stop-start fiscal stimulus packages should not have been expected to have worked. Fiscal expansion needed to be large, sustained and combined with similarly forceful monetary and banking system polices to be effective. This kind of fiscal policy was never tried. And fiscal consolidation in the midst of deflation was simply counterproductive.

The third lesson from Japan is that, faced with a crisis, the full arsenal of policy needs to be mobilized in a determined and coordinated way. In a financial crisis, particularly when there is deflation or a risk of it, monetary, fiscal and financial system policy all need to be mobilized in a consistent, coordinated and forceful way to achieve the policy goal. Half-hearted policy responses or policy responses operating at cross purposes minimize the chance of success.

US policymakers appear to have learned these lessons. They have acted quickly, aggressively, and on all fronts. Fiscal, monetary, banking system and housing policy have all been mobilized to end the financial crisis, restore liquidity to financial markets and head off deflation. Taking the start of the financial crisis as the outbreak of the sub-prime crisis in March 2007, it took just over one and a half years for the US government to put in place frameworks to buy up bad assets and recapitalize banks; it took Japan eight years to get to that point. Within a month of the outbreak of serious financial crisis in September 2008, the Fed had doubled the size of its balance sheet as it engaged in "credit easing". By contrast, the Bank of Japan's quantitative easing expanded the size of its balance sheet by only about 35% and took three years to do so. Finally, US policymakers have said that they will do "whatever it takes" to overcome the crisis.

Our forecasts are premised on the view that these lessons learned will eventually pay off.

Global Letter Paul Sheard

Anti-deflation "money printing"

By expanding their balance sheets in response to a crisis, central banks are acting in line with their price stability mandates. In our view, concerns that this could be inflationary miss the point.

As major central banks adopt "unconventional" policies and expand their balance sheets, concern has been expressed by some observers that this balance sheet expansion constitutes the "printing of money" and, therefore, will ultimately be inflationary. We think these concerns are misplaced and miss the mark on several counts.

Virtually all modern central banks have a legislative mandate to operate monetary policy – in normal times, that means setting a short-term interest rate – to achieve and maintain price stability. Some also have other goals, including pursuing maximum employment or sound economic growth. Central banks also typically have an explicit or tacit mandate to preserve financial stability, serving as "lender of last resort" in a financial crisis. The price and financial stability roles are interdependent: effective monetary policy requires a well-functioning financial system and a financial system in deep distress needs accommodative monetary policy.

A key feature of modern central banking is that central banks have "independence" from the government when making monetary policy decisions. In the parlance of game theory, this "commitment" by governments not to interfere in monetary policy decisions gives "credibility" to the "threats" of the central bank to take whatever actions are needed to ensure that its price stability goal is met. Having this credibility makes it much easier for the central bank to manage private sector expectations about the future path of inflation, which in turn helps the central bank to achieve its goal – indeed, inflation *expectations* are a key driver of inflation *outcomes*.

But having independence does not mean that central banks stand aloof from the government – quite the reverse. A good central bank works closely with the other arms of government to help the government meet the country's overall economic policy objectives. In particular, it works with the treasury on macroeconomic policy and the banking authorities on financial system stability.

It is against this backdrop, and in the context of the worst financial crisis since the Great Depression, that the recent extraordinary actions of central banks should be understood. By cutting interest rates to close to zero and (in some cases) significantly expanding the size and asset composition of their balance sheets, major central banks, including the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan, are acting unconventionally but in a way that is consistent with their "conventional" mandates.

But what of the concern that such "credit easing" or "quantitative easing" amounts to the virtual "printing of money" and therefore must be ultimately inflationary? To the extent that the central banks' actions do put upward pressure on the price level, this is good because inflation, a sticky variable, is dropping and the immediate threat is deflation, possibly even a collapse of the financial system and a deflationary spiral. We believe it is more accurate to view such policies as "anti-deflationary" rather than "inflationary". A central bank with a price stability mandate must guard against both inflation and deflation.

The concept of "money printing" is misleading. Central banks do not just print money and give it away in a Friedman-like helicopter drop. The two key parts of a central bank's liabilities – the money they can "print" – are reserves and banknotes in circulation. Central banks provide banknotes in response to the public's demand for cash – the private sector drives the "printing". In normal times, central banks provide reserves to the banking system reactively, to maintain a level consistent with achieving their interest rate target. Recently, many central banks have been ramping up the level of reserves but the reserves so created do not represent new money in the sense of private-sector purchasing power. Central banks are creating excess reserves in order to hold more assets and thereby unfreeze credit markets or trigger portfolio rebalancing by financial institutions, not to create money *per se*.

Real "money printing" occurs when governments use their central banks to monetize runaway fiscal deficits; that is, when central banks are neither independent nor target price stability. The quantitative easing and buying of government debt that central banks are doing is a far cry from this. We expect central banks to emerge from this crisis with their price stability mandates in tact.

Global Letter

Paul Sheard

Deleveraging matters

Shrinking demand for credit could stymie the Fed's "credit easing", but that is not our base case.

The "credit easing" being undertaken by the Federal Reserve will go down in monetary history as an extraordinary development, regardless of its ultimate success or failure. Since the financial crisis erupted last September, the Fed has more than doubled the size of its balance sheet. And it has recently announced programs that, if fully implemented, could more than double the size of its balance sheet again from here. By providing vast amounts of liquidity to financial institutions, lending directly to borrowers and investors, and buying lots of agency debt, agency-backed MBS and longer-term Treasury securities, the Fed is focused on "relieving the disruptions in credit markets and restoring the flow of credit to households and businesses".

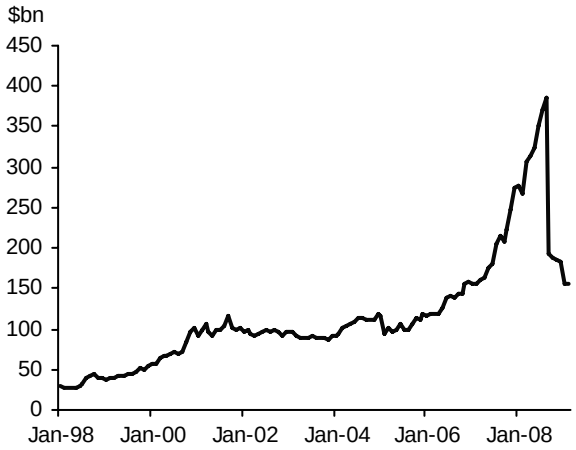
But the "flow of credit" to the economy is only one part of the credit equation; the other, which we consider more important, is *demand* for credit from households and businesses. Even if credit is able to flow, it will do so only if there are willing borrowers. A big concern is that, in the aftermath of the housing and credit bubble, the impulse among households and firms to pay down debt or avoid taking on new debt will prevail. In the current environment, "deleveraging" is the enemy of "credit easing". Could the US and other economies fall into a Japan-style liquidity trap?

We are relatively sanguine that such an outcome can be avoided. It is useful to distinguish between "financial (sector) deleveraging" – excessive leverage being taken out of financial institutions' balance sheets and products – and "real (economy) deleveraging" done by households and firms. Much of the deleveraging under discussion to date appears to be of the former variety (for one example, see Figure 1). It is deleveraging by households and firms, affecting consumption and investment activity, that can most stymie monetary policy stimulus.

Here, two points are worth bearing in mind, particularly when making comparisons with Japan's experience. First, deleveraging is not an exogenous process. Rather, the path on which an economy finds itself depends in part on the policies pursued and whether the economy reaches certain "tipping points" past which debt-deflation dynamics kick in. Our call is that the prompt, large-scale and comprehensive policy responses under way in the US will prevent a Japan-style outcome (see "Lessons learned", *Global Weekly Economic Monitor*, 27 March 2009).

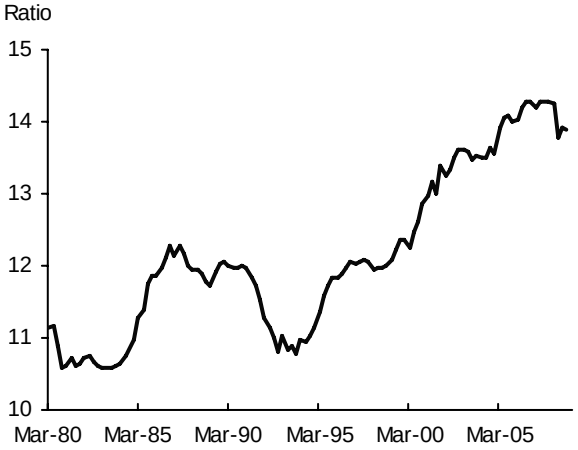
Second, deleveraging dynamics are likely to differ depending on whether the locus is the corporate sector (more the Japan case) or the household sector (the US). Corporates, left with a hefty debt overhang from a burst asset bubble, are likely to want – and need – to reduce that overhang relatively quickly, which can trigger vicious-cycle dynamics. Given the lifetime-income hypothesis, however, households should be able to smooth their deleveraging over time (Figure 2), but only if capital markets operate to allow households to make the necessary inter-temporal transfers (borrowing and saving). The Fed's credit easing, particularly the (up to) $1tr TALF (Term Asset-Backed Securities Loan Facility), seems particularly well-directed on that score.

Figure 1. US margin credit at broker-dealers



Source: New York Stock Exchange.

Figure 2. US household debt service ratio



Source: Federal Reserve. Note: Ratio of debt-service payments to disposable personal income.

Global Letter Paul Sheard

Central bank balance sheet expansion

The financial crisis has forced central banks into uncharted territory, with the Fed out in front.

In normal times, a central bank's balance sheet attracts little attention – markets focus on central bank policy rates and broader measures of money supply. This is for good reason: normally the central bank adjusts the size of its balance sheet reactively in response to the private sector's demand for banknotes and the amount of reserves that need to be maintained for the central bank to achieve its interest rate target; normally, central banks want to hold, or accept as collateral, only the most liquid and safest assets, usually short-term government debt. But with key policy rates at or approaching zero and financial systems in distress, central banks, led by the Federal Reserve, have started to use their balance sheets as an active policy tool.

Making cross-national comparisons of central bank balance sheets is fraught with difficulty because each central bank has different operational procedures and accounting and disclosure conventions. We have attempted to compare the changes in balance sheet size and composition of the major central banks by looking at year-on-year changes on as standardized a basis as possible. A number of points emerge from this exercise (see Global Special Topic: "Lining up the balance sheets" in this issue for details).

First, the Fed has been by far the most aggressive in expanding the size of its balance sheet, increasing it by 134% compared to a year ago. Recently announced programs imply that a further ramp-up in the size of the balance sheet is coming (by up to about $2trn, or a further doubling). The Fed and the Bank of Japan (BOJ) offer an interesting contrast: policy rates are close to zero in both cases and the Japanese economy has been contracting at a much faster rate than the US economy, threatening to exacerbate deflation, yet the BOJ has hardly expanded its balance sheet (7%).

Second, the Bank of England (BoE) has been quite aggressive in expanding its balance sheet but quite conservative in terms of its operations, sticking to conventional ones. This is changing under the recently announced Asset Purchase Facility, whereby the government has authorized the BoE to buy up to £150bn of assets, up to one third of which may consist of private sector assets (the first £75bn is under way). The BOJ so far has eschewed aggressive balance sheet expansion but has exhibited a willingness to take some non-conventional steps.

Third, central bank lending to the banking system has played an important part in Fed and ECB operations. By acting as a "lender of last resort" in this way, central banks help stabilize the financial system, circuit-breaking the asset fire-sales that are triggered when market funding dries up. In this regard, the degree of balance sheet expansion may serve as a barometer more of financial market distress than of monetary easing. Thus, the BOJ might contend that its modest balance sheet expansion is a sign of the absence of financial distress.

Fourth, the Fed has been much more aggressive than other central banks on two fronts: buying non-conventional assets and setting up schemes to provide credit to end-borrowers in the commercial paper and securitization markets. Together, these account for about half of the balance sheet expansion. This "credit easing" is aimed at improving the price and availability of credit and thereby the stimulus from interest rate cuts. Other central banks may follow suit.

Fifth, part of the balance sheet expansion of the BOJ and the ECB (and likely of other central banks) has been driven by the Fed's central bank liquidity swaps (latest: $294bn outstanding). Under these swaps, the Fed in effect uses other central banks as intermediaries to provide dollar funding to borrowers experiencing dollar funding shortfalls. This introduces some double counting into central bank balance sheet expansions.

Sixth, on the liability side of the balance sheet, the expansions have been driven by creating excess bank reserves and using other technical operations rather than by a pickup in the biggest component of central bank liabilities: banknotes or money demanded by the public.

All of the above underscores that central banks are expanding their balance sheets in response to a financial crisis and threat of deflation or depression. The actions are a far cry from the "money printing" by central banks and governments historically associated with runaway inflation.

Global | Special Topic Paul Sheard

Lining up the balance sheets

We compare the balance sheet expansions of major central banks on a standardized basis.

Since the financial crisis erupted, several central banks have actively expanded their balance sheets as part of monetary and financial stabilization policy. The Fed has explicitly called its policy "credit easing", announcing last December that its focus henceforth would be to support "the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of [its] balance sheet at a high level". After expanding its balance sheet substantially, the Bank of England (BoE) recently announced that it was shifting to a policy of "quantitative easing", the term coined during the Bank of Japan's (BOJ) 2001-06 experience. The ECB has substantially expanded its balance sheet, also characterizing it as a form of "credit easing"; the BOJ has taken various financial stability and corporate financing measures but has expanded its balance sheet only modestly.

To get a handle on what major central banks are doing with their balance sheets, regardless of how they may be communicating such actions, we looked at the balance sheets of the aforementioned central banks on as standardized a basis as possible and asked what changes in the composition of assets and liabilities was contributing to their respective balance-sheet expansions (this was challenging because central banks have different operating, accounting and disclosure practices). The results are shown in Figure 1 (see our Global Letter, "Central bank balance sheet expansion", in this issue for more discussion).

Central bank balance sheet operations can get very complicated and the details can depend on their respective operational rules. But the basic analytics are fairly straightforward. Central banks hold assets against the liabilities they have issued, the main liabilities being banknotes demanded by the public and deposits or reserves of financial institutions ("bank deposits" below).

Financial institution deposits or reserves play a pivotal role. Bank deposits with the central bank increase (decrease) when one of three things happens: the public deposits cash in (withdraws deposits from) the banking system; the central bank buys assets from (sells assets to) or supplies credit to (withdraws credit from), the financial system; the government makes payments to (receives payments from) the public. Central banks (and other governmental or international organizations) can also make deposits with other central banks. Fed central bank liquidity swaps – dollar funding operations to financial institutions outside the US – have been an important driver of recent balance sheet expansions.

Central banks supply reserves to the banking system through two main routes: by buying assets or by conducting repo (repurchase agreement) operations (on the asset side of the banking system's balance sheet), and by lending or providing credit (on the liability side).

Figure 1. Comparison of balance sheet expansions of major central banks: Latest versus year earlier

		Share of growth in assets (%)						
	Increase in size of balance sheet (% y-o-y)	Total	Conventional OMOs*	Non-conventional asset purchases**	Lending to banking system***	Lending to borrowers****	Foreign currency assets	Other
Fed	133.7	100.0	-14.4	30.5	61.6	21.4	0.0	0.9
BoE	83.6	100.0	130.9	0.0	0.0	0.0	0.0	-30.9
ECB	34.2	100.0	22.7	0.0	29.4	0.0	21.5	26.4
BOJ	6.6	100.0	-11.5	18.0	19.3	0.0	73.0	1.2

		Share of growth in liabilities (%)						
	Increase in size of balance sheet (local currency)	Total	Banknotes	Bank deposits	Government deposits	Reverse transactions	Central bank deposits	Other
Fed	$1195.3bn	100.0	7.3	68.3	18.4	2.4	0.0	3.6
BoE	£80.60bn	100.0	4.5	30.0	na	46.1	0.0	19.4
ECB	€466.0bn	100.0	21.4	16.8	17.1	0.0	30.6	14.1
BOJ	¥7066.5bn	100.0	10.6	67.0	-28.3	-21.5	71.9	0.3

Source: Nomura Global Economics; Notes: *Open Market Operations (OMOs) - main refinancing operations for the ECB; ** includes agency debt and MBS purchases and Maiden Lane portfolios for the Fed; *** includes central bank liquidity swaps for the Fed; **** Commercial Paper Funding Facility and Term Asset-Backed Lending Facility; balance sheet data as of 8 April for the Fed, 25 February for the BoE, 11 April for the ECB, 10 April for the BOJ.

Global Letter Paul Sheard

Taking no chances

US policymakers appear to be prudently putting in place a financial crisis contingency framework.

The release of the "stress test" results by the Federal Reserve yesterday marks another milestone in the US policy response to the financial crisis that surfaced in the summer of 2008 but which really erupted last September (see US Roundup in this issue for details).

Stepping back from the details, we continue to be impressed by the speed, scale and scope of the US policy response to the financial crisis and recession. Banking systems that have been left undercapitalised and in severe distress by the unwinding of an asset price bubble cannot be cleaned up and restored to health overnight. But one lesson to take from Japan's recent experience of financial crisis is that banking system problems should be tackled head-on rather than covered up or left to fester. US policymakers appear to have a plan and it strikes us as pretty much the right one: uncover and reveal the scale of the hole in bank balance sheets; take measures to resolve problematic assets; and ensure that the banking system has enough capital. And simultaneously implement expansionary macro policies to counter deflationary pressures.

It is simple balance sheet arithmetic that when asset prices collapse the equity of banks holding those assets is eroded, often to the point of disappearing altogether. The collapse in bank stock prices and banking sector market capitalization in the US and elsewhere in the past year is strong *prima facie* evidence that markets have judged banks to be severely undercapitalized.

Policymakers cannot, in our view, allow banks to remain inadequately capitalized. Bank capital provides the buffer that enables depositors, debt-holders and other suppliers of funds to the banking system to finance, with peace of mind, the bulk of the assets held by the banking system. Indeed, it provides the cushion that allows the banking system to engage in "maturity transformation", bank assets on average being less liquid than the claims issued to finance them. A banking system collapses when confidence in the adequacy of bank capital erodes and holders of bank liabilities withdraw their funds. Such a dynamic was starting to play out in the second half of last year. The stress test – and the injection of capital it is likely to trigger –, coming on top of the Capital Purchase Program of the TARP (Troubled Asset Relief Program) ($218bn already allocated), is just the latest policy action aimed at quelling that dynamic.

But, as happened in Japan and as has happened in other financial crises, what if the ultimate hole in bank balance sheets – and the concomitant need for new capital in one form or another – turns out to be much bigger than an interim assessment reveals? The stress tests found that 10 banks will need $75bn of capital. Of the $700bn in TARP funds, $590.4bn has been committed, leaving only $109.6bn (or $134.6bn, allowing for funds expected to be repaid in the next year). Given the political hurdles, are US policymakers in a position to "do whatever it takes" to finish off the banking system cleanup if it turns out that much more financial resources are needed?

US policymakers may already be preparing for that eventuality. On 5 March, Senator Christopher Dodd at, the request of the Treasury, the Fed and the Federal Deposit Insurance Corporation (FDIC), introduced legislation to increase, until end-2010, the amount that the FDIC can borrow from the Treasury from $30bn to $100bn, but up to $500bn in an emergency. For the FDIC to borrow more than $100bn, the treasury secretary would need to approve after consulting with the president and receiving a two-thirds majority recommendation from the FDIC board and the Fed board of governors. This legislation moved closer to becoming law this week.

Although such funds could not be used by the FDIC as part of a program established by the Treasury under the Emergency Economic Stabilization Act of 2008 (including the TARP), the Federal Deposit Insurance Act contains an emergency systemic risk clause (under Section 13). Under this clause, the treasury secretary (under the same kind of arrangement as above) can authorize the FDIC "with respect to an insured depository institution" to "take any other action or provide assistance … as necessary to avoid or mitigate [serious adverse effects on economic conditions or financial stability]". This is a pretty big loophole clause. With funding, it gets teeth.

The stress test results suggest that the Financial Stability Plan, announced by the treasury secretary on 10 February, is on track. It appears to us, though, that policymakers are putting in place a financial crisis contingency framework that is immune to political risks – just in case.

Global Letter Paul Sheard

Japan's chickens coming home to roost

Japan's downturn is being exacerbated by its failure to have fixed its own post-bubble economy.

One of the striking features of this financial crisis and global recession has been how hard some countries outside the US epicentre have been hit, Japan being near the top of that list. Japan's Q1 GDP release this week showed the economy shrinking by an unprecedented 4.0% quarter-on-quarter (unannualized) and by 9.7% year-on-year (see Japan Roundup: "The return of deflation" in this issue for details). In just two quarters, the Japanese economy has contracted by 7.7%, whereas the US economy has shrunk by 3.2% in the same period. Japanese industrial production fell by 37% from peak (February 2008) to trough (February 2009), whereas the peak-to-trough (December 2007-April 2009) fall in the US has been "just" 14%. It appears that when the US catches a cold, Japan catches pneumonia.

As our US chief economist David Resler points out, this differential impact partly reflects the high import content of US consumption, the still large share of the US in global GDP and the gearing that particular economies have to the US (see US Roundup: "Globalization means shared distress" in this issue).

But that is just the exogenous shock part of the equation. That Japan has been hit so hard by the financial crisis and global recession emanating from the US also speaks to Japan's own policy choices in recent years and – at the risk of sounding harsh – policy failures. Japan was ill prepared for this global demand shock because the economy had never fully "normalized" after its own banking crisis and deflation. The fact that the level of nominal GDP in Japan only once (in 2Q08) exceeded its Q2 1997 post-bubble peak (and then by only 0.9%) – it is now 7.9% *below* that new peak – and policy rates peaked at just 50bp in this cycle underscores that point.

In our view, Japan made three critical policy errors, the lessons from which US and other policymakers appear to have learned and to be applying in the handling of their own crises. First, Japan, rather than tackle its banking system problems head on and early on (which it could only have done by injecting a huge amount of public funds into the banking system), pursued the counterproductive policy of trying to grow out of the problem (forbearance). The hole in bank balance sheets, rather than going away, just got bigger.

Second, even though deflation prevailed, the government failed to pursue the kind of aggressive and sustained expansionary fiscal policy that, together with other appropriate policies, we think could have brought an early end to deflation. To make matters worse (from 2001 in particular), the government made fiscal consolidation a cornerstone of economic policy. Japanese policymakers concluded that, because they had tried fiscal expansion and it had not worked, and government debt was mounting, a fiscal consolidation was called for. Rather they should have concluded that they needed to use fiscal policy even more aggressively, and that a large and rising current account surplus provided adequate domestic savings to finance it.

Third, admittedly not helped by the other arms of policy, the Bank of Japan failed to prevent deflation from taking root and then, when it did, allowed deflation expectations to become entrenched and – because inflation expectations are a key driver of inflation outcomes – self-fulfilling. Unlike the Fed recently, the Bank of Japan failed to do "whatever it takes" to achieve its mandate of preserving price stability.

To these three policy errors could be added the over-riding one that Japanese policymakers failed to pursue a coordinated policy mix where fiscal, monetary, financial system and structural reform policies complemented one other, rather than operated at cross purposes.

Where to now? Our Japan chief economist Takahide Kiuchi points out that the output gap in Japan is now much bigger than in the previous deflationary period, although the risks of a deflationary spiral are less given the much healthier state of the banking system and corporate sector and more limited scope for asset price deflation. But policymakers should not be complacent in such a situation. US policymakers, cognizant of the lessons from Japan, have shown that the way to deal with a crisis and threat of deflation is to pull all the relevant policy levers aggressively and to do so in a coordinated fashion. It remains to be seen whether Japanese policymakers have learned the same lessons – their own lessons – themselves.

Global Letter Paul Sheard

"Money printing" and price stability

The extraordinary actions taken by central banks in this crisis are consistent with their price stability mandates. The measures are unlikely to lead to runaway inflation.

With major central banks continuing to expand their balance sheets as part of "quantitative easing" or "credit easing", often buying government debt in the process, many observers worry that this "money printing" or "monetization of debt" could ultimately lead to runaway inflation. In our view, such concerns are largely misplaced.

Monetary history is littered with examples of hyperinflation driven by governments "printing money" and central banks "monetizing" out-of-control fiscal deficits. So it is perhaps not surprising that some observers, putting two and two together, fear that the price of "money printing" today will be runaway inflation tomorrow. But what major central banks have been doing in this financial crisis and global recession is a far cry from that kind of "money printing". Indeed, we find it totally consistent with their price stability mandates.

Context is very important here. Most modern central banks have a mandate to operate monetary policy to achieve price stability (sometimes made explicit as "inflation targeting"). That means operating monetary policy to avoid deflation as well as inflation. Moreover, most central banks also have an explicit or tacit mandate to preserve financial stability (in fact, this function came first). Preventing a collapse of the financial system and ensuring that the system is functioning dovetail with the central bank's price stability goals. Thus, the recent extraordinary actions of central banks in no way imply that they are going soft on inflation.

In the recent financial crisis and global recession, the threat to the financial system has been acute, as has the threat of serious deflation or even a deflationary spiral. Central banks have taken aggressive and unconventional actions to stem those risks. These policies are not inflationary, although they would be in a different context (say, in a booming economy). In the current context, they are counter-deflationary. That is why independent central banks with price stability and lender-of-last resort mandates are implementing them.

What of the argument that, by taking these extraordinary actions today, inflationary problems are being stored up for tomorrow; that is, that the price of success in dealing with challenges now will be even bigger problems in the future? For sure, central banks and governments will face innumerable challenges – policymaking is never easy, least of all during a once- or twice-in-a-century crisis and its aftermath. But the counterfactual needs to be considered – the fact that there will be future challenges is no reason for policymakers not to take necessary actions today.

More to the point, the concerns about money printing and debt monetization seem misplaced. Central banks, although they have myriad operating procedures that vary by country, are in the *business* of "printing money" – creating reserves in the banking system and, when deposits are taken out of banks, supplying banknotes to the public. And many central banks hold government debt as the counterpart asset to the money liability created; that is, they "monetize debt".

What is important for future inflation is not whether central banks are "printing money" or "monetizing debt" but rather *why* they are doing so, whether as independent central banks judging that they need to take such measures to achieve medium-run price stability or as the hand maidens of the treasury. It is only in the latter case that inflation becomes a concern: when runaway fiscal deficits financed by a central bank under the control of the government result in "too much money chasing too few goods". This is not what is going on in the world today.

Those who worry that the recent actions of central banks are planting the seeds of future runaway inflation must believe that central banks will lose either their independence or their credibility. We see very little reason for either to occur. In the aftermath of this crisis there will no doubt be many lessons learned, but we doubt that one of them will be that it was a mistake for governments to have given central banks price stability mandates and the operational independence to pursue them. A more likely lesson is that central banks need to be given a more explicit mandate and better tools to manage systemic risk. Nor should central banks lose their credibility if their unconventional actions to stave off a financial collapse and/or deflation prove to be successful; to the contrary – ultimately their credibility stands to be enhanced.

Global Letter Paul Sheard

Let the regulatory aftermath begin

The proposed US regulatory reforms look broadly sensible but they are no silver bullet.

Major regulatory and institutional innovations in financial markets tend to come about as a result of lessons learned from financial crises. The impetus for the establishment of the Federal Reserve in 1913 was the "panic of 1907"[1] and modern securities regulation and bank deposit insurance in the US were borne out of the Wall Street crash of 1929 and bank runs of that era. Banking and securities regulations were drastically overhauled in Japan in the wake of the 1990s banking crisis. Examples abound.

Given the scale of the recent global financial crisis, it is to be expected that there will be major regulatory fallout and permanent changes to the rules of the road of financial markets. The "comprehensive plan for regulatory reform" (full title: *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation*) announced by the Obama administration this week is the start of this process in the US. Like most aspects of this crisis, US policymakers have been quite quick to move: they continue to show reluctance to let the grass grow under their feet.

By and large, the plans look sensible, if on the complicated side, and there are few surprises. The proposed reforms amount to a combination of preventative and remedial measures, and include: creating a new "Financial Services Oversight Council", housed within the Treasury, to identify emerging systemic risks and improve interagency cooperation; giving the Federal Reserve new authority to supervise all firms (not just banks) that could pose a threat to financial stability; creating a National Bank Supervisor, also within the Treasury; establishing a new authority, modeled on the Federal Deposit Insurance Corporation, to allow the government to resolve failing bank holding companies or other nonbank financial firms; increasing capital and liquidity requirements for financial firms, and even more so for systemically important ones; and increasing the regulation of securitization markets, over-the-counter derivatives and consumer financial products, including the creation of a Consumer Financial Protection Agency. In the bureaucratic power stakes, the Treasury and the Fed, the two agencies at center stage throughout this crisis, come out as winners.

These plans, were they to be implemented as proposed, would probably lead to a stronger financial system and one less prone to crisis and meltdown in times of crisis, particularly in the early years of the aftermath when market and social learning are most potent in preventing bubbles from forming. But that will necessarily come with some loss of dynamism as the regulatory burden on financial market participants increases. And it would be a mistake to believe that increased regulation could prevent financial bubbles and crises from developing in the future. The history of financial bubbles and crises is so long and rich in material, it beggars belief that a series of reforms was just waiting to be found that would consign them to the dustbin of history.[2] The ones proposed here certainly look too incremental and conventional to have such a revolutionary effect. Mostly they reduce to the formula: markets failed because there was not enough regulation, so increase the amount of regulation. Problem solved.

But, regulation too is inherently subject to failure and limitations – and to the law of unintended consequences. It is not enough that regulatory bodies be set up, or told to cooperate with one another and given various mandates and powers. They need to have the ability and incentive to acquire the necessary information, interpret it and act on it. These attributes may appear to be in abundant supply in the wake of this crisis, when faith in the power of government is riding high, but will likely be much less so at the height of the next boom, when institutional memory has faded and financial innovation has gone through several more cycles. Identifying "whether an individual financial firm poses a threat to financial stability" is easier said than done, particularly when financial stability has been the norm in the recent past. One of the reasons that financial crises keep reoccurring is that, when it comes to preventing financial (or perhaps any) crises, success sows the seeds of failure. Unfortunately, this time is likely to be no different.

[1] See Bruner, Robert F. and Carr, Sean D., 2007: *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*, Hoboken, NJ: John Wiley & Sons.
[2] See Reinhart, Carmen M. and Rogoff, Kenneth S., 2008: "This time is different: A panoramic view of eight centuries of financial crises", NBER Working Paper No. 13882.

Global Letter

Paul Sheard

Why not to expect future high inflation

Central banks are unlikely to lose their independence and excess reserves do not fuel inflation.

The notion that one of the aftermaths of this "great recession" is likely to be a sustained period of very high (maybe even hyper) inflation is widespread. That such an outcome is highly unlikely continues to be one of our most high-conviction views ("Anti-deflation 'money printing'", *Global Weekly Economic Monitor*, 3 April 2009; "'Money printing' and price stability", 5 June 2009).

Those who argue that high inflation looms someway down the track explicitly or implicitly are proffering one of two kinds of argument: that central banks will no longer target price stability, or that, while they may try to, they will fail. We find neither position convincing.

The main reason not to expect runaway inflation in developed world (and many emerging market) economies is that most central banks target price stability and are given the autonomy to do so. The recent extraordinary actions of central banks are consistent with those price-stability mandates. As economies recover, output gaps close and inflation risks loom, we expect central banks to tighten policy to contain inflation. Central banks know how to fight inflation. To point to what appears to be "money printing" – when those actions are taken to stem a deflationary threat – as evidence that future inflation is inevitable, is to miss the point.

High public debt levels will be a feature of this crisis/recession's aftermath. Some observers worry that central banks will face intense political pressure to "monetize" these mounting fiscal deficits and that this will lead to high inflation. But this argument assumes that central banks will lose their legislatively-granted independence. Independent, price-stability-targeting central banks, by definition, will not monetize deficits if that would lead to inflation. Full stop.

It is highly unlikely, in our view, that governments will take the ultimately counterproductive step of stripping central banks of their independence. For one thing, central banks would likely put up a huge fight, and would have many allies. As ECB President Jean-Claude Trichet noted at his 4 June press conference, "we are fiercely independent; and you know that we can prove that".

Another common argument is that the massive excess reserves that central banks, particularly the Fed, have created may, in an animal spirits-infused recovery scenario, "flow into" bank lending and fuel inflation. Central banks, their independence and price-stability mandates in tact, may try to contain inflation but will fail because the credit creation genie will be out of the bottle.

This argument rests on a misunderstanding of how the credit creation process and monetary system works. Many commentators speak as if banks can "take" the excess reserves "sitting on" their balance sheets and "lend them out" to corporations and households, thus ridding themselves of excess reserves. This way of describing matters conjures up the image of a tsunami of liquidity (excess reserves) poised, waiting to flood the economy and ignite inflation.

But credit creation does not work that way. Banks can only directly lend their reserves to other banks that hold reserves at the central bank, in which case the aggregate level of reserves does not change – they cannot directly lend their reserves to households or corporations.

Rather, the way in which lending by banks leads to a decrease in (excess) reserves in the banking system is more indirect. When a bank initiates a loan, it does so by crediting the borrower with a deposit. It is only when the borrower withdraws the money as cash that reserves in the banking system decline. If the borrower spends the money and the recipient re-deposits the cash in the banking system, reserves go up again.

What drives credit creation is not the amount of reserves banks have but the willingness of borrowers to take on new debt. In fact, the level of reserves itself is not important for credit creation. For a given policy interest rate, central banks will always supply the amount of reserves that is associated (via minimum reserve requirements) with the level of deposits, such deposits being the balance sheet counterpart of loans. Loans drive reserves, not the other way around!

In any case, the Fed and other central banks have adequate tools to extinguish excess reserves if they want to (see "Exit strategies", *Global Weekly Economic Monitor*, 26 June 2009; "Exit strategies: Q&A", 31 July 2009). The looming inflation risk is a mirage, in our view.

Comparing QEs

Major central banks have expanded their balance sheets to enhance the efficacy of monetary policy, but they have conceptualized and implemented this "quantitative easing" in different ways.

The Bank of Japan (BOJ) was the pioneer of so-called "quantitative easing" (QE), operating a regime for five years from March 2001 to March 2006, but the world's other major central banks, the Federal Reserve, the European Central Bank (ECB) and the Bank of England (BoE) have all implemented their own forms of QE – in the sense of expanding their balance sheets way beyond normal levels – since this crisis broke. Compared to levels just before the crisis erupted last September, the Fed has increased its balance sheet by 2.22 times, the BoE by 2.36 times and the ECB by 1.28 times. There are some interesting differences among the approaches taken by the three recent quantitative easers and the pioneering BOJ. Consider three.

First, each central bank's communication has been quite different. The BOJ, surprisingly, for a long time steered clear of the term "quantitative easing"; rather it talked, blandly, of "[changing] the main operating target for money market operations … from the … uncollateralized overnight call rate to the outstanding balance of the current accounts" (effectively bank reserves). The Fed (under then Chairman Bernanke) has called its policy "credit easing", careful to distinguish it from BOJ-style QE. The ECB's President Trichet talks not of QE but of the bank "concentrating on non-conventional measures of extreme boldness". The BoE unabashedly calls its policy QE.

Second, the central banks differ in terms of which sides of their balance sheet they seem to be focusing on. The Fed in particular, with its myriad credit easing programs, but also the ECB with its unlimited refinancing operations, are focused on the asset side, treating what happens on the liability side as largely subsidiary to that. The BOJ was focused almost exclusively on the liability side, targeting a step-wise expansion in the level of bank reserves, with the asset side being subsidiary to that: "we decided to allow an increase in the outright purchase [of long-term government bonds] only in the case when such an increase is necessary for providing funds smoothly to meet the target current account balance". The BoE, on the other hand, is looking at both sides: by buying assets from non-banks it aims to increase the money supply (deposits in the banking system) and by financing these purchases by creating reserves it purports to aim for banks to boost their lending to consumers and businesses.

Third, and related, the central banks seem to envisage quite different hoped-for transmission mechanisms of their unconventional balance sheet expansion policies. The BOJ was never very explicit in its formal policy announcements about how it envisaged its QE working. Its strongest conviction about policy efficacy, ironically, related to something that had nothing to do with balance sheet expansion per se: the so-called "time duration effect" of committing to continue QE, and therefore keep the overnight rate pegged at or close to zero until deflation ended, thus serving to impart an interest rate stimulus by flattening the yield curve. The BOJ had a vague notion of a "portfolio rebalance effect", the notion that banks flush with non-yielding reserves would have an incentive to redeploy their reserves into yielding assets (although the BOJ well understood that the banks in aggregate could not reduce the amount of reserves they had as long as the BOJ targeted that level). It also appeared to envisage announcement or expectation effects, hoping that its "shock therapy" would help stem the threat of a deflationary spiral. It did.

The Fed has been very clear about its transmission mechanism: by aggressively expanding the size and changing the composition of its balance sheet, it aims to stabilize financial markets and ease credit conditions, even supply funds directly to credit-starved borrowers. The Fed steers well clear of any monetarist explanation. The BoE, on the other hand, while aiming for some Fed-style "credit easing" and asset price/wealth effects, seems to take a very monetarist tack, arguing that it is trying to increase nominal spending by directly increasing the (broader) money supply: "the sellers of the assets [that the BoE buys] have more money so may go out and spend it". The ECB appears to have aimed primarily to quell financial distress and ease stresses in the banking system, operating more in line with traditional lender-of-last resort thinking; latterly, with its €60bn covered bond purchase scheme it has paid more direct homage to credit easing.

But for all their differences, the approaches of the central banks share one common feature: never for a moment suggest or act as if the monetary ammunition has run out. That's smart.

Global Coordination in Financial Supervision

Symposium on Building the Financial System

Of the 21st Century

October 23~25, 2009

NAOKI TABATA

Executive Senior Advisor

RHJ International Japan, Inc.

Preface

One of the main reasons for this financial crisis is the failure of supervising as well as regulating financial institutions and products. These failures are l divided into two categories, macro and micro prudential area.

Regarding macro-prudential area, the authorities of both developed and developing countries have left the global imbalances in savings and investments as it is for the last couple of decades. In particular, continuing huge over investments in the US has made large liquidity inflow in the US from over-savings countries ,China, Japan and so forth . This coupled with long monetary easing by the US authorities, made sub-prime housing loan increase severely, and got housing price rise substantially like babbles. The tightening of monetary policy was actually delayed in the US. Both over investment as well as over savings countries have not correct their imbalances through macro economic policies. Accordingly, the global imbalances have continued up to the bursting bubbles of the US housing markets that incur huge losses in financial institutions and threaten the financial systems in the world wide.

Regarding the failures of micro-prudence areas are as follows; realizing huge losses of the financial institutions investing in risky financial assets using high leverages, lacking of corporate governance allowing extremely large bonuses to the senior executives, and pursuing short-term profit maximizing, leaving non-regulating financial institutions, hedge funds, investment banks and housing loan corporations expanding their businesses so quickly, lacking of regulations on new financial products, CDS, CDO, Derivatives , Continuing of false credit ratings on securitized products by rating-companies and conflict of interests between those companies rated and the rating- companies.

Reflecting these failures of policy implementation in macro as well as micro prudence areas, the EU, the US, the Financial Stability Board, and the Basel Committee on Banking Supervision have begun reviewing the current supervising systems as well as regulations.

The EU Reforming Plan

The EU Council already approved its Reforming Plan at the end of June. The main parts of the macro prudence area are as follows;

Establishing European Systemic Risk Board to analyze the financial markets as well as the policies implementing by the member countries and make warnings and recommendations to avoid systemic risk in the EU area.

Regarding micro-prudence area, European System of Financial Supervisors (ESFS) is established to implement strict supervision on the financial institutions engaging in cross-boarder businesses. Under the ESFS, European Banking Authority, European Insurance and Occupational Pension authority and European Securities Authority will be established to supervise these three fields across the EU member countries.

The US Reforming Plan

The main features of the US proposal are as follows;

1) Large and interconnected financial institutions are required maintaining sufficient capital as well as liquidities, and integrating the current segmented supervisors, the Financial Services Oversight Council will be established..

2) Regulating securitizing products; harmonizing the regulation on futures transaction and securities, safeguarding of payment and settlement system, strong over -sighting on over-the-counter derivatives.

3) Building a strong framework for consumer and investor protection.

4) Establishing a resolution mechanism for the orderly resolution of financial holding company,

5) Taking a leading role to improve regulations and supervision in global.

On the basis of these proposals, Financial Service Oversight Council(FSOC), Consumer Financial Protection Agency(CFPA), National Bank Supervisory Agency(NBSA) will be established.

New Agreement by the Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision has reached the agreement in the following five points on September 6.

1) The predominant form of Tier 1 Capital must be common shares and retained earnings. Appropriate principles will be developed for non-joint stock companies. Deduction and prudential filters will be harmonized internationally.
2) Introducing a leverage ratio harmonized internationally.
3) Introducing a minimum global liquidity coverage ratio.
4) Introducing a framework for countercyclical capital buffers above the minimum

requirement.

5) Issuing recommendations to reduce the systemic risk associated with the resolution of cross-border banks.

Restructuring of Japanese Supervisory System

The negative impact of this financial crisis has not been so serious on Japanese financial system as a whole nor individual financial institutions.

Regarding macro-prudential area, Japan has the Financial Crisis Coping Council chaired by prime minister to respond the systemic risk as well as the crisis to use public funds to rescue the failed financial institutions. However, no formal organization is established yet to respond the uncertainty, drying-up of liquidity and spreading worries throughout of the markets. Shortly after the Lehman bankruptcy, liquidity of commercial papers market suddenly dried-up and the big enterprises in Japan were confronted with difficulties not to issue the ＣＰ Under these circumstances, the banks strongly insisted that some organization should buy CPs directly from the market. Finally the government prepared the procedures that the Japan Development Bank can buy CPs from market. This experience clearly show establishing an organization, like ESRB, might be necessary.

Regarding micro prudential area, the followings are necessary to improve;

1) the relation between cross holding of stocks by banks and their own capital,
2) risk management in synthetic financial products,
3) strict supervision on non-banks including hedge funds,
4) raising quality and quantity of capital,
5) corporate governance in executives bonus as well as shortermism,

Other area necessary to improve for stopping systemic risk is expanding the Bank of Japan's examination to the life and causality insurance companies having become one of the important players in financial markets, they should have account in the Bank of Japan and be covered by its onsite examination.

Global cooperation in financial supervision

G-20 Summit and Finance Minister and Central Bank Governors Meeting, Financial Stability Forum and the Basel Committee on Banking Supervision are the main forum to discuss regulations and supervision on financial institutions. Before this financial crisis, the discussions

have been concentrated on micro prudence areas. The experiences in last couple of years force us concentrate further more on macro prudence area including adequacy of implementation of macro economic policies ,in particular monetary policy. In this sense, establishing ESRB in EU and FSOC in the US are most welcome.

The critical point is to make these organizations really work effectively and quickly. If the EU reforming plan had been implemented since 2007, BNP-pariba's conduit could have been examined by the Banking Commission of France more strictly, the result would have been reported to the European Banking Authorities, then, it might have been discussed at the European System of Financial Supervisors. The ESRB decided providing liquidity to the markets and indicated the Bank of France to do so.

Quick decision and actions are all the more important. If it takes some time, then market condition might change substantially, and systemic risk might arise.

Consequently, effective and quick functioning of the organizations for coping with systemic risk should be assessed by some international organization. In the first half of 1990s, IMF had responsibility for conducting multilateral surveillance on macro-economic policy coordination among G-7 countries. At that time, I had engaged in the multilateral surveillance process as a member of the IMF Board representing Japanese government. The IMF Board made recommendations to the G-7 authorities, however, they had no legal binding nor obligation for executing. Consequently, Board's decisions did not necessarily make the expected effects.

Avoiding or reducing systemic risk, immediate implementation of these warnings and recommendations should be guaranteed buy some rules or if necessary, by legal bindings.

Banks should stand on mission, not on regulation.

Eiichi Tanabe

This distinguished Program focus on research on capital markets regulation and fosters the interchange of ideas on international finance through their acclaimed series of symposia on Building the Financial System of the Twenty-First Century. As a Treasurer of a company which heavily depends on bank borrowing and capital markets,, I would like to express some views and thoughts in terms of Banking and Securities regulation and responses to the future of the current Financial Crisis.

Corporations expect the banking community to provide funds as necessary at a reasonable cost. Availability and cost of funds depend on the creditworthiness of a borrower, thus the financial institutions bring discipline to the borrower.
In order to fulfill this function, banks should maintain and improve the following qualities through competition.

a. the proper financial soundness
b. the capability of monitoring and providing support to clients
c. the efficiency consistent with the best commercial standards
d. the innovation in products and services

As a consequence of the repeated consolidations in the financial community in conjunction with Gramm-Leach-Bliley Act or similar laws, they resulted in financial conglomerates and the so-called “Mega-Banks “were created, and this should have created financial soundness, competitiveness and effectiveness, based on scale.

This kind of massive architecture of financial organization was to ultimately results in benefits for the clients. However, unfortunately and ironically, it transformed into the model of “Too big To Fail “with the possible risk of “Moral Hazard “.

So as not to repeat need for a bailout in the future, the current argument is that we reach the conclusion that the soundness of financial institutions shall be maintained and preserved by means of regulation including additional capital requirements.

We need to accept the fact that the systemically important financial institutions will be governed and protected by further regulations. However, while additional capital requirements will bring an allopathic result, a homeopathic strengthening of the capability of risk management as a preventive measure, also needs to be prescribed. Rather than further depending on the power of regulation, we should believe in the power of self-discipline of the professional managers of the banks and that of organization itself. The level of remuneration can be a part of discussion, however the regulator has to examine the mechanism, by which the management of the banks try to incorporate the self-discipline into the organization from the perspective of “loan desk” functioning in an appropriate control environment. Self-discipline here should include understanding a mission of financial institutions to “nurture” their clients and industries (as well as that of fiduciary duty).

It must be acknowledged that financial institutions are governed and protected as necessary by the rules and regulators. In this respect, the capital markets, in particular, stock market needs to understand the uniqueness and seeks for the appropriate method of valuation including the targeted return. Otherwise, the cost for the burden to maintain the soundness will be further delivered to the clients as “pass-thorough “transferred basis.

To avoid that happening, such appropriate mechanisms as to minimize the costs are necessary, including efforts to promote best commercial standards and “ innovation “. We cannot deny the financial technology including the securitization nor the entities such as Private Equity firms and Hedge Funds, each of which will continue to be a necessary vehicle to provide risk capital in future while financial institutions are acting in a more conservative manner under the Regulators and Authorities. Financial institutions will need to learn how to coexist with and sometimes guide them.

There has been remarkable progress in the last decade in banking practices including the risk management, which rely on the scientific and statistical approach. They should always be greatly respected. Simultaneously, to establish the trust between debtors and creditors via constant dialogues, solution providing, and mutual recognition should be the real essence of risk management. We should always remind ourselves of the historical lesson that multiple securitizations, which were regarded as the crystallization of scientific and statistical approach, entirely cut the value chain of dialogues and trust. In contrast, an important example is given, in the area of micro-finance; a great deal of care to borrowers provided by staff of such institutions, coupled with peer to peer monitoring in the community, seems to be playing a big role in realizing sound banking activities.

We admit that there is ambivalence; It shouldn't be an easy task to fulfill the varied needs and diversified anticipations held by the clients in either wholesale or retail market and at the same time to achieve soundness as well as profitability.
This financial crisis has given us a lesson. We have set the benchmark as being global, rationale, and objective under the scientific and statistical approach, but we sometimes could fail to see the forest for the trees. More importance must be placed on the approach of reviewing the whole picture as well as each individual part and understanding and influencing clients or counter- parties through dialogues.

Finally, I would like to get touch upon a key factor for the emerging countries, namely development of capital markets.

Another lesson given by the financial crisis is that diversification of financing source is critical in risk management of corporations. Although government intervention should not be taken for granted, it is true government support proved to function well in the situation where the banking market is not functioning or significantly shrunk due to some reasons while the capital markets functioned well as a complement via the operation to purchase of commercial papers or bonds by the central bank.
We need to see the further, speedy, and planed development of the capital markets in emerging countries.

It is our regret that even in our mother market, Japan, the market volume or size of Commercial Paper together with Bonds is roughly 10% compared to that of United States. It is hoped the capital markets with sufficient volume and high liquidity will be fostered in Asian region. This should be achieved by way of the further development of Japanese capital markets and the deregulation of other Asian markets.

Queen Elizabeth II brought the phrase to prominence, in a speech to the Guildhall on 24 November 1992, marking the 40th anniversary of her Accession, in which she described the closing year as an "annus horribilis".
If the recent upheaval in the external environment tipped off by the financial crisis is regarded as a “ once-in-a-century event ”, we are now experiencing "annus horribilis", however by way of the global collaboration and great efforts made by every business sector at the exceptional price of economy, we will get through the most difficult part of this turmoil with a right sense of direction. I am writing with the hope that we will get together to be further motivated by the Symposium in Armonk. .

Eiichi Tanabe
Treasurer, Senior Vice President
Mitsubishi Corporation, Tokyo

The Future of Banking and Securities Regulation

2009.10.23 Tomoyoshi Uranishi

1, What is a different point between bank business and security company business from the viewpoint of financial activities?

・Banks take deposit from individuals and companies.

・ Security companies as a broker sell financial products to investors.

・ Financial products are manufactured by asset management companies and other financial entities related security companies.

・ As a total financial group, security companies play the same role like banks in the financial world.

2, Who owes debts?

・There must be a financial institution who must pay debts belonging to financial products.

・ In case of banks, it is very simple to answer who pays debts.

・ In case of security companies, third parties owe the debts belonging to financial products.

・ Security companies owe debts as a group for various financial products like ETN or Link note.

・ So it is essential for security companies or investment banks as a group to have an adequate capital or reserve equivalent to risks.

3, Is there any difference between CDS and insurance products?

・There are many financial products which have different brands and have same financial function.

・ CDS is a same financial product as insurance for credit default.

・ Insurance companies have to make reserves for default risks, on the other hand financial institution who issue CDS do not have to make reserves for risks.

3, The future of financial regulations

・Banks, security companies, investment banks and insurance companies sell various financial products.

・ Those financial products have different or same characters.

・ If financial products have different characters, different

regulations should be applied to such products.

- Regulations should vary according to different character of financial products.
- However, if financial products have same characters, same regulations should be applied to such products.
- Through the deregulation of financial regulatory framework and the development of financial technique, different financial institutions invent substantially common financial products.
- In the future, common regulation should be introduced into the field like capital, reserve and debt allowance regulations in the banking, securities and insurance regulations.

END

The exit from Quantitative Easing (QE): The Japanese experience.[1]

Adrian van Rixtel

Head International Financial Analysis
International Financial Markets Division, Associate Directorate General International Affairs, Bank of Spain

Executive summary

- ***The exit from QE in Japan was announced in March 2006 and conducted in a well-managed fashion and in just 3-4 months in order not to disrupt financial markets.***
- ***The exit from QE was primarily conducted by reducing rapidly the most flexible asset on the BoJ's balance sheet which is the amount of its bills purchases from private banks, to match the rapid decline in the amount of excess reserves.***
- ***The advantage of this strategy was that the exit of QE was predominantly limited to just one item on the BoJ's balance sheet and that the balance sheet adjustments were conducted through operations directly with the banking sector, which facilitated the management of the exit process.***
- ***Intentionally, the BoJ chose to reduce its holdings of Japanese government securities very slowly and moderately in order not to distort supply and demand conditions in Japanese bond markets. In fact, the BoJ kept in place its regular purchases of long-term Japanese government bonds. It realized the gradual reduction of Japanese government securities on its balance sheet mainly by reducing the amount of short-term Japanese government securities.***
- ***The BoJ implemented certain new liquidity providing operations in order to promote the proper functioning and stability of interbank money markets. The Japanese experience shows that when exiting from QE, a central bank needs to consider very carefully how to restore the functioning of these crucial markets, as one result of QE may be that activity in interbank markets becomes very subdued.***
- ***All in all, the exit from QE in Japan has been considered a success and its experience may serve as a useful example for other central banks.***

[1] Fernando Gutiérrez del Arroyo González provided excellent statistical support. The views expressed in this note are solely the responsibility of the author and should not be interpreted as reflecting the views of the Bank of Spain.

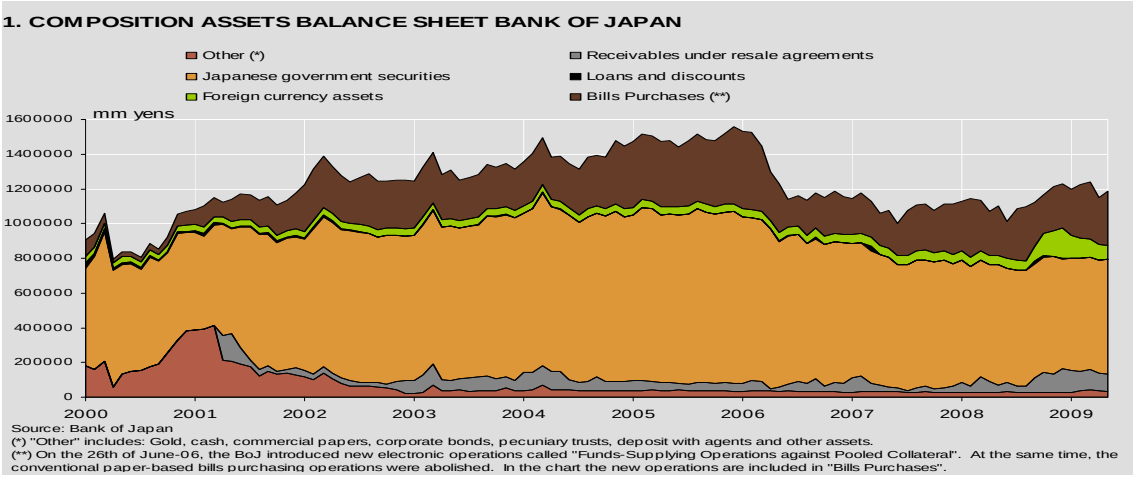
1 Quantitative Easing (QE) in Japan

After having followed a zero interest rate policy strategy and facing a further deteriorating economy in an environment of falling prices (deflation), the Bank of Japan (BoJ) announced the introduction of QE on 19 March 2001 and kept it in place until 9 March 2006. The Japanese version of QE consisted of the following elements, such as published by the BoJ:

1) Monetary policy target: The current account balances (CABs = required + excess bank reserves) became the operating instrument of Japanese monetary policy, replacing the overnight uncollateralized call rate. Thus, the BoJ moved to an explicit system of reserve targeting with a publicly announced target level of CABs. The initial target for CABs was set at 5 trillion yen, 1 trillion more than the average outstanding balance in February 2001. This target was raised seven times, reaching a target range of 30-35 trillion yen in January 2004. This resulted in a strong expansion of the BoJ's balance sheet.
2) Instruments: The BoJ announced publicly that it would start to increase the amount of its outright purchases of long-term Japanese government bonds to 400 billion yen per month, which it ultimately enhanced to 1.2 trillion yen per month from November 2002 onwards. In January 2002, the range of bonds to be purchased was broadened from only 10 and 20-year bonds to also include shorter-maturities (2, 4, 5 and 6-year bonds).
3) Commitment horizon: The BoJ publicly committed to keep QE until y-o-y core inflation would turn positive.

2 The implementation of QE in Japan

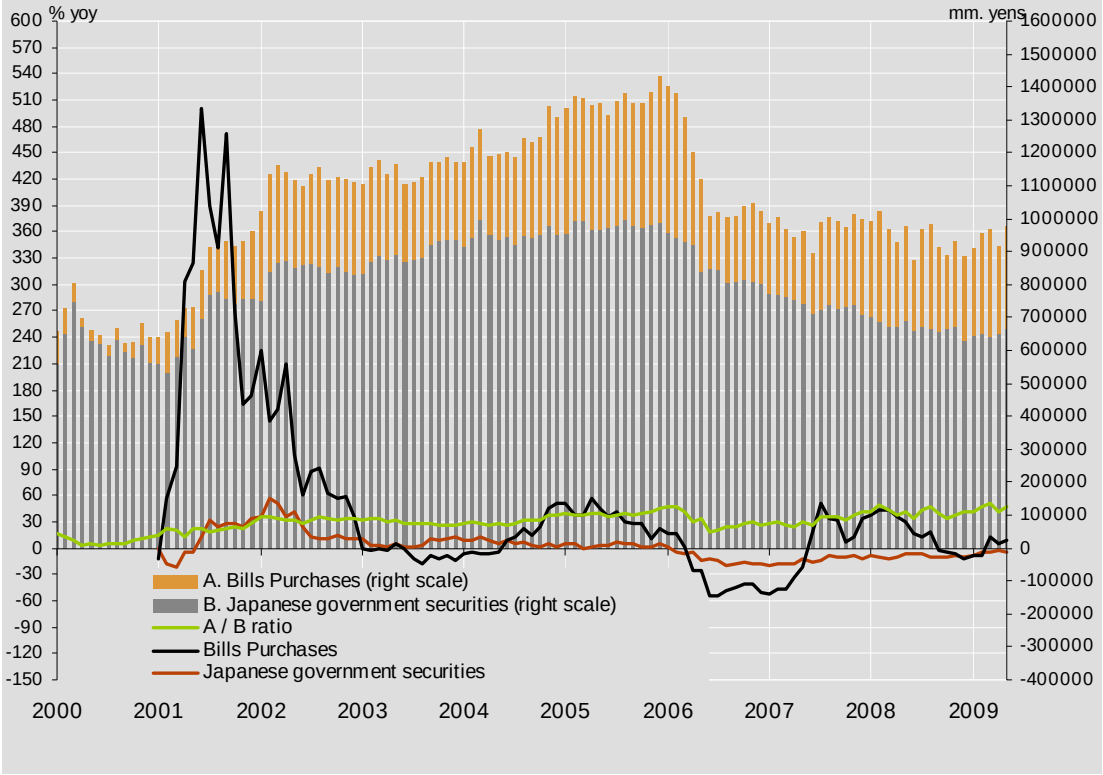
The implementation of QE in Japan can be followed by analyzing the composition of the assets and liabilities sides of the BoJ's balance sheet. Chart 1 shows the steady increase in the amount of Japanese government securities (which include Japanese government bonds and short-term government bills such financing bills, treasury bills and treasury discount bills) on the assets side from March 2001 onwards as part of the policy of QE. Japanese government securities increased from yen 57.7 trn at end-March 2001 to yen 93.3 trn at end-March 2006. The importance of this item as instrument of QE is shown by the very high correlation coefficient of 82% of its yoy changes with yoy changes in bank reserves (current account balances or current deposits) for the period March 2001 – March 2006.



Interestingly, at the same time, the amounts of bills purchased by the BoJ started to increase as well in the course of 2001, and at a much faster pace than the expansion of the BoJ's government securities portfolio.

Chart 2 shows that the growth rate of the amount of bills purchased was many times higher than the growth rate of the government securities holdings when the BoJ started to implement QE. The importance of the bills purchases relative to the Japanese government securities operations can be gauged from looking at their ratio, which reached a maximum level of 47% in February 2006 (see A/B ratio, Chart 2), implying that bills purchases were almost equal to half the total Japanese government securities portfolio of the BoJ. All in all, it seems that the bills purchases by the BoJ have been an important money market operation particularly for the initiation of QE in Japan (and for its termination as well, see section 3), in order to start rapidly the increase BoJ's balance sheet. The correlation coefficient between yoy changes in bills purchases and yoy changes in bank reserves (current account balances or current deposits) during March 2001 – March 2006 was 30%, which suggests that these operations were not a systemic instrument of QE. The amount of the bills purchases increased rapidly from yen 11.4 trn at end-March 2001 to yen 37.8 trn at end-March 2006. The largest amount of bills purchases was conducted in January 2006, recording yen 44.2 trn.

2. ASSETS BANK OF JAPAN: Bills purchases and government securities portfolio



The bills purchases of the BoJ are outright purchases of bills issued by banks and collateralized by a pool of assets submitted to the BoJ.[2] The assets which are eligible as collateral include a wide range of public and private sector financial instruments, including public debt instruments, corporate bonds, commercial paper (CP) and other private debt instruments. The bills are a very convenient instrument for the banks, as they can pool a lot of different assets as collateral and obtain liquidity for the BoJ. The advantage for the BoJ are that these operations are very flexible, are directly conducted with the banking sector and allow the Bank to conduct liquidity adjustments in response to short-term fluctuations in autonomous factors which affect money market conditions. These bills operations were increasingly conducted through the Regional offices of the BoJ, in order to spread liquidity to regional banks. On 26 June 2006, the BoJ

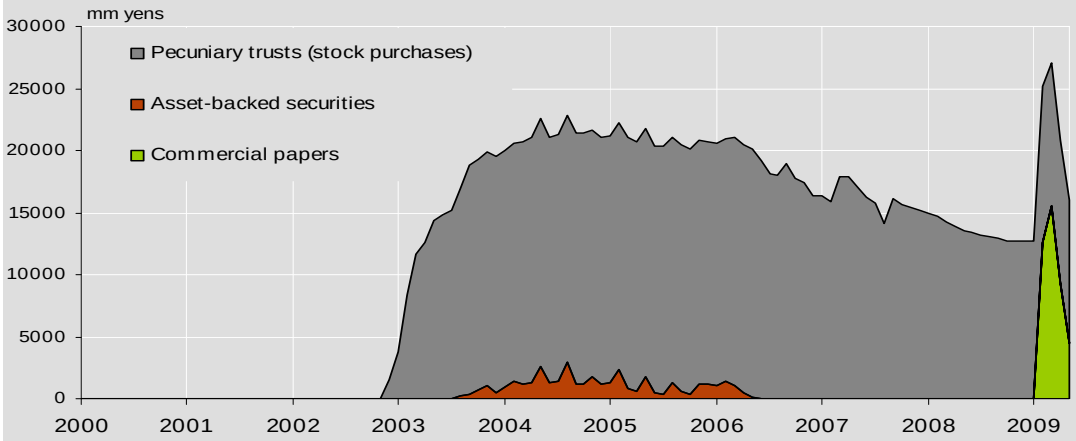
[2] Bank of Japan, "Money market operations in Fiscal 2003", Financial Markets Department, August 2004.

introduced new paperless (or electronic) so-called Funds-Supplying Operations against Pooled Collateral as part of new money market operations after the conclusion of QE and abolished the conventional paper-based bill purchasing operations (which have been included in Charts 1 and 2).[3] That the BoJ considered its bills purchases important can be deducted from the fact that it introduced various reforms to make these operations more attractive for banks, for example by extending their maturity to up to one year, expanding the number of counterparties and broadening the collateral eligible.

The BoJ may have used rather extensively its direct bills purchases in the build-up of QE as it did not want to become overly dependent on outright purchases of Japanese government bonds as its sole instruments of QE for two reasons.[4] First, a much larger increase in long-term Japanese government bonds would lead to a large increase of assets that would remain for a long time on the BoJ's balance sheet, which could limit the room to conduct short-term funds-supplying operations in the future unless the Bank would sell the purchased Japanese government bonds (possibly at a loss). Second, a larger increase in the BoJ's holdings of long-term Japanese government bonds (JGB) could send wrong signals to financial markets that the Bank was trying to support JGB prices or financing the government.

The BoJ started also to conduct more non-conventional asset purchases in the course of its implementation of QE, such as direct purchases of asset-backed securities (ABS), including both short-term ABCP and longer-term ABS, and direct purchases of stocks (so-called pecuniary trusts held by commercial banks; see Montero and van Rixtel, 2008). As is evidenced by Chart 3, the size of these operations was very small. For example, the maximum amount of stock purchases was only around yen 22 billion, which compared to bill purchases that reached up to around yen 40 trillion. The BoJ experimented also with some minor non-conventional operations, such as a facility to provide government securities to the market, but these were terminated relatively fast.

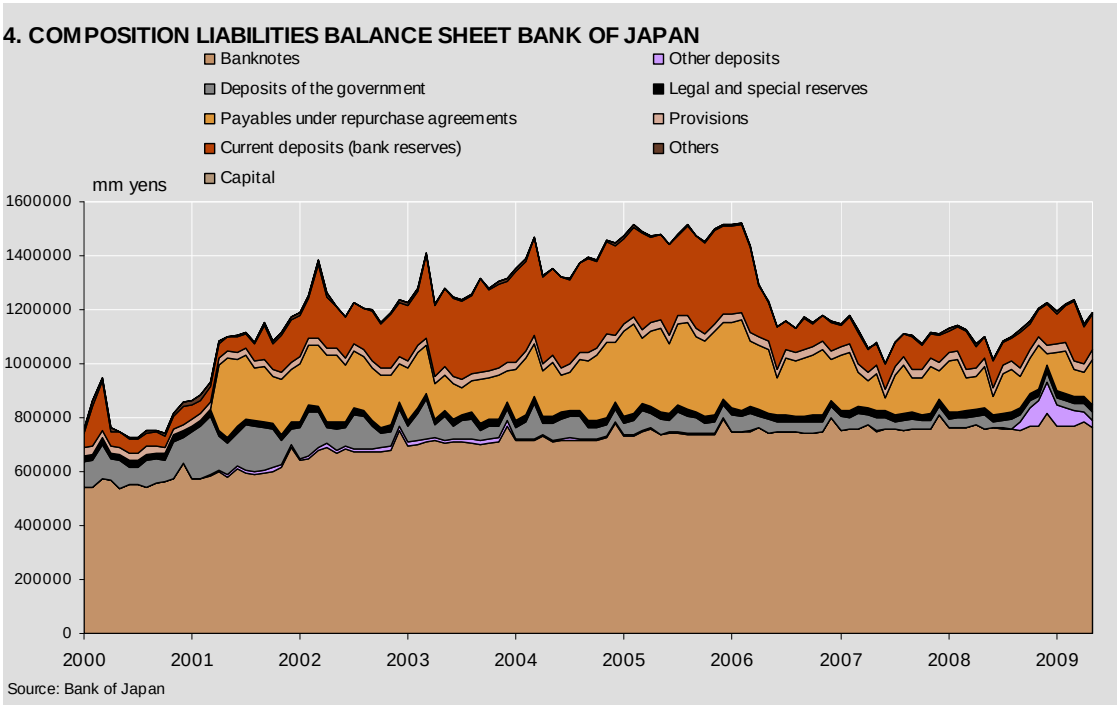
3. ASSETS BANK OF JAPAN: More non-conventional instruments of QE



Source: Bank of Japan

Turning now to the liability side of the BoJ's balance sheet, the strong increase in excess reserves, which are incorporate in the item "current deposits", is clearly visible from March 2001 until March 2006 when this process was reversed, reaching a lower and more steady level between yen 8.6 trn and yen 11.8 trn during the second half of 2006 (Chart 4). The payables under repurchase agreements are reverse repo operations (so-called reverse *gensaki* operations) which the BoJ used as short-term funds-absorbing operations in order to keep the current account balances (CABs) at their target level.[5] For example, due to various autonomous factors affecting the money market, the amount of excess reserves of Japanese banks could deviate from the CAB target.

[3] Bank of Japan, "Annual Review 2007", August 2007.
[4] E. Maeda, B. Fujiwara, A. Mineshima and K. Taniguchi, "Japan's open market operations under the Quantitative Easing policy", Bank of Japan Working Paper Series No.05-E-3, 2005.
[5] Goldman Sachs, "Quantitative Easing: The final chapter", Japan Economics Analyst, 3 March 2006.



3 The exit from QE in Japan

The exit from QE was announced after the Monetary Policy Meeting of 9 March 2006 as follows: "… The outstanding balance of current accounts at the Bank of Japan will be reduced towards a level in line with required reserves. … the reduction in current account balance is expected to be carried out over a period of a few months, taking full account of conditions in the short-term money market. The process will be managed through short-term money market operations. With respect to the outright purchases of long-term interest-bearing Japanese government bonds, purchases will continue at the current amounts and frequency for some time."

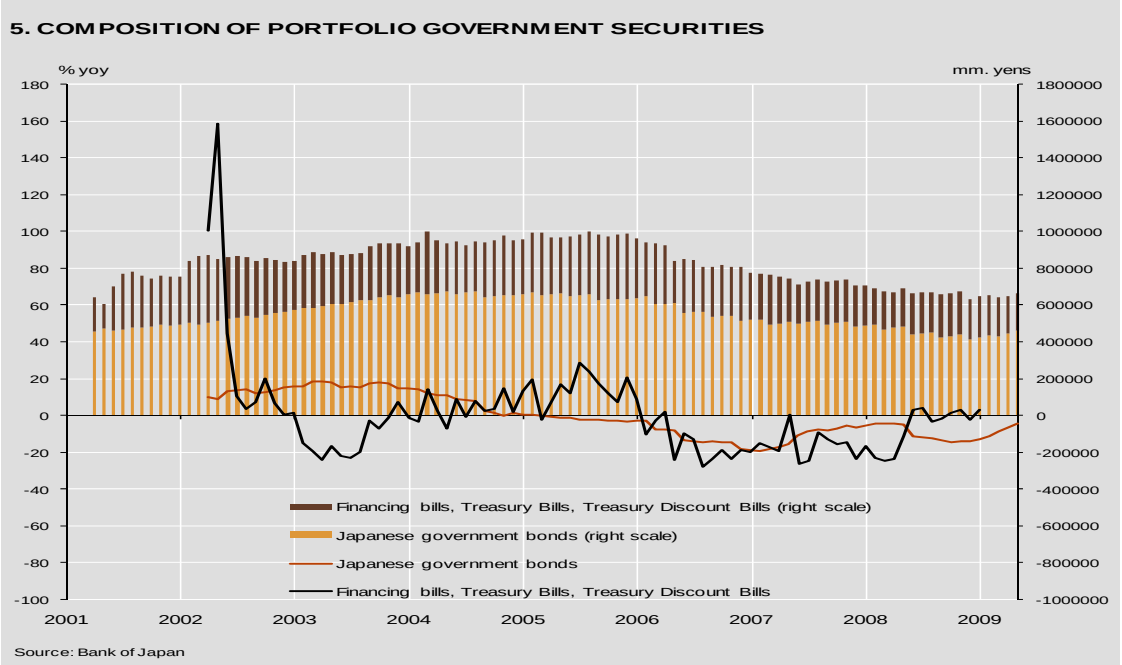
Thus, the BoJ made it clear that the reduction of the excess reserves would be conducted through adjustments of its liquidity operations and not by a rapid reduction of its portfolio of Japanese government securities. In fact, the BoJ announced that it actually would maintain its outright purchases of long-term Japanese government bonds (JGBs) at the pace of yen 1.2 trn yen.

Financial markets had been very concerned that the BoJ would start unwinding rapidly the large amount of government securities on its balance sheet, as this could lower bond prices and result in significant valuation losses for investors in JGBs.[6] The BoJ chose for a very orderly and gradual unwinding of its government securities portfolio, by continuing its regular purchases of these securities. The amount of government securities on the BoJ's balance sheet would decline anyway by the fact that continuously a fraction of these securities would mature. For example, at end-March 2006, the BoJ had yen 93.2 trn on its balance sheet. Assuming that this portfolio had a fictional residual maturity of 5 years, it would mean that every year on average 20% of these bonds would mature or yen 18.4 trn.

All in all, by continuing its buying operations, the BoJ provided support to maintaining orderly conditions in the JGB market. That the redemptions of bonds on its balance sheet were larger than its purchases can be seen from the gradual decline of Japanese government bonds in its government securities portfolio (see Chart 5). This chart also shows the gradual decline of short-term securities in this portfolio (Financing

[6] Goldman Sachs, "Quantitative Easing: The final chapter", Japan Economics Analyst, 3 March 2006; Goldman Sachs, "BoJ terminates quantitative easing policy: Nominal tightening, but real easing", Japan Economic Flash, 9 March 2006.

Bills, Treasury Bills and Treasury Discount Bills). As a matter of fact, the share of these securities in the BoJ's portfolio declined gradually, from around 51% in 2005 to 50% in 2006 and 47% in 2007. Thus a limited unwinding of QE was realised through a reduction of short-term government securities on the balance sheet of the BoJ.



If the termination of QE in Japan, which implied a very swift and substantial reduction in excess reserves (current deposits, see Chart 4) was not realised through a similar reduction in the amount of government securities on the balance sheet of the BoJ, which operation on the assets side of this balance sheet was implemented to match the decline in liabilities?

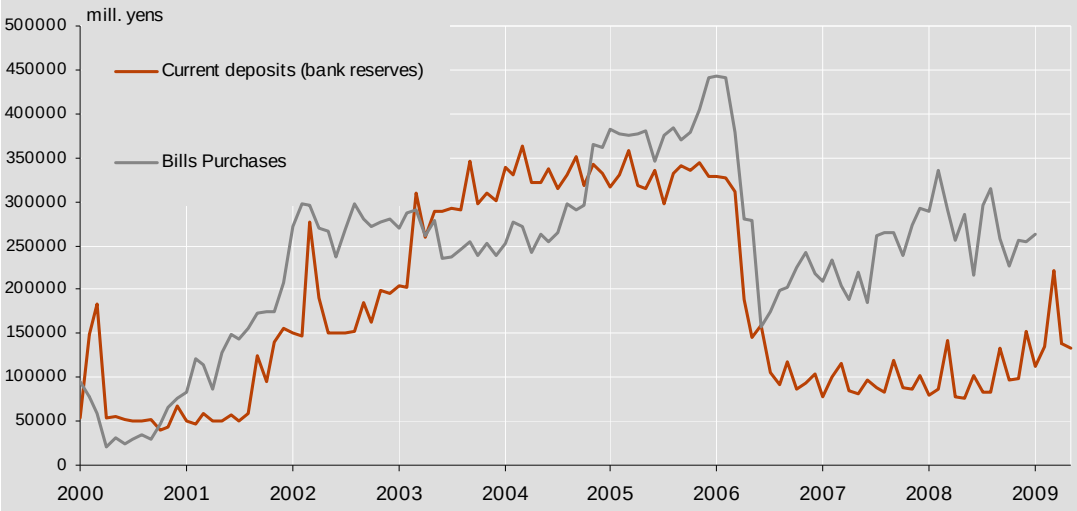
Chart 6 shows very clearly and unequivocally that the main instrument that was used to exit from QE in Japan was the rapid and substantial decline in outright bills purchases which are conducted directly with the banking sector. The decline in current deposits from yen 31.2 trn at end-March 2006 to around yen 10 trn in the summer of 2006 was almost perfectly matched by a corresponding decline in bills purchases. This reduction in current deposits started in April 2006 and was mainly implemented by letting mature (or not rolling over) bills purchased on the BoJ's balance sheet. Namely, the average residual maturity of the bills purchased from the banking sector had been reduced to below four months in the first quarter of 2006, meaning that the majority of them would mature automatically in the summer of 2006. At the same time, in order to maintain stability in the money markets, the pace of reduction in liquidity provision was adjusted by undertaking some new short-term funds-supplying operations (such as the new electronic Funds-Supplying Operations against Pooled Collateral on 26 June).[7] These are included in the bills purchases in Chart 6 from June 2006 onwards.

Its careful management of the unwinding of QE allowed the BoJ to restore activity in the interbank money markets, where operations had declined to very low levels after years of rather exuberant provision of excess reserves by the BoJ. During the three months following the conclusion of QE, interbank money markets increased in size and their functioning steadily recovered. This was particularly the case in the uncollateralized call market, which was seen as a success, as the uncollateralized overnight call rate had become the new operating target of monetary policy after the end of QE, from the

[7] BoJ, "Money market operations in Fiscal 2006", Financial Markets Department, July 2007, p.7.

outstanding balance of current accounts at the BoJ. Thus, a proper functioning of this market, which had contracted the most drastically in size under the QE policy, was absolutely vital. Nevertheless, the BoJ identified a number of shortcomings in the proper functioning of money markets after the exit from QE, and it set out a series of recommendations and policy actions to address these.[8]

6. THE UNWINDING OF QUANTITATIVE EASING IN JAPAN



Source: Bank of Japan

[8] BoJ, "Issues regarding money markets after the conclusion of the Quantitative Easing Policy", Financial Markets Department, August 2006; BoJ, "Changes observed in money markets after the conclusion of the Quantitative Easing Policy", September 2006. See also C. Kramer and M. Stone, "A post-reflation monetary framework for Japan", IMF Working Paper No.WP/05/73.

4 Lessons from the exit from QE in Japan

The BoJ managed to exit from its policy of QE in an orderly fashion by:

- Reducing its most flexible asset, i.e. bills purchases, to the largest extent possible and in a rather market neutral way by not rolling over existing positions. Essentially, the BoJ had to adjust only one item on the assets side of its balance sheet for its immediate exit from QE in the second quarter of 2006. Moreover, it could do this in a very short time span of just a couple of months, without causing major disruptions in financial markets. In addition, the reduction of the current accounts of banks was matched by a reduction in bills operations with banks, thus the adjustments on both sides of the balance sheet were kept directly within the banking sector, which facilitated the management of the process. All in all, bills purchase operations were an important instrument for the management of the process of QE in Japan. This was the case when QE started but even more so when it ended.
- Maintaining its holdings of long-term Japanese government bonds (JGB) to the greatest degree possible and reducing it only gradually over time, in order not to disturb demand/supply conditions in JGB markets and have unintended consequences for financial markets.
- Reducing more strongly but still gradually its holdings of short-term Japanese government securities.
- Implementing certain new liquidity providing operations in order to promote the proper functioning and stability of interbank money markets. The Japanese experience shows that when exiting from QE, a central bank needs to consider very carefully how to restore the functioning of these crucial markets.

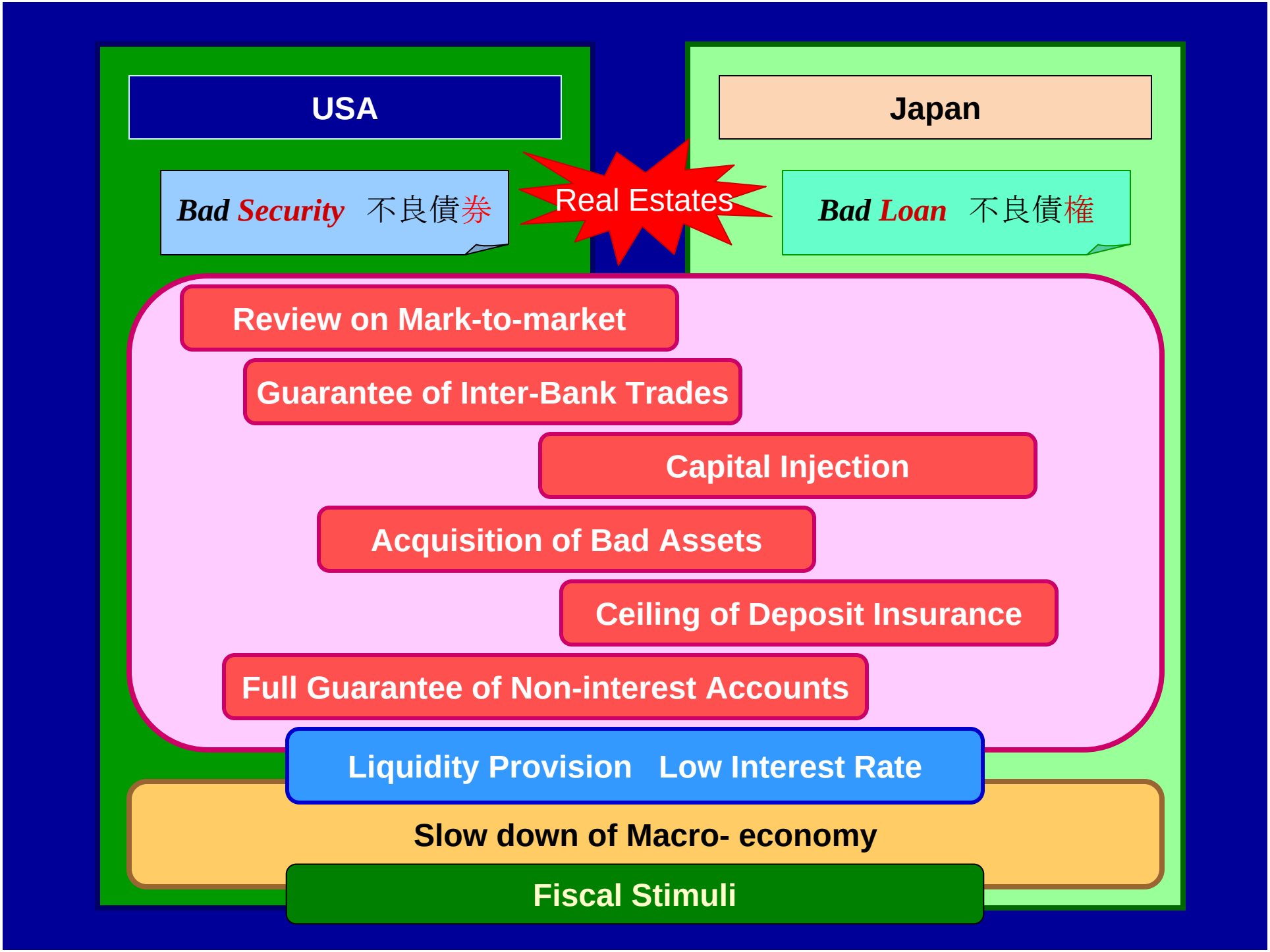
Symposium on Building the Financial System of the 21st Century

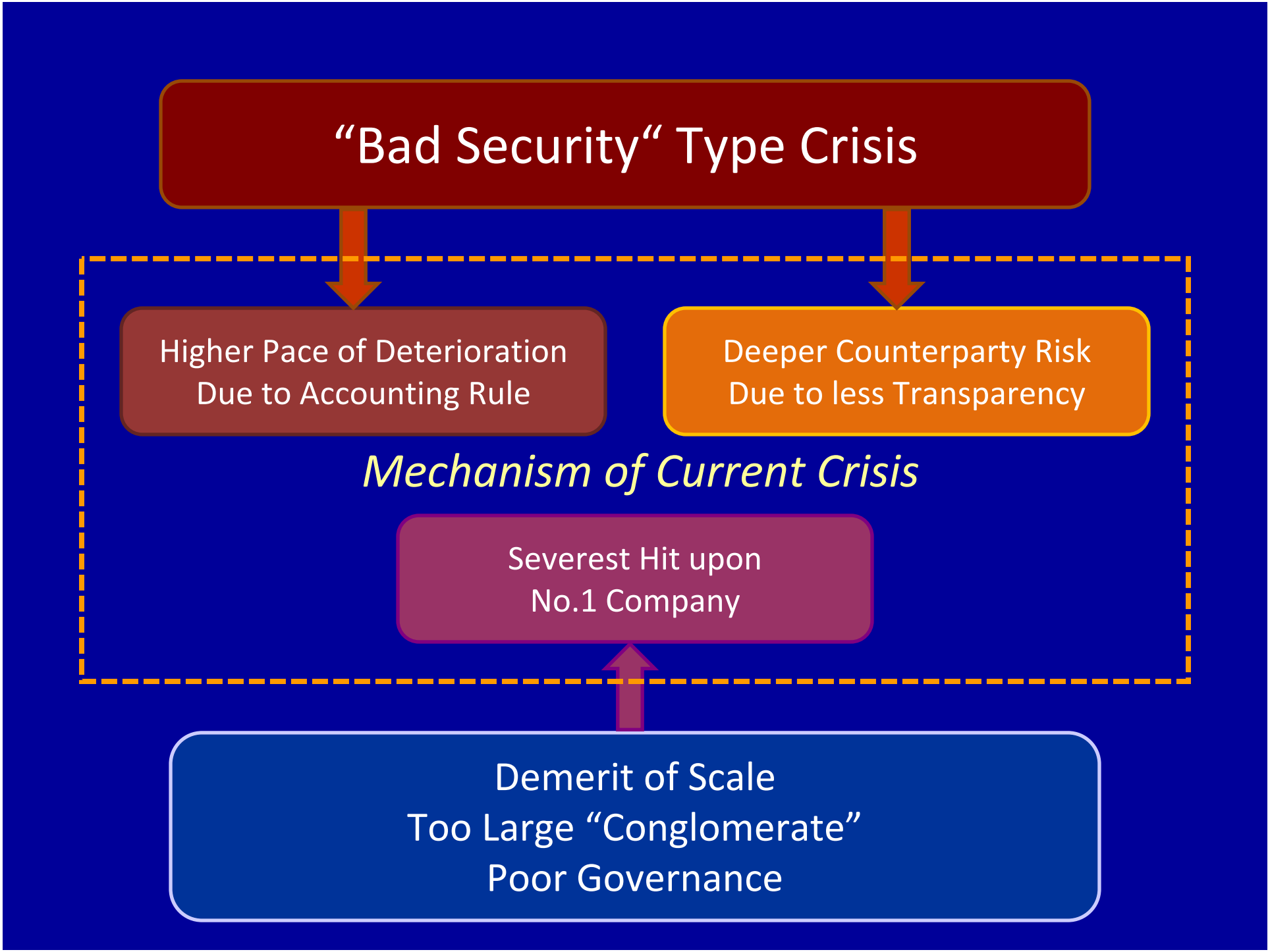
How Should the U.S. Respond to the Financial Crisis: Lessons from Japan

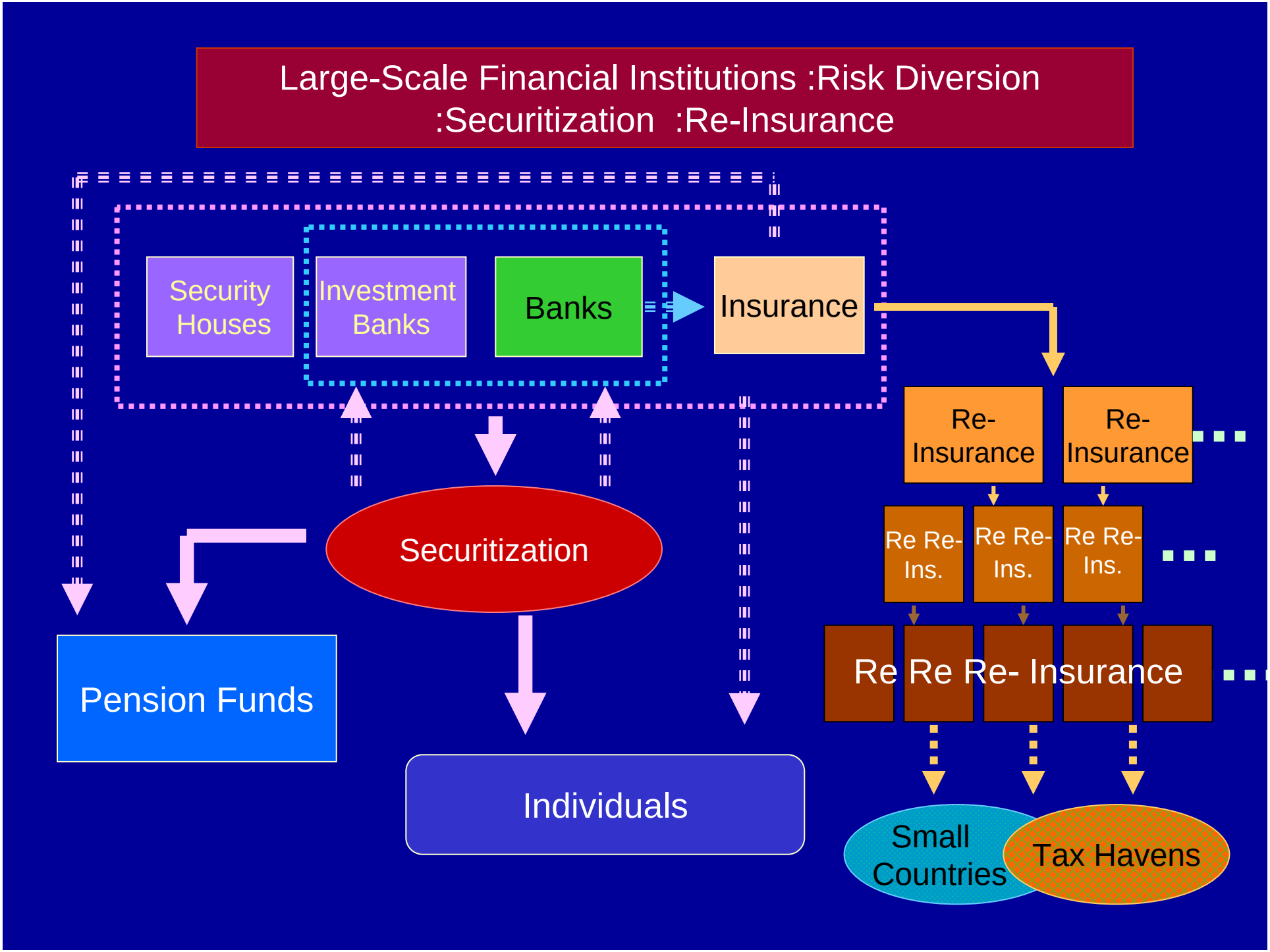
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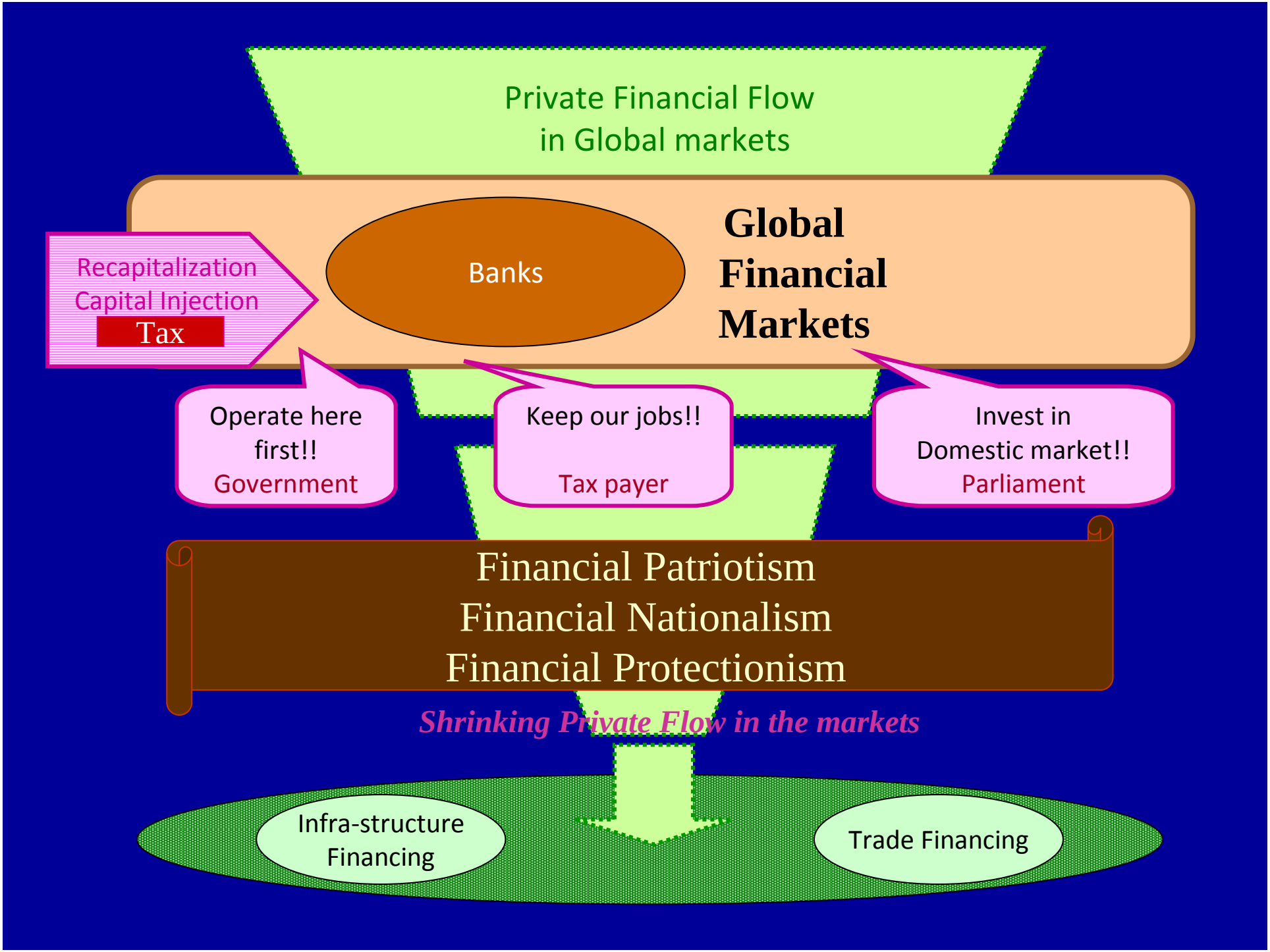
Hiroshi Watanabe

Japan Bank for International Cooperation


USA
Japan
Bad Security 不良債券
Real Estates
Bad Loan 不良債権
Review on Mark-to-market
Guarantee of Inter-Bank Trades
Capital Injection
Acquisition of Bad Assets
Ceiling of Deposit Insurance
Full Guarantee of Non-interest Accounts
Liquidity Provision Low Interest Rate
Slow down of Macro- economy
Fiscal Stimuli


"Bad Security" Type Crisis
Higher Pace of Deterioration
Due to Accounting Rule
Deeper Counterparty Risk
Due to less Transparency
Mechanism of Current Crisis
Severest Hit upon
No.1 Company
Demerit of Scale
Too Large "Conglomerate"
Poor Governance


Large-Scale Financial Institutions :Risk Diversion
:Securitization :Re-Insurance
Security Houses
Investment Banks
Banks
Insurance
Re-Insurance
Re-Insurance
Re Re-Ins.
Re Re-Ins.
Re Re-Ins.
Re Re Re- Insurance
Securitization
Pension Funds
Individuals
Small Countries
Tax Havens


Private Financial Flow
in Global markets
Recapitalization
Capital Injection
Tax
Banks
Global
Financial
Markets
Operate here
first!!
Government
Keep our jobs!!
Tax payer
Invest in
Domestic market!!
Parliament
Financial Patriotism
Financial Nationalism
Financial Protectionism
Shrinking Private Flow in the markets
Infra-structure
Financing
Trade Financing

JBIC Initiatives midst of Financial Turmoil

Total Amount
13.5 Billion USD
(As of Oct., 2009)

L I F E

(Leading Investment to Future Environment)
5 Billion USD for 2 years
** Clean Power Generation * Energy Efficiency Improvement*
** Water * Urban Transportation*

Bank Capitalization Fund

with IFC
2 Billion USD

Guarantee for Samurai Bond issued by Asian Countries (MASF)

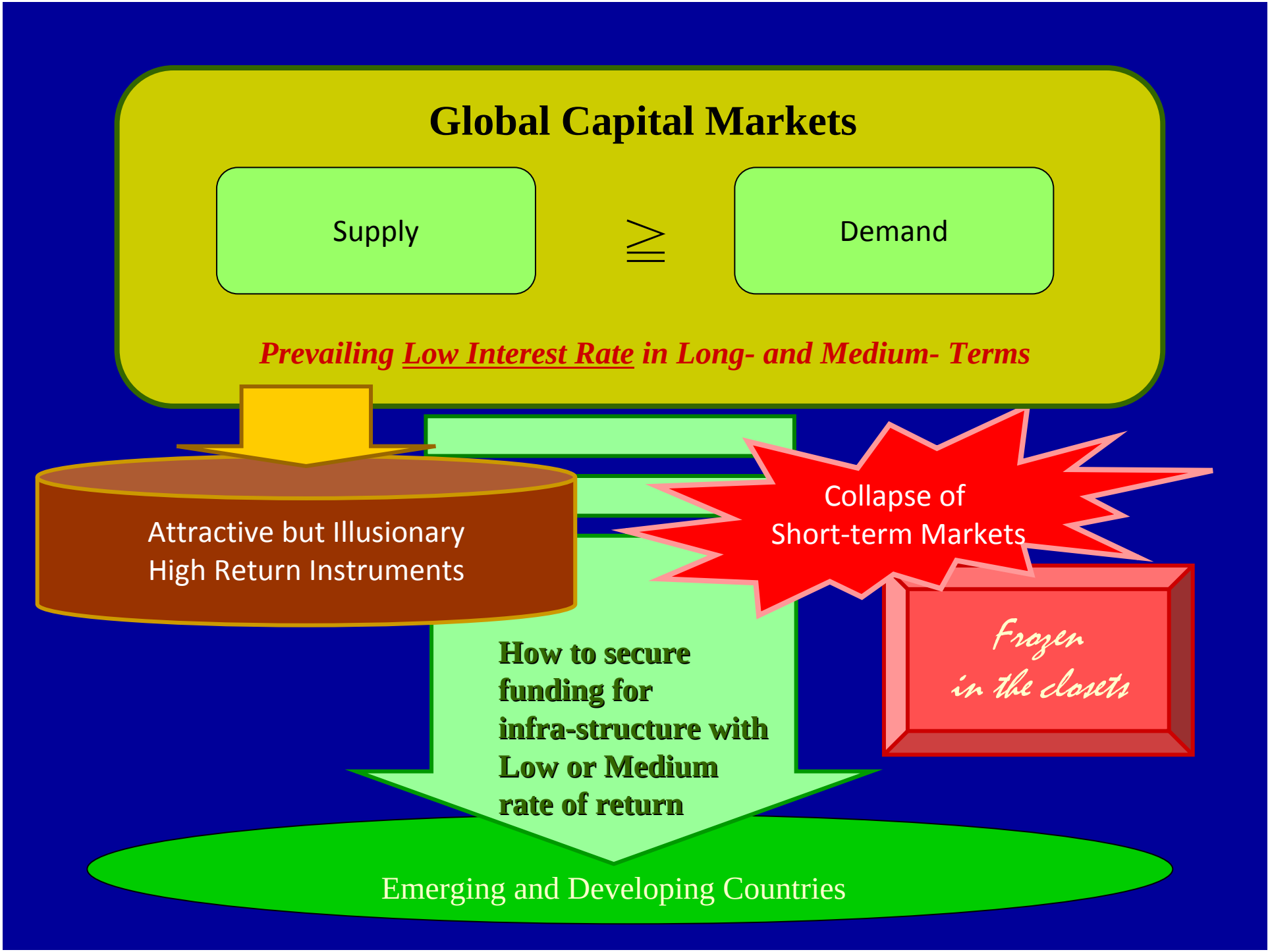
Up to 5 Billion USD

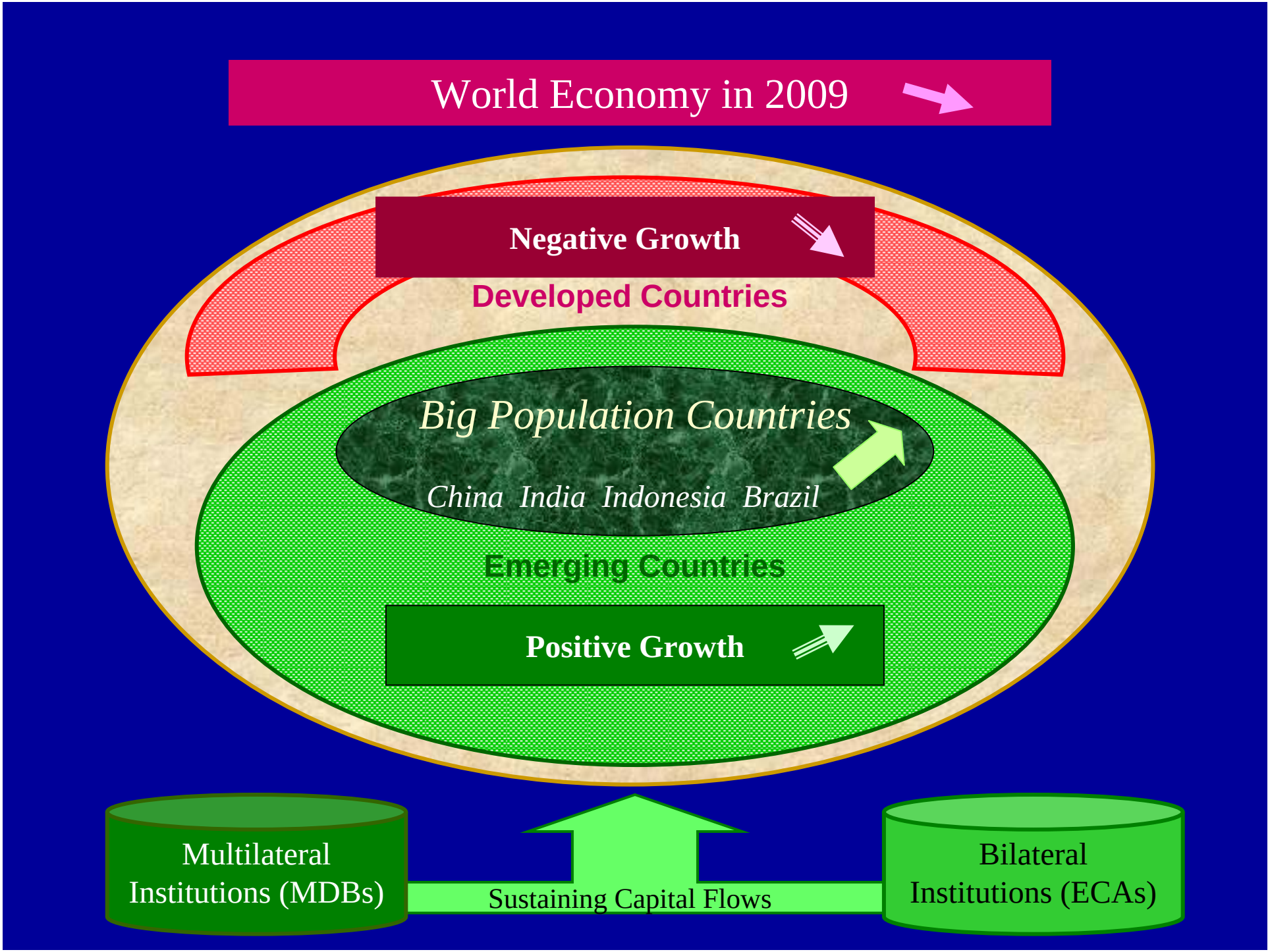
Trade Financing Facility Enhancement

Create 6 Billion USD trade by providing 1.5Billion USD for 2 years

Joint Initiative with
ADB, IFC etc

Coordination with
NEXI Trade Insurance (16 Billion USD)


Global Capital Markets
Supply
≧
Demand
Prevailing Low Interest Rate in Long- and Medium- Terms
Attractive but Illusionary
High Return Instruments
Collapse of
Short-term Markets
Frozen
in the closets
How to secure
funding for
infra-structure with
Low or Medium
rate of return
Emerging and Developing Countries


World Economy in 2009
Negative Growth
Developed Countries
Big Population Countries
China India Indonesia Brazil
Emerging Countries
Positive Growth
Multilateral Institutions (MDBs)
Sustaining Capital Flows
Bilateral Institutions (ECAs)



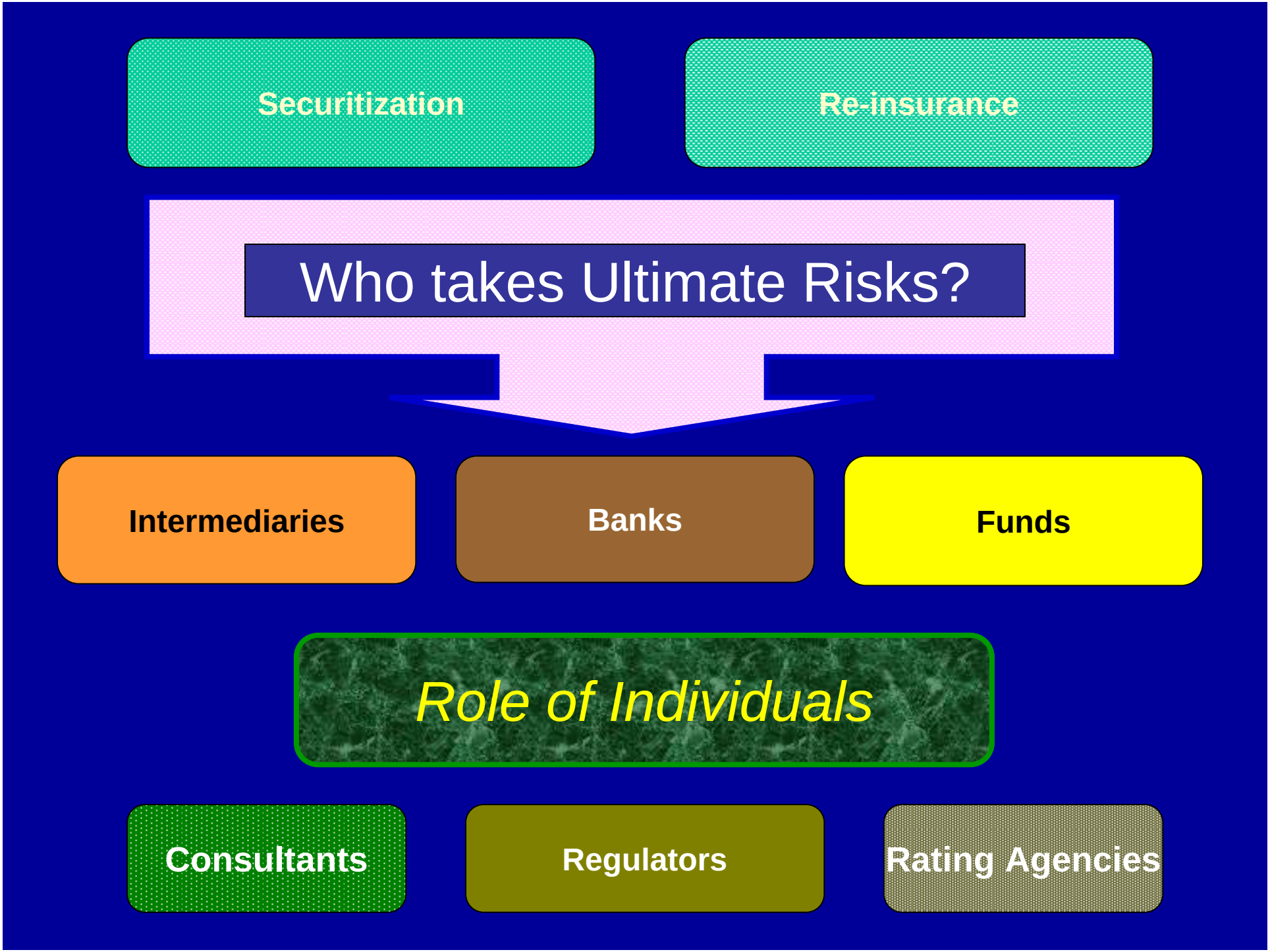
Acceptance of Persistent Low Rates

Risk of Virtually High Rates

Review of Structured Instruments

Source of Profit (Interest, Fee, Capital Gain?)

Promotion of Longer Holding of Stocks


Securitization
Re-insurance
Who takes Ultimate Risks?
Intermediaries
Banks
Funds
Role of Individuals
Consultants
Regulators
Rating Agencies

Thank you!

The Future of Banking and Securities Regulation
Increasing Concern on "Public Interest"

Shuji Yanase
Of Counsel, Nagashima Ohno & Tsunematsu

1. Introduction

Wealth of a nation tends to become spread among its people. At the moment we note widely-spread wealth among people in the United States and some of the EU countries. Japan is classified as a nation of widely-spread wealth, with 1,500 trillion yen household financial assets. Many countries, including large countries in terms of population or territory, are yet in the process of accumulating wealth in the hands of increasing number of people.

In those countries with widely-spread wealth among people, the financial system becomes an important matter of concern of the people, not only due to its indispensable functions in the economy but also to the costs which people must bear for receiving financial services, in normal course and at the time of financial crisis as well. People must bear, as taxpayers, the costs of public funds spent to bailout failed financial institutions for the purpose of maintaining financial system as the United States, the United Kingdom, Japan and many other countries did in the financial crisis which arose in 2008 and preceding other financial crises. In order to justify those costs to be borne by the people, the expenditure must be fair and reasonable and must be capable of being justified in the name of "public interest".

2. Re-examination of "Public Interest" in Financial Services

A huge amount of government moneys have been spent to rescue failed financial institutions, and the government is now a large shareholder of those financial institutions. The costs of such governmental moneys need to be explained to the public by specifying the "public interest" which is to be accomplished by the infusion of such government moneys. Reasonable recapture of the funds, if realized, is not sufficient.

Deposit-taking, safe keeping, money transfer, clearing of instruments, settlement of accounts in foreign trade as well as allocation of funds through lending and providing credit by guarantee are among the conventional financial services rendered by banks. Underwriting, dealing, and brokerage

services are among the conventional services rendered by securities firms. Operations of financial institutions have been diversified and developed, seeking opportunities to make money by investments on their own account, advisory services for investors, taking risks on swaps and derivatives and at the same time engaging in securitization and other transactions with a view to reduce their risks.

In view of the diversified and complicated activities of financial institutions, what is "public interest" which the government tried to accomplish and is now aiming at in its management, as large shareholder, of these financial institutions? Are all fields of operations of these financial institutions beneficial to the public? What if some of them are operated by a business model which tends to make money in violation of agency responsibilities to investors or by way of short-term or speculative transactions? Should such fields of operations be separated from the financial institutions in which the government moneys are put? How could we identify those fields of operations which are in the "public interest"?

"Free market" is indispensable for creative and innovative activities to make progress in and development of financial services. The regulation of market must be limited to provide fair and equal opportunity to market participants. This will lead to an idea that we need two different areas in the financial services, one which is to provide financial services in the "public interest" and is therefore regulated as such, and the other area which is to be left generally free and should fall within the "free market" activities. This idea would be in compliance with the two different motives on the part of customers of financial services providers. Customers would like to maintain a part of their financial assets in safe and conservative bank-deposits or similar type of investments and, with respect to the remaining part, may wish to make risk investments for higher return. While the operations of financial services providers are intergraded into one within their group of business, it seems to be natural to recognize these two different areas in terms of governmental regulations as well as customers' needs.

The practical approach would be to re-examine and re-define the "public interest" in the financial services, which deserve the rescue by the government moneys and should be subject to close regulations of the government on their business operations.

The proposals and discussions on the future banking and securities regulations seem to have been, by and large, focused on how to re-organize regulatory bodies and what sort of regulations should be imposed on financial institutions, leaving the current scope and manner of business operations of financial services providers as they are. The huge amount of public funds spent in response to the 2008 financial crisis, coupled with the widely-spread wealth of nation, would require the difficult task of re-examination of financial services and re-definition of "public interest" in financial services.

3. Protect Consumers and Investors

In addition to the costs which consumers and investors must pay for receiving financial services at the time of financial crisis, the manner in which a dispute, if arises between financial services providers and their customers, will be handled and the costs associated therewith, are important issues. Fair and reasonable resolution of disputes between financial services providers and their customers is essential to attain and maintain the credibility of consumers and investors in the financial system. The system for quickly providing such fair and reasonable resolution constitutes an infrastructure of the financial system.

The Obama Administration's White Paper proposes the creation of a Consumer Financial Protection Agency to protect consumers from abusive practices in financial products and services. In Japan, the Financial Services ADR has been introduced by the 2009 Amendment to the Financial Instruments and Transaction Law. The Amendment was enacted in June of this year and will take effect not later than June 2010. Under the Amendment all financial institutions will become obliged to enter into an agreement with one of the ADR Bodies which are under supervision of the Financial Services Agency of Japan. Under the agreement, a financial institution shall consent to participate in the mediation and conciliation procedure taken by a ADR Panel, shall submit to the ADR Panel all documents held by it relating to the dispute, and shall accept the settlement plan put forward by the ADR Panel unless the financial institution brings the case before the court.

The legal framework of the financial services ADR is now in the statute. There remains, however, an important and difficult task to create and develop the standards to be applied in formulating settlement plans. If the

ADR Panel follows the court practice in determining the facts and to decide upon rights and obligations in accordance with statutory law, it will not be able to provide the parties with a prompt solution of the dispute. The procedure must be flexible and the standards to be applied to resolve the dispute must be fair and reasonable. The ADR Panel will have to depart from the court practice and must accept that it may arrive at a settlement plan different form the decision to be made by a court. Nevertheless both procedure and standards must be supported by the court as falling within the orbit of justice by law. Unlike the common law countries, Japan adopted statutory rights after the Meiji Restoration and has, in general, not seen development of law in response to needs for remedies. In order to make the financial ADR system provide cost-efficient, prompt, and flexible fair and reasonable resolutions of disputes in satisfaction to both financial institutions and customers, a proper financial ADR practice must develop.

For this purpose, there must be recognized and defined what should be reasonable practice in financial services. Financial services providers must take the initiative in developing and determining what should be the fair and reasonable conduct of those engaged in providing financial services. Their views will be examined in light of benefits or value of their financial services to consumers and investors. Accumulation of precedents before the ADR Panel will produce the standards to be applied by the Financial ADR system.

We must look into conducts of financial services providers in detail and determine what should be their conducts in light of interests of consumers and investors. In the course of this exercise, we will have to re-examine financial services in light of the public interest.

(Note) In November 2008, the Japan Financial ADR/Ombudsman Research Group, for which I have acted as Chair, announced its proposal, "Model for a Financial ADR Organization and Measures for its Realization". An English translation of the proposal, which was prepared by the Waseda University COE Project, can be found in http://www.globalcoe-waseda-law-commerce.org/activity/090608_Proposal.pdf.

The Instability of the Budget Deficits and Its' Impact on Capital Market in Japan*

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Abstract

This paper analyzes why LDP continued to obtain majority of seats at the Diet after WWII by focusing on the role of public investment. The paper separates into three periods, namely, (i) high growth period, (ii) Asset Bubble period, (iii) economic downturn after the bubble. The government expenditure had been increased by increasing government bond just before the election. The GDP increased in the short run due to high public investment. Increases in GDP raised the tax revenue and the budget deficits were diminished. The government investment had strong output effect and it increases the tax revenue in the medium and long run. Effectiveness of the private capital stock and high positive output effect of public works during high growth period raised tax revenue.

LDP in those days focused not only short run policy but also long run stability of the government budget since LDP was keep on ruling Japanese diet.

During the asset bubble period of the late 1980s, Japanese tax revenue increased due to high asset price and property prices.

High appreciation of Japanese yen pushed strong manufacturing move to overseas since early 1990 to mid 1990s. Japanese economy faced with slower growth since 1990s after the collapse of asset bubbles. Aging population and manufacturing drain lowered the growth rate of Japan. LDP kept on spending to save for elderly workers, public works etc. by issuing government bonds. JGB (Japanese government bonds) are sold to mainly financial institutions such as banks, postal savings, insurance, pension funds.

However, sub-prime loans problem deepened Japanese economic recession. The government spending policy cannot overcome negative impact of recent worldwide financial crisis. Accumulated government debt amounted to 180% of GDP and it will be very difficult to keep on issuing JGB any further.

Finally, the reduction of government budget can be attained by increasing the effectiveness of both public investment and private investment. Increase of price elasticity will also raise output when government infrastructure investment policy is pursued. It also suggests that the need for flexible wage rate is required to recover Japanese economy.

JEL Classification: E61, E62

1. Introduction

The Liberal Democratic Party (LDP) has maintained majority in both upper House and Lower Houses in Japan since 1955 until 1994. Why did LDP win in most of the general elections despite of various fluctuations of the economy? Why they lost most recent national election in August 30th, 2009?

The purpose of this paper is to show that the public works implemented just before each election had increased economic growth until 1980s by the effectiveness of public works. It brought high income growth to general public until 1980s after the election. People had satisfied with LDP policies since their income was growing.

Despite the decline of economic growth of 1980s, Japanese economy experienced bubble economy in late 1980s which pushed up stock price and land price. They lead positive wealth effect and created strong demand for business sectors. Up to the end of the Bubble economy of 1990, LDP gained popularity due to higher income growth. LDP tried to implement more public works whenever their election is close. Fortunately these public works pushed Japanese economy upward so that positive economic growth was attained until late 1990s.

However, high appreciation of Japanese yen in late 1980s pushed strong manufacturing move to South East Asia. Japanese economy faced with slower growth since 1990s after the collapse of asset bubbles. Aging population and manufacturing drain lowered Japanese growth rate. LDP kept on spending for public works and other government expenditures believing that Keynesian policy will recover Japanese economy quickly. LDP kept of used government expenditures for elderly workers and other welfare expenses by issuing government bonds. JGB (Japanese government bonds) are sold to mainly financial institutions such as banks, postal savings, insurance, pension funds. These positive government expenditures helped LDP to keep gaining popularity. However, sub-prime loans financial crisis deepened Japanese economic downturn and the government spending policy cannot overcome negative impact of recent worldwide financial crisis. Accumulated government debt amounted to more than 180% of GDP and it will be very difficult to keep on issuing JGB any further. DP (Democratic Party) for the first time received majority seat at lower house in August 2009 and LDP lost tremendous amount of seats.

Our paper will show that the short term oriented political party tends to expand their government spending to gain popularity by issuing government bonds. It contradicts the long run optimal policy. The party who wants to obtain popular support from the public only takes into account of short run policy objectives rather than to take into

account of entire macroeconomic conditions and long term outcomes. Finally the paper will address the conditions of reducing how to reduce the government budget deficits by concentrating on fiscal expenditures which would create strong positive impact on aggregate supply curve.

There is a mystery that LDP had been a ruling party for a long period of time. Several seminal works tried to answer the question from the points of “the political business cycles theory”. The political business cycle model first developed by Nordhaus (1975) shed some light on the relationships between political parties and macroeconomic performance. According to the seminal study by Nordhaus, the ruling party has an incentive to try to manipulate the economy before the election in order to boost up the likelihood of his winning. A variety of theoretical and empirical research had been conducted by many scholars following to the Nordhouse. Most of empirical research focuses on the presidential system in the U.S.A.. However, there are some works which examined the political business cycles in the parliamentary system in Japan (Ito and Park 1988, Ito 1990, Kohno and Nisizawa 1990, Cargill and Hutchison 1991, and Hecklman and Berument 1998). The seminal work by Ito and Park shows that the ruling cabinet has tend to call general elections in Japan when the economic is in good condition. Ito and Park tested the endogeneity of election cycle empirically and examined whether the ruling Liberal Democratic Party (LDP) used monetary and fiscal policies in order to win the elections, However, they found no such evidence in Japan. Ito and Park applied instrumental variable method for the timing of election. Kohno and Nishizawa investigated the electoral business cycle in Japan empirically and emphasize the importance of public construction to gain popularity. Although these studies focused on the relationship between the election timings and public policies by the ruling LDP party they did not pay attention to the budget deficits. This paper will construct a simple macroeconomic model to investigate the relationship between the role of public works to support LDP’s popularity and the budget imbalance. Both high-growth and post-bubble periods are investigated.

The LDP depended heavily on the public expenditure in order to win the general election. Since Japanese economy enjoyed high economic growth, Japanese government could receive enough tax revenue to compensate for the extra public disbursement just before the election. In addition, domestic financial institutions and institutional investors such as insurance companies purchased government-issued bonds. Therefore, the supply of government bond and the demand for the government bond were almost balanced until 1965. The stability condition for the government budget balance by comparing government bond issues and the money supply policy such paper as Blinder

and Solow (1973) is well cited.

However the post-bubble period could not satisfy these conditions any more. The economic effect of public works drastically declined as is shown in Yoshino and Nakahigashi (2000, 2001). The marginal productivity of public infrastructure reduced drastically both from its direct effect and indirect effect. Effectiveness of private capital is also declined[1]. Since the public infrastructure investments declined its effectiveness, it could not achieve higher economic growth and it did not increase tax revenues.

Nevertheless, LDP pushed its expenditures to gain support from retired people by spending much more money for social welfare and medical cares. It created huge budget deficits as is shown in figure 1.

Recent changes in the parliament system are as follows. Prior to 1994, the election system in Japan is the medium-sized constituencies (i.e. single non-transferable vote (SNTV)) about 130 electoral districts. Each constituency chooses between 3 to 5 representatives by SNTV under the system of medium-sized constituencies. However in 1994, the Hosokawa cabinet[2] introduced the small electoral district system jointed with proportional representation system. Each constituency votes one representative in small electoral district and one political party. In total, the number of representatives chosen by the small electoral district amount to 300 seats. The number of representatives chosen from the proportional representation system is 180 seats. Since 1955, the Liberal Democratic Party (LDP) has maintained a majority in the House of Representatives. However, the introduction of small electoral district system allows forming two big political parties, LDP and DP. The paper applies the Hibbs' (1977) partisan's view.

This paper is organized as follows: in section 2, we demonstrate the general settings of the model. Then, we analyze and work on our economic model to describe the ruling party's behaviour. First we investigate the fiscal policy in the short run before the

[1] See Yoshino and Nakahigashi (2000) and Yoshino (2001) and in detail. Yoshino and Nakahigashi (2000) investigate the relation between social capital stock and economic growth by estimating the productivity effect of social capital stock after WWII in Japan. They find that during the high economic growth period, the productivity of the social capital stock in Japan keeps a high level. However since 1970, because of structural change, it becomes to a low level standard. From the market quality theory advocated by Yano (2009), we apply Yano's view to the effectiveevaluation scheme of the effective public investments.

[2] Morihiro Hosokawa is the 79th prime minister of Japan. He belonged to the Japan New party (JNP). It is the first time that LDP became to be the opposition party in the Diet. JNP does not exist because of the formation of New Frontier Party (NFP). Some JNP members succeeded to the member of Democratic Party.

general election. Next we investigate the effect of LDP's policy in the long run by taking account of the government budget constraint. Finally, we summarize the paper and discuss implications of the behaviour of political parties in Japan.

2. Model

2.1. Model Description

In this section, we establish three simple macroeconomic models to assess the role of public works in Japan: the model which describes macroeconomic situation in the short run without taking into consideration of the budget constraint, and the model which takes into account of macroeconomic situation in the long run by including the government budget constraint.

The paper tries to reflect the behavior of Japanese political party since after World Wide War II until the Bubble economy (1986-1990). After introducing the small electoral district in 1994, we establish the different model. Since then, the Japanese political parties tended to converge to two large parties, namely LDP and DP.

We take into account the following game among political parties. In our model, until now LDP always keeps the majority and opposition parties are not strong enough to win the majority. We divide the three period of political situation of Japan after WWII because the political situation in Japan is totally changed. Table 4 shows that the percentage of vote LDP acquired are gradually decreased. In summer 2009, LDP completely lost the election. The DP won (acquired 308 seats in the Lower House). Now DP becomes to be the ruling party in 2009 and LDP is going to be an opposition party for the first time. That is the reason why we roughly classify the political situation in Japan into the two periods. The first period is before the bubble economy burst. The second period is that LDP becomes to an opposition party.

In the first period, LDP did not worry about the opposition parties since LDP always formed the ruling cabinet. That is, LDP just choose the public expenditure in order to maximize their seats in the Diet. The opposition party is no power to implement their manifest during the LDP ruling period. However now we consider the situation after the LDP's historical election defeat in 2009.

The timing of the game in the second period is the following:

(Step 1) At the end of the period, the constituent can select either the ruling party or opposition party, denoted by R (Ruling) and O (Opposition), depending on the state of

the economy.

(Step 2) In order to maximize their seats required to maintain majority at the Diet, Ruling party offers fiscal stimulus just before the general election.

(Step 3) Based on the fiscal stimulus packages, each constituent decides whether to vote for ruling party or not. Payoff is the expected seat of the Lower House in the Diet.

Our first model is based on the simple short run macroeconomic model where the government budget constraint, aggregate supply effect etc. are not taken into account. Whether the ruling party will win or lose is assumed to be depending on the level of GDP. Thus the ruling party stimulates the economy by increasing public works and other government expenditures (denoted by G_t). Figure1 shows that the public investment (G_I / Y_t) increased right before the election until 1981.

Since LDP was majority until 1989, it was possible for LDP even to determine the timing of election.

The objective of the ruling party is to minimize competitor's seats. The number of seats at the diet is a function of quadratic gap between the actual level of GDP and the target (full employment) GDP.

$$L(N_R) = N_R\left[\left(Y_t^R - Y^f\right)^2\right] \ ,$$

Where Y_t^R is the ruling party's expected level of GDP. Y_t^O is the opposition party's targeted GDP level and Y^f is the full-employment GDP level and N_R is the number of the seat which the ruling party is going to achieve.

The total number of the diet seats are given by $N_R + N_O = \overline{N}$.[3]

N_O is the number of oppositions' seats which will be expected to be obtained by the general election. Only the minimization problem of the ruling party is analyzed in the paper because the policy of the opposition party cannot be implemented for long period of time in Japan (from 1955 to 1994).

Table 1. The Expected Number of Seat in the Diet

	For Ruling Party (LDP)

[3] In Japan, the total number of the House of Representatives is 480. The total number of the Upper House is 242. Here in our model, considering recent changes in Japan, we assume that there are two big political parties (LDP and DP) competing each other.

The Loss function of Seat in the Diet	$N_R\left[\left(Y_t^R - Y^f\right)^2\right]$

At first, the short rum macro model is explained[4]. The output is made up of four components, namely,

(1) Consumption spending (C_t);

(2) Investment (I_t);

(3) Government purchases (G_t);

(4) Net Export (NX_t);

$Y_t = C_t + I_t + G_t + NX_t$.

where $C_t = c_0 + c_1(1-t)Y_t$ and $c_0 > 0$ is the autonomous consumption.

t is the income tax rate, and $c,\ 0 < c < 1$ is the marginal propensity of consumption.

The short run macro model does not take into account of the government budget constraint. The ruling party solves the short run macro model before the election. We call the model as "the LDP ruling scheme".

$$\min_{G_t} L(N_R) = N_R\left[\left(Y_t^R - Y^f\right)^2\right] \tag{1}$$

$$\text{s.t.} \quad Y_t = C_t + I_t + G_t + NX_t \tag{2}$$

$$C_t = c_0 + c_1(1-t)Y_t \tag{3}$$

$$I_t = \bar{I} \tag{4}$$

$$NX_t = \overline{NX} \tag{5}$$

where Y_t is expressed as the function of G_t and B_t, i.e. $Y_t = Y_t\left(G_t, B_t; t, \bar{I}, \overline{NX}\right)$.

The first order condition for "the LDP ruling scheme" is as follows:

$$\frac{\partial L(N_R)}{\partial G_t} = 2N_R{}'\left[\left(Y_t^R - Y^f\right)^2\right]\left(Y_t^R - Y^f\right)\frac{\partial Y_t^R(G_t)}{\partial G_t} = 0 \tag{6}$$

At the optimal level, $Y_t^R = Y^f$ will be satisfied.

Therefore the optimal level of G_t is given as:

$$G_t^* = Y^f\left(1 - c_1(1-t)\right) - c_0 - I_t(r_t) - \overline{NX} \tag{7}$$

[4] We choose the Keynesian type of macroeconomic model since it is often said that Japanese economy strongly influenced by the government policy intervention and implementation.

It will be examined whether the Blinder-Solow condition[5] of government bond financing is satisfied or not. The ruling party tries to expand public investment in order to gain majority of the seats in general election.

Investment is assumed to depend on the interest rate r_t, i.e., $I_t = I_t(r_t), r_t = r\left(B_t, G_t; t, \overline{NX}\right)$.

Under the government bond financing, the government flow budget constraint in the short run can be written as follows:

$$\Delta B_t = G_t^* + r_t B_{t-1} - tY_t \qquad (8)^6$$

where G_t^* is given by equation (7) and ΔB_t is the new issue of the government bonds.

2.2 Test of the stability of the government budget constraint

First of all, the Blinder-Solow condition is tested whether $\frac{\partial \Delta B_t}{\partial B_t} < 0$ is satisfied or not by use of the "LDP ruling scheme".

Total differentiation of the government budget constraint (equation (8)) yields;

$$\frac{\partial \Delta B_t}{\partial B_t} = r_t - \left(\overset{(-)}{\frac{\partial I_t}{\partial r_t}} \overset{(+)}{\frac{\partial r_t}{\partial B_t}} + t \overset{(+)}{\frac{\partial Y_t}{\partial I_t}} \overset{(-)}{\frac{\partial I_t}{\partial r_t}} \overset{(+)}{\frac{\partial r_t}{\partial B_t}} - B_{t-1} \left(\frac{\partial r_t}{\partial B_t} \right)^2 \right) > 0 \qquad (9)$$

Equation (9) shows that the sign is positive. Since an increase of the government bond will raise interest rate (r_t) which pushes down the private investment (I_t). Therefore LDP's short run oriented policy will lead to instability of the government budget.

However, Blinder-Solow condition shown in (9) differentiates ΔB_t with respect to B_t instead of G_t.

The stability condition should be evaluated by the level of public expenditure since G_t is the policy instrument. Therefore it would be better to check the stability condition of the government budget constraint based on the $\frac{\partial \Delta B_t}{\partial G_t}$.

We obtain the following equation:

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[5] Originally, Blinder and Solow (1973) consider the following two cases: (i) the case which government prints new money to finance the additional government expenditure (ii) the case which government issues additional bond to balance its book. In our model, since we look into the effectiveness of fiscal policy in Japan, we focus on the effect of bond financing only.

[6] In our model, the timing of bond interest payment is at the end of the period t.

$$\frac{\partial \Delta B_t}{\partial G_t} = \left(r_t \frac{\overset{(+)}{\partial B_t}}{\partial G_t} + B_{t-1} \frac{\overset{(+)}{\partial r_t}}{\partial G_t} - \frac{\overset{(-)}{\partial I_t}}{\partial r_t} \frac{\overset{(+)}{\partial r_t}}{\partial B_t} \frac{\overset{(+)}{\partial B_t}}{\partial G_t} - t \frac{\overset{(+)}{\partial Y_t}}{\partial I_t} \frac{\overset{(-)}{\partial I_t}}{\partial r_t} \frac{\overset{(+)}{\partial r_t}}{\partial B_t} \frac{\overset{(+)}{\partial B_t}}{\partial G_t} \right) - \left(\frac{\overset{(-)}{\partial I_t}}{\partial r_t} \frac{\overset{(+)}{\partial r_t}}{\partial G_t} + t \frac{\overset{(+)}{\partial Y_t}}{\partial I_t} \frac{\overset{(-)}{\partial I_t}}{\partial r_t} \frac{\overset{(+)}{\partial r_t}}{\partial G_t} \right) > 0$$

where $$\frac{\partial B_t}{\partial G_t} = \frac{B_{t-1}\left(\frac{\partial r_t}{\partial B_t} + \frac{\partial r_t}{\partial G_t} \right) \frac{\partial r_t}{\partial G_t} - \frac{\partial I_t}{\partial r_t} \frac{\partial r_t}{\partial G_t} \left(1 - t \frac{\partial Y_t}{\partial I_t} \right)}{r_t - \frac{\partial I_t}{\partial r_t} \frac{\partial r_t}{\partial B_t} - t \frac{\partial Y_t}{\partial I_t} \frac{\partial I_t}{\partial r_t} \frac{\partial r_t}{\partial B_t}} \tag{10}$$

Equation (10) is positive when an increase of the government expenditure leads to higher rate of interest (r_t) and it reduces the private investment (I_t) drastically.

The ruling democratic party (LDP) does not take into account of its budget constraint in the short run. However, LDP was concerned the long run government budget constraint during high growth period since LDP was continuously ruled the diet and it was their responsibility to keep Japanese economy in stable condition even in the long run.

Therefore during high growth period between 1950 and 1970s, equation (10) was not explosive. The public works brought higher economic growth and higher income. It attributed to an increase in tax revenue which stabilized the government budget constraint.

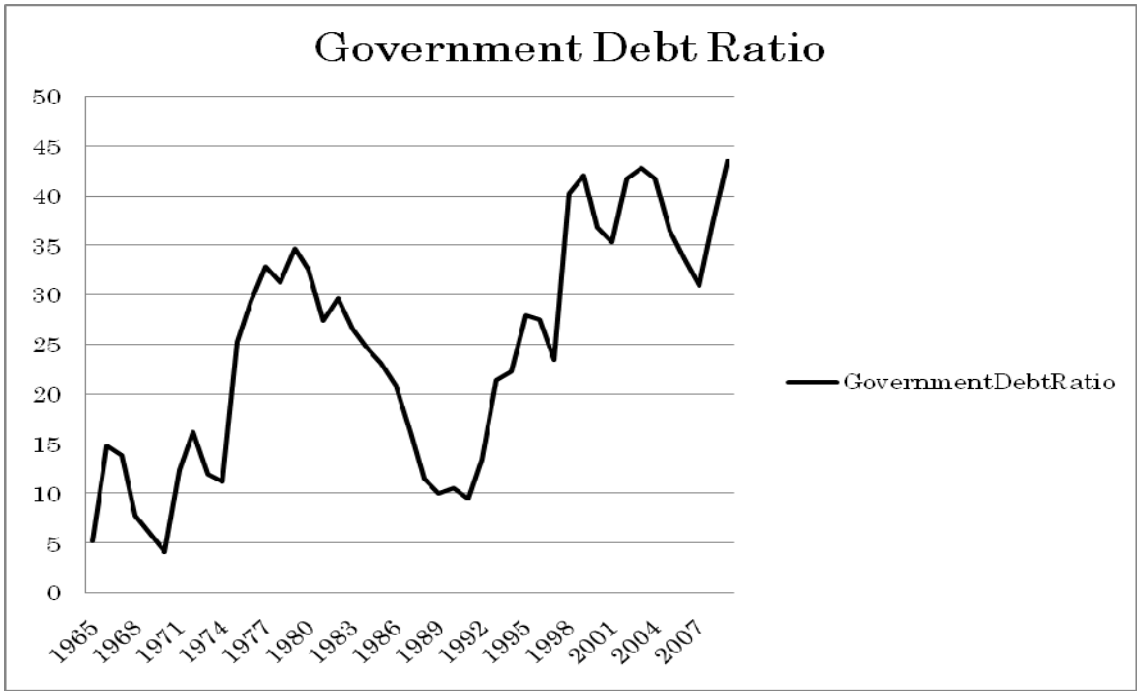
However, the situation had drastically changed after the burst of the bubble of 1990. LDP kept on spending for the government investment (infrastructure investment) hoping for the recovery of Japanese economy. LDP believed (especially Prime Minister Miyazawa at that time) that the supply side effect of the public works would have been strong. However, the effectiveness of public investment declined as is shown in the following table. The effectiveness of private capital stock also can be seen reduced its efficiency especially after 1990s. Burst of the bubble created excess capacity and the marginal effect of private investment declined sharply. Government infrastructure investment cannot induce private investment into the region. Fiscal stimulus could not bring back the recovery of Japanese economy. Instead, the government budget deficits had been worsened. The ruling LDP had myopic behavior in order to acquire more seats in the Diet.

Table 2. Translog Production function $Y_t = f\left(Kp, L, Kg\right)$

Year	1956-69	1960-64	1965-69	1970-74
Private Capital Stock	0.7558	0.7304	0.6463	0.4131
Public Capital Stock	0.6487	0.8016	0.8168	0.0842

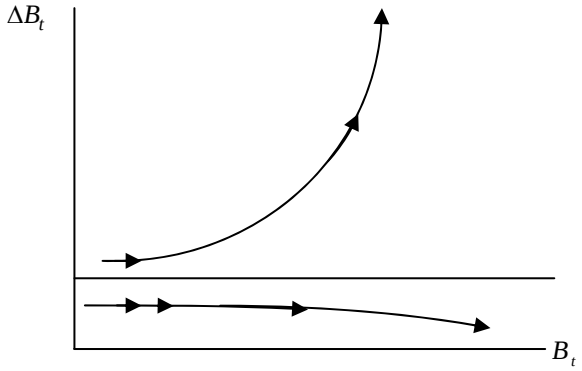
Year	1975-79	1980-84	1985-89	1990-93
Private Capital Stock	0.3124	0.2578	0.2280	0.1995
Public Capital Stock	0.0397	0.0590	0.2525	0.2246

Figure 1. Government Debt / Total Government Expenditures in Japan



The government reliance on bond out of its total expenditure is shown in the above figure 1. The ratio of bond issue to total government expenditure was quite low until 1980s and it declined sharply during the bubble period of late 1980s and started to increase drastically in the 1990s.

Figure 2. Fiscal Policy under government-bond financing (unstable case)



2.3 Long-Run Macro model and the stability of the Government Budget

Next we turn to the long run macroeconomic model where the government budget constraint, aggregate supply curve etc. introduced. The long run model can be summarized as follows:

$\min_{G_t} L(N_R) = \sum_{t=1}^{T} \rho^t N_R \left[\left(Y_t^R - Y_t^O \right)^2 \right]$: Loss Function (11)

$Y_t^S = F\left[N\left(\ln \frac{W}{P} \right), K_t^p, K_t^G \right]$: Aggregate Supply Function (Production Function) (12)

$K_t^P = I(r_t) + K_{t-1}^P$: Real Private Capital Stock (13)

$K_t^G = G_I + K_{t-1}^G$: Real Government Infrastructure investment (14)

$G_t = G_C + G_I \quad where\ G_C = \theta G_t,\ G_I = (1-\theta) G_t$: Total Government Expenditure (15)

$A = D_t + B_t = K_t^P + K_t^G$: Nominal Private Financial Assets (16)

$(1-t)Y_t - C_t = S_t = I(r_t) + G_t$, where $S_t = \Delta D_t + \Delta B_t$: IS Balance (17)

$Y_t^D = c_0 + c_1(Y_t - tY_t) + c_2(A - p) + I(r_t) + G_t$: Aggregate Demand Curve (18)

$\Delta B_t^S = G_t + r_t B_{t-1} - tY_t$: Supply of the Government Bond (Government Budget Constraint) (19)

$\Delta B_t^D = \Delta A - \Delta D_t = S - \Delta D_A = (1-t)Y_t - C_t - \Delta D_t$: Demand for the Government Bond (20)

where A_t : asset, D_t : deposit, p^e : expected price level (wage rate), K_t^P : private capital, K_t^G : public capital, $\theta,\ 0 \le \theta \le 1$:the distribution ratio for government expenditure, G_C :Government Consumption, and G_I :Government Investment

The ruling party minimizes its loss function (11) subject to the long run macroeconomic model described by equations from (12) to (20).

The long run macroeconomic model can be explained as follows:

The equation (13) determines the level of private capital stock. Equation (14) determines the level of the government capital stock. The aggregate supply function

(AS, equation (12)) and aggregate demand function (AD, equation (18)) determine GDP (Y) and price level (p). The new supply of the government bond (equation (19)) and the demand for government bond (equation (20)) determine the level of new issued bond and the interest rate.

The Aggregate Supply (AS) curve (12) can be rewritten as follows;

$$Y_t^S = a_1\left(p - p^e\right) + a_2 K_t^P + a_3 K_t^G \quad \text{where} \quad \ln w = p^e, \ln p = p \qquad \text{(AS curve)} \qquad (21)$$

Substitute equation (13) and equation (14) into the AS curve (21), we obtain

$$Y_t^S = a_1\left(p - p^e\right) + a_2\left(I\left(r_t\right) + K_{t-1}^P\right) + a_3\left(G_I + K_{t-1}^G\right) \qquad \text{(AS)} \qquad (22)$$

Equation (23) is the aggregate demand curve (AD) where the wealth effect (A-P) for the consumption function is explicitly introduced.

$$Y_t^D = c_0 + c_1\left(Y_t + G_C - tY\right) + c_2\left(A - p\right) + I\left(r_t\right) + G_t \qquad \text{(AD)} \qquad (23)$$

The optimal government expenditure for LDP party can be obtained as follows;

$$\frac{\partial L\left(N_R\right)}{\partial G_t} = 2\rho^t N_R{}'\left[\left(Y_t^R - Y_t^O\right)\right]\left(Y_t^R - Y_t^O\right)\frac{\partial Y_t^R\left(G_t\right)}{\partial G_t} = 0 \qquad (24)$$

From equation (11), the target level of GDP is the full employment level, namely $Y_t^R = Y_t^O\left(= Y^f\right)$.

Substituting the AS-curve (equation (21)) into the AD-curve ((23)) and by eliminate p, the reduced form for GDP (Y_t) is obtained as follows:

$$Y_t = -b_1 p^e + b_2 c_0 + b_3 I\left(r_t\right) + b_4 G_t + b_5 D_t + b_6 B_t + b_7 K_{t-1}^G + b_8 K_{t-1}^P \qquad (25)$$

where
$$b_1 = \frac{a_1 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}, b_2 = \frac{a_1}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}, b_3 = \frac{a_1 + a_2 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)},$$
$$b_4 = \frac{a_1\left(1+\theta c_1\right) + \left(1-\theta\right)a_3 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}, b_5 = \frac{a_1 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}, b_6 = \frac{a_1 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)},$$
$$b_7 = \frac{a_3 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}, b_8 = \frac{a_2 c_2}{\left(a_1 + c_2\right) - a_1 c_1\left(1-t\right)}.$$

The reduced form of price level (p_t) can be obtained from both AS (equation (22)) and AD (equation (23)) curves as follows;

$$p_t = g_1 p^e + g_2 c_0 + g_3 I\left(r_t\right) + g_4 G_t + g_5 D_t + g_6 B_t + g_7 K_{t-1}^G + g_8 K_{t-1}^P \qquad (26)$$

$$g_1 = \frac{a_1\left[1-(1-t)c_1\right]}{(a_1+c_2)-a_1c_1(1-t)}, g_2 = \frac{1}{(a_1+c_2)-a_1c_1(1-t)}, g_3 = \frac{1-a_2\left[1-(1-t)c_1\right]}{(a_1+c_2)-a_1c_1(1-t)},$$

where $g_4 = \frac{(1+c_1\theta)-a_3(1-\theta)\left[(1-t)c_1-1\right]}{(a_1+c_2)-a_1c_1(1-t)}, g_5 = \frac{c_2}{(a_1+c_2)-a_1c_1(1-t)},$

$$g_6 = \frac{c_2}{(a_1+c_2)-a_1c_1(1-t)}, g_7 = \frac{a_3\left[(1-t)c_1-1\right]}{(a_1+c_2)-a_1c_1(1-t)}, g_8 = \frac{a_2\left[(1-t)c_1-1\right]}{(a_1+c_2)-a_1c_1(1-t)}.$$

The effect of an increase in the government expenditure on GDP can be obtained by differentiating the equation (25) with respect to G_t as follows;

$$\frac{\partial Y_t}{\partial G_t} = \frac{1}{\Delta}\left((a_1+a_2c_2)\frac{\partial \overset{-}{I_t}}{\partial r_t}\frac{\partial \overset{+}{r_t}}{\partial B_t} - a_1c_2\frac{\partial \overset{+}{p^e}}{\partial G_t} + a_1(1+c_1\theta)+(1-\theta)a_3c_2 \right) \begin{matrix}\leq \\ \geq\end{matrix} 0 \qquad (27)^7$$

$$where \frac{1}{\Delta} = \frac{1}{(a_1+c_2)-a_1c_1(1-t)} = \frac{1}{a_1\left[1-c_1(1-t)\right]+c_2} > 0$$

The sign of an additional government expenditure on GDP (equation (27)) depends on coefficients and elasticity in equation (27).

If the total effect of $\frac{\partial I_t}{\partial r_t}\frac{\partial r_t}{\partial B_t}$ (an increase in the government bond crowd outs private investment) are large and the effect of $a_1(1+c_1\theta)+(1-\theta)a_3c_2$ (where a_1 is the effect of price on GDP and a_3c_2 is the effect of the government capital stock on GDP multiplied by the wealth effect on consumption) are small, then the additional increase of the government expenditure on GDP will become negative.

Namely, when the crowding-out effect of government debt on private investment becomes larger ($\frac{\partial I_t}{\partial r_t}\frac{\partial r_t}{\partial B_t} = -1$), the effects of the additional government expenditure on GDP will be smaller (or even negative).

In order to prevent that the equation (27) turns to be small (or negative), $a_1(1+c_1\theta)+(1-\theta)a_3c_2 > 0$[8] must be achieved. It means that the effectiveness of public capital on output must be high, the price elasticity on output must be high and the wealth effect on consumption is large.

However, during the high-growth periods of 1960 to 1980, the crowding-out effect

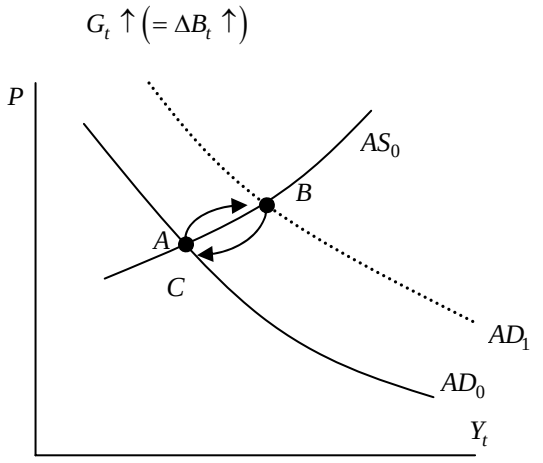
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[7] In our model, at the optimal, the optimal θ^* can be derived as $\theta^* = -\frac{(a_1+a_3c_2)}{a_1c_1-a_3c_2}$.

[8] In the current model, the effect of $\frac{\partial p^e}{\partial G_t}$ is regarded as very small. Therefore we ignore this effect.

($\frac{\partial I_t}{\partial r_t}\frac{\partial r_t}{\partial B_t}$) was very small and the coefficient of K_t^G, a_3 was large. Since the public infrastructure investment created both high direct effect and high indirect effect. Therefore the effect of the additional government expenditure on GDP was positive during high growth period.

Figure 3. Short-run effect of fiscal policy under bond financing



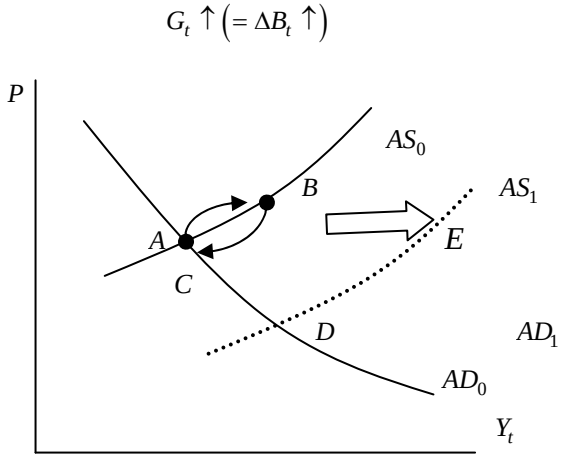
A → B: the temporary effect of public investment on real GDP

B → C: the crowding out effect through the reduction of bank loans by holding more government bonds and higher interest rate which pushed private investment down.

However, if the government shifts the aggregate supply curve to the right (up to the point E) as is shown in Figure 4, it will create positive effect on real GDP.

If the technological progress shifts the AS curve further to the right, the long run effect of G_t will be even larger.

Figure 4. Long-run effect of fiscal policy under bond financing



The optimal government spending in the long run can be obtained as follows by setting $Y_t = Y^f$

$$G_t^* = \frac{1}{b_4}\left(Y^f + b_1 p^e - b_2 c_0 - b_3 I(r_t) - b_5 D_t - b_6 B_t - b_7 K_{t-1}^G - b_8 K_{t-1}^P\right) \quad (28)$$

Substituting G_t^* into $\Delta B_t = G_t + r_t B_{t-1} - tY_t$.

Then the supply of the government bond will become as: $\Delta B_t = G_t^* + r_t B_{t-1} - tY_t$.
Under bond finance, the government flow budget constraint in the long run can be written as

$$\Delta B_t = G_t^* + r_t B_{t-1} - tY_t \quad (29)$$

where $G_t^* = \frac{1}{b_4}\left(Y^f + b_1 p^e - b_2 c_0 - b_3 I(r_t) - b_5 D_t - b_6 B_t - b_7 K_{t-1}^G - b_8 K_{t-1}^P\right)$

$$\frac{\partial \Delta B_t}{\partial B_t} = \frac{\partial G_t^*}{\partial B_t} + \frac{\partial r_t}{\partial B_t} B_{t-1} + r_t - t\frac{\partial Y_t}{\partial B_t} > 0 \quad (30)$$

The first component of the right hand side of equation (30) is positive.

$$\frac{\partial G_t^*}{\partial B_t} = b_1 \frac{\partial p^e}{\partial B_t} - b_2 \frac{\partial I_t}{\partial r_t}\frac{\partial r_t}{\partial B_t} > 0$$

Next, we introduce the demand for government bonds.

$$\Delta B_t^D = (1-t)\, p_t Y_t - p_t C_t - \Delta D_t \quad (31)$$

The supply of government bond can be rewritten as:

$$\Delta B_t^S = p_t G_t + r_t B_{t-1} - t(p_t Y_t) \quad (32)$$

Next step is to compare the effect of the change in new issue of government bond with respect to G_t and B_t. Since the government bond is not the policy instrument, the G_t is better to be used to check the stability of new issue of government bonds.
$\frac{\partial \Delta B_t}{\partial G_t}, and \frac{\partial \Delta B_t}{\partial B_t}$.

From both equation (31) and (32), the following simultaneous equations system will be obtained.

The effects of changes in $\Delta B_t, G_t, \frac{\partial \Delta B_t}{\partial G_t}, and \frac{\partial \Delta B_t}{\partial B_t}$ will be obtained from the following simultaneous equations.

$$\begin{bmatrix} 1 & (1-t)\dfrac{\partial p_t}{\partial r_t}Y_t - \dfrac{\partial p_t}{\partial r_t}C_t + (1-t)\,p_t\dfrac{\partial Y_t}{\partial r_t} - p_t\dfrac{\partial C_t}{\partial r_t} - \dfrac{\partial \Delta D_t}{\partial r_t} \\ 1 & B_{t-1} - t\dfrac{\partial p_t}{\partial r_t}Y_t - tp_t\dfrac{\partial Y_t}{\partial r_t} - \dfrac{\partial p_t}{\partial r_t}G_t \end{bmatrix} \begin{bmatrix} d\Delta B_t \\ dr_t \end{bmatrix} = \begin{bmatrix} H_t dt + H_G dG_t + H_B dB_t + \cdots \\ J_t dt + J_G dG_t + J_B dB_t + \cdots \end{bmatrix}$$

where

$$H_G = (1-t)\left[g_4 \frac{\partial p_t}{\partial G_t}Y_t + \frac{\partial Y_t}{\partial G_t}b_4 p_t \right] - \frac{\partial p_t}{\partial G_t}g_4 C_t - p_t\frac{\partial C_t}{\partial G_t} - \frac{\partial \Delta D_t}{\partial r_t}\frac{\partial r_t}{\partial G_t} \begin{matrix} >> 0 : \textit{High growth period} \\ \geq 0 : \textit{Recent period} \end{matrix}$$

$$J_G = \frac{\partial p_t}{\partial G_t}g_4 G_t + p_t + \frac{\partial r_t}{\partial G_t}B_{t-1} - t\frac{\partial p_t}{\partial G_t}g_4 Y_t - tp_t b_4\frac{\partial Y_t}{\partial G_t} \begin{matrix} << 0 : \textit{High growth period} \\ \leq 0 : \textit{Recent period} \end{matrix}$$

$$H_B = (1-t)\left[\frac{\partial p_t}{\partial B_t}g_6 Y_t + \frac{\partial Y_t}{\partial B_t}b_6 p_t \right] - \frac{\partial p_t}{\partial B_t}g_6 C_t - p_t\frac{\partial C_t}{\partial B_t} - \frac{\partial \Delta D_t}{\partial B_t}$$

(33)

$$J_B = g_6\frac{\partial p_t}{\partial B_t}G_t + p_t\frac{\partial G_t}{\partial B_t} + \frac{\partial r_t}{\partial B_t}B_{t-1} + r_t - t\left(g_6\frac{\partial p_t}{\partial B_t}Y_t + b_6\frac{\partial Y_t}{\partial B_t}p_t \right)$$

By using Cramer's rule, we obtain the effect $\dfrac{\partial \Delta B_t}{\partial B_t}$ and $\dfrac{\partial \Delta B_t}{\partial G_t}$

$$\frac{\partial \Delta B_t}{\partial G_t} = \frac{\overset{(+)}{H_G}\left(B_{t-1} - t\dfrac{\partial p_t}{\partial r_t}Y_t - \overset{(+)}{tp_t}\dfrac{\partial Y_t}{\partial r_t} - \dfrac{\partial p_t}{\partial r_t}G_t \right) - \overset{(-)}{J_G}\left((1-t)\dfrac{\partial p_t}{\partial r_t}Y_t - \dfrac{\partial p_t}{\partial r_t}C_t + (1-t)\,p_t\dfrac{\partial Y_t}{\partial r_t} - p_t\dfrac{\partial C_t}{\partial r_t} - \dfrac{\partial \Delta D_t}{\partial r_t} \right)}{\left(B_{t-1} - t\dfrac{\partial p_t}{\partial r_t}Y_t - tp_t\dfrac{\partial Y_t}{\partial r_t} - \dfrac{\partial p_t}{\partial r_t}G_t \right) - \left((1-t)\dfrac{\partial p_t}{\partial r_t}Y_t - \dfrac{\partial p_t}{\partial r_t}C_t + (1-t)\,p_t\dfrac{\partial Y_t}{\partial r_t} - p_t\dfrac{\partial C_t}{\partial r_t} - \dfrac{\partial \Delta D_t}{\partial r_t} \right)} \qquad (34)$$

$$\frac{\partial \Delta B_t}{\partial B_t} = \frac{H_B\left(B_{t-1} - t\dfrac{\partial p_t}{\partial r_t}Y_t - tp_t\dfrac{\partial Y_t}{\partial r_t} - \dfrac{\partial p_t}{\partial r_t}G_t \right) - J_B\left((1-t)\dfrac{\partial p_t}{\partial r_t}Y_t - \dfrac{\partial p_t}{\partial r_t}C_t + (1-t)\,p_t\dfrac{\partial Y_t}{\partial r_t} - p_t\dfrac{\partial C_t}{\partial r_t} - \dfrac{\partial \Delta D_t}{\partial r_t} \right)}{\left(B_{t-1} - t\dfrac{\partial p_t}{\partial r_t}Y_t - tp_t\dfrac{\partial Y_t}{\partial r_t} - \dfrac{\partial p_t}{\partial r_t}G_t \right) - \left((1-t)\dfrac{\partial p_t}{\partial r_t}Y_t - \dfrac{\partial p_t}{\partial r_t}C_t + (1-t)\,p_t\dfrac{\partial Y_t}{\partial r_t} - p_t\dfrac{\partial C_t}{\partial r_t} - \dfrac{\partial \Delta D_t}{\partial r_t} \right)}$$

(35).

	High Growth Period	Recent Period
H_G	$(1-t)b_4\dfrac{\partial Y_t}{\partial G_t}p_t >> 0$ Large positive effect of G on Y	$\overbrace{(1-t)b_4\dfrac{\partial Y_t}{\partial G_t}p_t}^{\geq 0} - \overbrace{\dfrac{\partial \Delta D_t}{\partial r_t}\dfrac{\partial r_t}{\partial G_t}}^{(--)} > 0$ Smaller effect of G on Y Zero interest rate policy (r)
J_G	$\left(-tp_t b_4\dfrac{\partial Y_t}{\partial G_t} \right) << 0$ Large positive effect of G on Y	$\left(-tp_t b_4\dfrac{\partial Y_t}{\partial G_t} \right) \geq 0$ Smaller effect of G on Y

Nominator $\frac{\partial \Delta B_t}{\partial G_t}$	$H_G\left(-t\frac{\partial p_t}{\partial r_t}Y_t\right)-J_G\left(\left(1-t\right)p_t\frac{\partial Y_t}{\partial r_t}-\frac{\partial \Delta D_t}{\partial r_t}\right)$ $=tp_t\,b_4\overbrace{\frac{\partial Y_t}{\partial G_t}}^{(+++)}\left(-\overbrace{\frac{\partial \Delta D_t}{\partial r_t}}^{(-)}\right)>0$	$tp_t\,b_4\overbrace{\frac{\partial Y_t}{\partial G_t}}^{(+++)}\left(-\overbrace{\frac{\partial \Delta D_t}{\partial r_t}}^{(---)}\right)>0$ Deposits depends much more on changes iu interest rate
Denominator $\frac{\partial \Delta B_t}{\partial G_t}$	$tp_t\overbrace{\frac{\partial Y_t}{\partial r_t}}^{(--)}-\left(1-t\right)p_t\frac{\partial Y_t}{\partial r_t}$ $=-p_t\overbrace{\frac{\partial Y_t}{\partial r_t}}^{(--)}<0$	$B_{t-1}-tp_t\frac{\partial Y_t}{\partial r_t}-\left(1-t\right)p_t\frac{\partial Y_t}{\partial r_t}>>0$ Accumulation of government bonds increased outstanding B
Final sign $\frac{\partial \Delta B_t}{\partial G_t}$	$\frac{\partial \Delta B_t}{\partial G_t}<0$ Stability	$\frac{\partial \Delta B_t}{\partial G_t}>>0$ Instability

From equation (34), we interpret our comparative statics results applying for the Japanese historical economic situations:

(i) $H_G >> 0, J_G << 0$ corresponds to the high-growth periods in Japan,

(ii) $H_G > 0, J_G \square 0$ corresponds to the recent Japanese economy.

The following components are major factors which contribute to determine the stability of the budget balance.

(1) Effectiveness of government expenditures on GDP
(2) Incentives to by government bond (i.e. encourage demand for government bond by reducing demand for deposits in this model)
(3) Interest rate sensitivity on private investment
(4) Effectiveness of private capital stock on real GDP
(5) Sensitivity of tax revenue both on private capital and public capital
(6) Multiplier effect of G (government investment) on real GDP

<High growth period>

The figure 5 shows both the bond supply and demand for bond during high-growth period of Japan. The ruling Liberal Democratic Party determined to expand public investment ($p_tG_t \uparrow$) before the election. Since the effectiveness of public infrastructure was large during high growth period, it leads to higher real GDP which increased tax revenue. Infrastructure investment also induced private investment which created long run productivity effect on real GDP during high growth period. Higher growth of real

GDP contributed higher demand for government bonds as in shown in Figure 5.

<Asset Bubble Period>

Figure 6 corresponds to the bond supply and demand for bond in the bubble period. As stock price and land price continued to rise, the Japanese economy enjoyed high wealth effect and tax revenue increased drastically which brought down the budget deficits as is shown in figure 2. Higher demand for the government bonds were observed due to strong positive wealth effect.

<Recent Period>

Finally, figure 7 shows the bond supply and the demand for government bond during the slow growth period after the bubble. In order to cope with slower growth in early 1990s, LDP implemented huge public investment by issuing government bond (Figure 2). Due to excess capacity after the bubble, private firms rely less bank borrowing and banks invested their money much more to government bonds. Therefore the government can afford to issue new bonds into the domestic financial institutions as is shown in figure 7.

Figure 5. The bond supply and demand in the high-growth periods

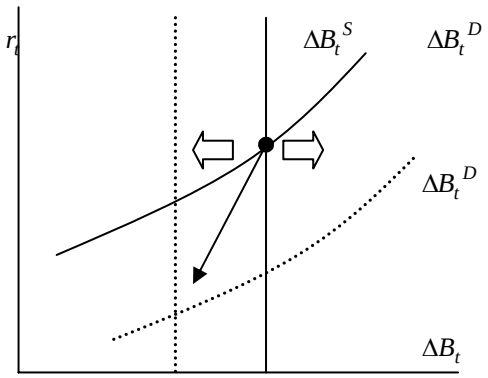


Figure 6. The bond supply and demand in the Bubble periods

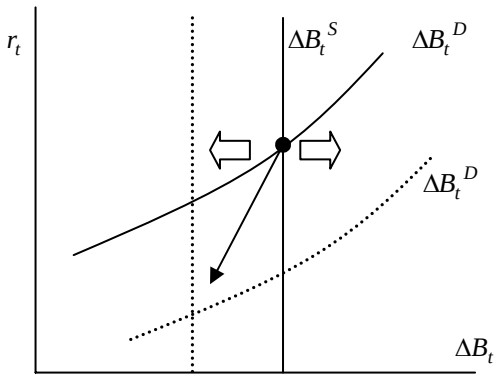
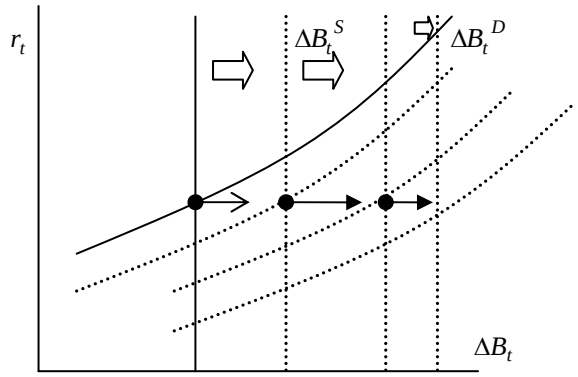


Figure 7. The bond supply and demand in the Slow Growth after the Bubble periods



3. Conclusion

This paper tries to answer why LDP continues to govern after WWII by focusing on the role of public investment. The paper focused on three periods, namely, (i) high growth period, (ii) Asset Bubble period, (iii) economic downturn after the bubble.
During high growth period, when the government expenditure is increased by increasing bond supply just before the election, the GDP level increased in the short run. Increases in GDP raise the tax revenue therefore the budget deficits are reduced. The government investment had strong output effect and it increases the tax revenue in the medium and long run, therefore the total issues of the government bond were reduced.

$$G_t \uparrow \left(= \Delta B_t^S \uparrow\right) \rightarrow Y_t \uparrow \rightarrow tY_t \uparrow \left(= \Delta B_t^S \downarrow\right)$$

High economic growth increased deposits supply by households and firms which lowered interest rate which pushed private investment. Private capital stock and high positive output effect during high growth period which raised tax revenue much further.

LDP in those days focused not only short run policy but also long run stability of the government budget since LDP was keep on ruling Japanese diet. Long run budget deficits will eventually become their responsibility.

During the asset bubble period of the late 1980s, Japanese tax revenue increased due to high asset price and property prices.

High appreciation of Japanese yen pushed strong manufacturing move to overseas since early 1990 and mid 1990s. However, Japanese economy faces with slower growth since 1990s after the collapse of asset bubbles. Aging population and manufacturing drain lowered Japanese economic growth rate. LDP kept on spending to save for elderly workers, public works etc. by issuing government bonds. JGB (Japanese government bonds) are sold to mainly financial institutions such as banks, postal savings, insurance, pension funds. These positive government expenditures helped LDP to keep on survived.

However, sub-prime loans problem deepened Japanese economic recession and the government spending policy cannot overcome negative impact of recent worldwide financial crisis. Accumulated government debt amounted to 180% of GDP and it will be very difficult to keep on issuing JGB any further.

Finally, the reduction of government budget can be attained by increasing the effectiveness of both public investment and private investment. Increase of price elasticity will also raise output when government infrastructure investment policy is pursued. It suggests that the need for flexible wage rate is required to recover Japanese economy.

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Figure 8. Voting Rate and the ratio of government expenditure to the GDP level, the ratio of public investment to the GDP level

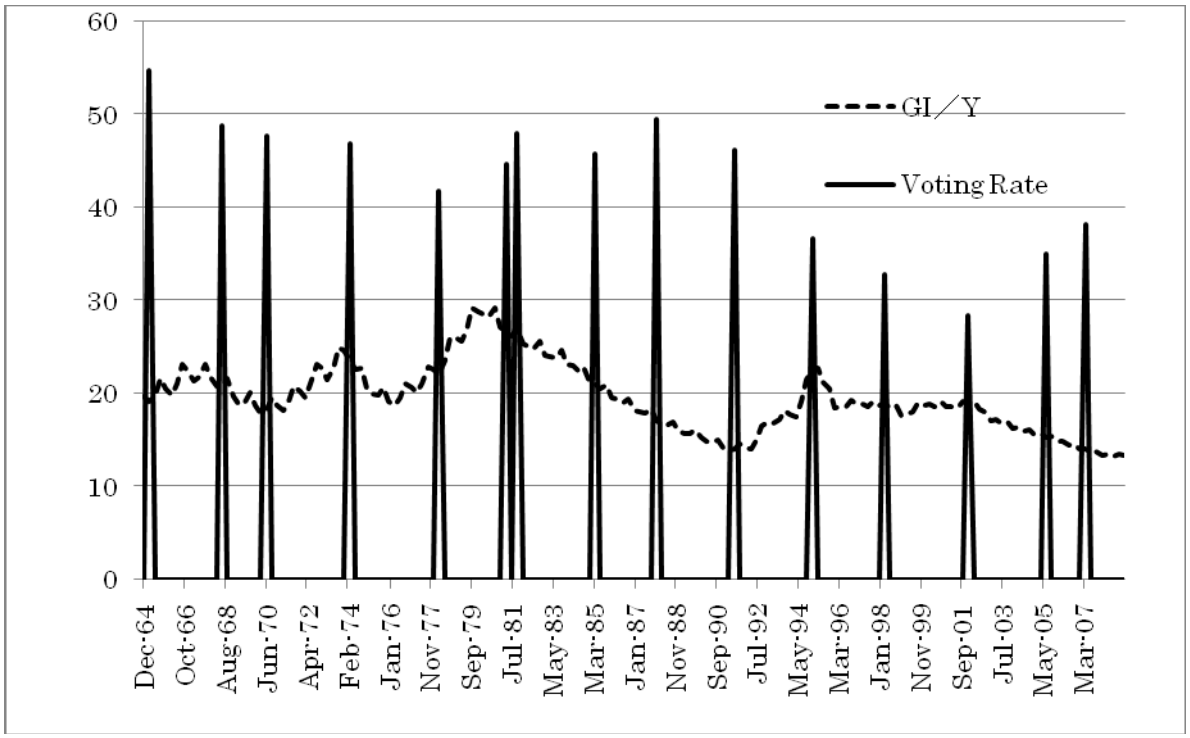


Figure 9. Economic Growth and Income Growth in Japan

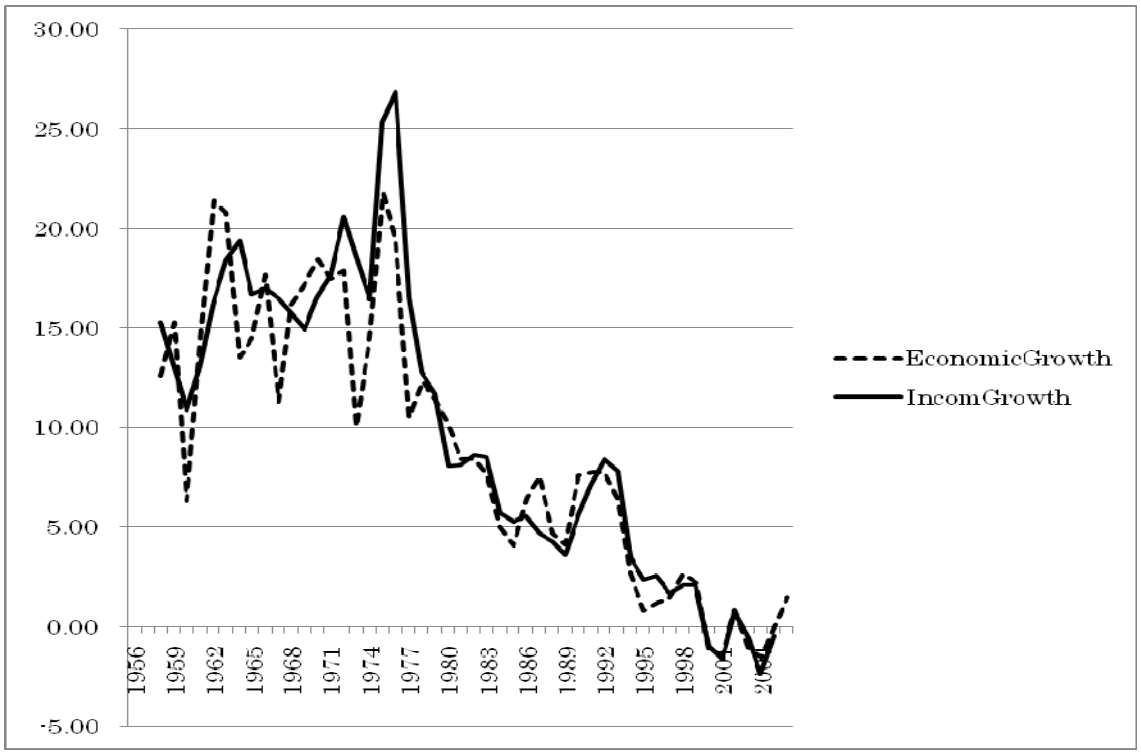


Figure 10. Government Bond / Household's Asset Ratio in Japan

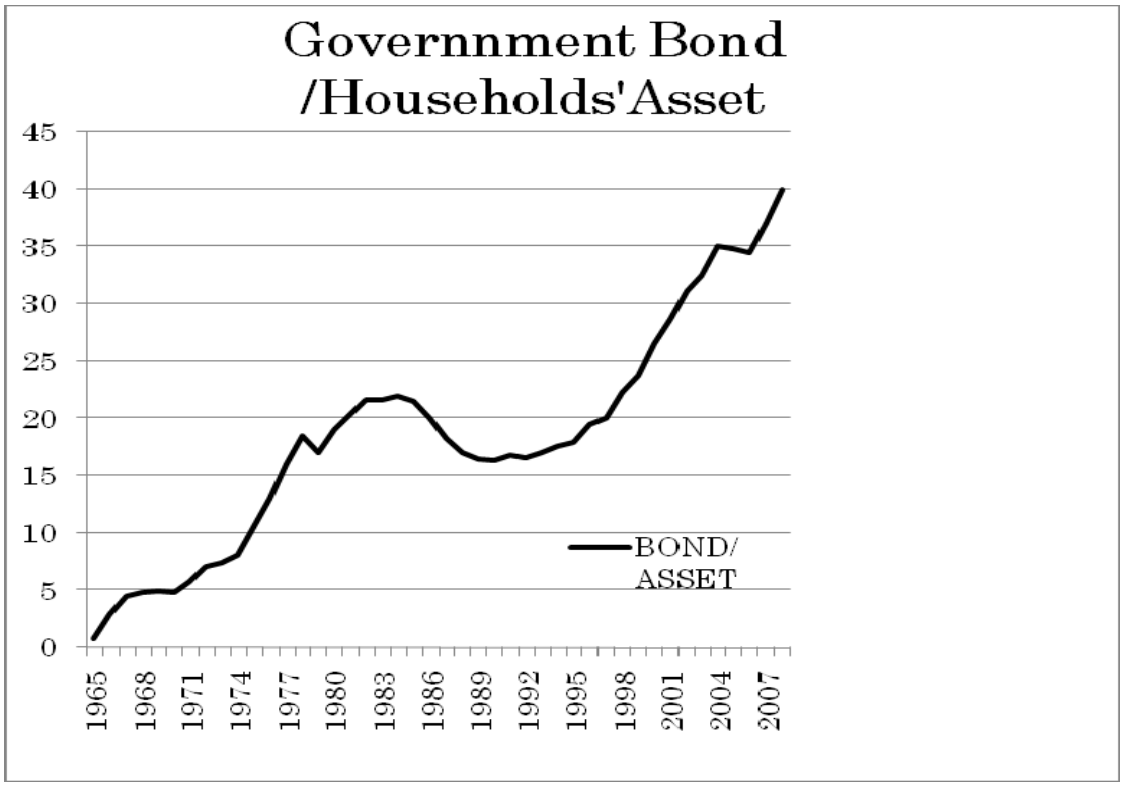


Table 4. The number of seats and percentage of vote acquired by LDP in the Lower House Election in Japan.[9]

Year	Number of Seat (LDP)	Percentage of vote (LDP)
1960	296	57.56
1963	283	54.67
1967	277	48.80
1969	288	47.63
1972	271	46.85
1976	249	41.78
1979	248	44.59
1980	284	47.88
1983	250	45.76
1986	300	49.42
1990	275	46.11
1993	223	36.62
1996	239	32.76

[9] After 1996, Japan introduces both the small electoral district system and the proportional representation system. However, in our case, we only consider the votes in the case of the proportional representation system only.

2000	233	28.31
2003	237	34.96
2005	296	38.18
2009	119	26.70

Table 5. The number of seats and percentage of vote acquired by DP in the Lower House Election in Japan.[10][11]

Year	Number of Seats (DP)	Percentage of Vote (DP)
2000	127	25.18
2003	177	37.39
2005	113	31.02
2009	308	42.40

Table 6. The Average Growth Rate of Tax Revenue in Japan

Year	The Average Growth Rate of Tax Revenue
1955-1970	16.23
1971-1980	14.52
1981-1990	8.40
1991-2000	-1.56
2001-2007	0.23

[10] Current DP was formed on 27 April 1998. The four independent small parties (the Good Governance Party, the New Fraternity Party, the Democratic Reform Party, and Former DP) were merged. So we only consider the number and percentage of vote same as the LDP case.

[11] The total number of seats in the Lower House is: 467 from 1960 to 1963; 486 from 1967 to 1969; 491 in 1972; 511 from 1976 to 1983;512 from 1986 to 1990;511 in 1993; 500 in 1996, 480 from 2000 to present.

APPENDIX II

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APPENDIX III

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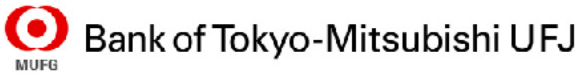


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Davis Polk

For nearly 160 years, Davis Polk has advised industry-leading companies and global financial institutions on their most challenging legal and business matters. The firm ranks among the world's preeminent law firms across the entire range of its practice. Based in New York City, Davis Polk has approximately 700 lawyers in nine offices, including Tokyo, Hong Kong and Beijing.

Davis Polk has a long history as one of the leading international firms in Japan. We opened a Tokyo office in 1987 and since then have played a leading role in the development of cross-border capital markets, M&A, private equity, credit, dispute resolution and other matters involving Japanese companies. Our Tokyo office is also closely integrated into our growing and diverse Asia practice, with Tokyo-based Davis Polk lawyers regularly engaged in matters involving Korea, China, Hong Kong, the Philippines, Indonesia and India.

For more information visit our website at davispolk.com.



Development Bank of Japan Inc. (DBJ) was established as a joint-stock company on 1 October 2008 as the successor to the Development Bank of Japan, which had been a governmental financial institution for nearly a half-century. DBJ is currently wholly owned by the Japanese government and in the process of being privatized in line with the Development Bank of Japan Inc. Law ("DBJ Law"). The DBJ Law contemplates full privatization of DBJ over a period of five to seven years from its establishment.

However, DBJ has recently engaged in crisis response business as a part of the response to economic and financial crises. In consideration of this important DBJ role, the Japanese Diet approved the Law for Partial Amendment of the Development Bank of Japan Inc. Law (the "Amendment Law") in June 2009, which enables the Japanese government to strengthen DBJ's financial base through capital injections up to the end of March 2012. In addition, under the Amendment Law, the targeted timing for the full privatization has been extended to approximately five to seven years from April 1, 2012. Further, the Amendment Law provides that the Japanese government is to review the organization of DBJ, including the Japanese government's holding of DBJ shares, by the end of fiscal year 2011, and until such time, the Japanese government will not be disposing of the DBJ shares it is holding.

ELLIOTT

Elliott Management Corporation oversees two funds, Elliott Associates, L.P. and Elliott International, L.P., who together have more than $14 billion of capital under management. Founded in 1977, Elliott is one of the oldest firms of its kind under continuous management, and its investors include large institutions, college endowments, charitable trusts, family offices, and friends and employees of the firm.

Elliott has major investment interests around the world, and pursues a diversified investment and trading program, emphasizing a culture of thoroughness, hard work, creativity, and tenacity. The firm seeks to generate a moderate return with a high degree of consistency, regardless of fluctuations in the stock and bond markets. From inception through July 1, 2009, Elliott has generated for its investors a 14.4% net compound annual return, compared to 10.3% for the S&P 500 stock index. The annual standard deviation of returns over this period was only 5.8%, compared with 16.2% for the S&P 500. Elliott's returns have been highly consistent throughout many market cycles, and have resulted in only nine losing quarters during its more than 32-year history.



Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 130,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young ShinNihon LLC is a member firm of Ernst & Young. We are the leading audit firm in Japan, with the largest number of people, and with offices throughout the country. We are committed to providing the highest quality audit and assurance services, and to offering a range of other financial advisory services.

Together with the Ernst & Young global network, we strive to ensure trust in our capital markets and improve their functioning to achieve the potential of the global economy and our wider communities, which surround Japan.

For more information, please visit www.shinnihon.or.jp.



JSDA is a hybrid association functioning both as a self-regulatory organization (SRO) and as a trade association in the Japanese securities market. JSDA's more than 500 members consist of securities firms and other financial institutions operating securities businesses in Japan.

As a full-fledged SRO, JSDA extensively regulates market intermediaries. Its self-regulatory functions encompass rule-making, enforcement, inspection, disciplinary actions, accreditation of sales representatives, and dispute mediation.

As a trade association, JSDA relays the voice of the industry to the government and other related parties, conducts and promotes investor education to expand the base of knowledgeable investors, and implements various research and studies to generate policy recommendations for further activating the market.



J.P. Morgan is a leader in financial services, offering innovative and intelligent solutions to clients in more than 100 countries with one of the most comprehensive global product platforms available. We have been helping our clients to do business and manage their wealth for more than 200 years and we keep their interests foremost in our minds at all times. This combination of product strength, intellectual capital and character sets us apart as an industry leader.

J.P. Morgan is part of JPMorgan Chase & Co. (NYSE: JPM), a global financial services firm with assets of $2.0 trillion.

In Japan, J.P. Morgan offers investment banking, treasury services, asset management and global custody, to meet a variety of needs of our clients.



KPMG AZSA & Co. is one of Japan's leading audit corporations with approximately 5,300 people in major cities across the country, providing audit, attestation, and advisory services such as preparation for initial public offerings and financial advisory services. KPMG AZSA & Co. also offers professional services in specialized fields including financials, manufacturing, retail, IT, media, government, and healthcare.

As a member firm of KPMG International, KPMG AZSA & Co. provides clients with a consistent set of professional services globally through a network in 144 countries.

Linklaters

Linklaters is a law firm which advises the world's leading organizations on their most challenging transactions and assignments. With over 2,000 lawyers in 26 offices in the world's major business and financial centers, the Linklaters network delivers an outstanding service to our clients anywhere in the world. Our lawyers work closely with leading corporates, investment banks and other major institutions, offering the highest quality advice to meet our clients' global and local requirements. We offer our clients an unrivalled range of leading practices, making us the obvious choice for legal advice in the areas of banking, capital markets, competition, corporate/M&A, employment & incentives, environment & climate change, financial regulation group, insurance, intellectual property, investment management, litigation & arbitration, pensions, private equity, projects, public & administrative law, real estate & construction, regulatory, restructuring & insolvency, tax, and technology, media & telecommunications.

Linklaters is widely recognized as the leading global law firm in Japan. Our fully integrated Japanese and international law capability provides a truly 'one-stop-shop' for clients seeking value-added advice on their most complex and challenging transactions. With 9 partners and over 50 Japanese and international lawyers, we are able to field integrated teams on transactions seamlessly crossing product, practice and jurisdictional lines. Underpinning our leading position is the strength and depth of our offering across all the major practice areas—we are the only international law firm in Japan to rank in the top tier across all of our practice areas, a position Linklaters has held for the past four years.

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

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 60,000 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.



MHCB provides optimal solutions to meet the increasingly diverse and sophisticated needs of customers in the areas of both finance and business strategies, focusing its efforts on serving major corporations (such as those listed on the first section of domestic stock exchanges), financial institutions and their group companies, public sector entities, and Japanese and foreign companies overseas.

In addition to taking full advantage of the functions of other group companies such as MHBK, MHSC and MHTB, MHCB is utilizing its alliances with financial institutions around the world to offer a comprehensive range of groundbreaking financial service solutions on an ongoing, multifaceted basis as it aspires to become a top corporate finance provider that understands the broad-ranging needs of its customers.



Monex Group, Inc. was established in 2004 as a holding company of Monex, Inc. and Nikko Beans, Inc., both established in 1999 as online brokerage firms. In 2005, Monex, Inc. and Nikko Beans, Inc. merged and became Monex, Inc., a core subsidiary of its group. The group also contains the companies in charge of asset management business, investor education business, M&A business, FX business, etc. and has overseas offices in New York and Beijing. Monex Group, Inc. is listed in the first section of TSE and is continuing to grow its businesses, aspiring to become a technology-based global online retail financial service provider.

Morgan Stanley

Morgan Stanley is a leading global financial services firm providing a wide range of investment banking, securities, investment management and wealth management services. The Firm's employees serve clients worldwide including corporations, governments, institutions and individuals from more than 1,200 offices in 37 countries.

Our leading position in Japan's financial markets reflects more than 35 years of client focus, innovation and the continuous pursuit of excellence. With more than 1,500 people in Japan, Morgan Stanley is one of the largest and most active foreign financial firms in the Japanese market. We are a preeminent provider of investment banking, sales & trading and real estate products and services.

For further information about Morgan Stanley, please visit www.morganstanley.com.



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, 2009, we have 328 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: http://www.noandt.com.

Nikko Asset Management (Nikko AM) is a leading Japan-based asset management group. Since its establishment 50 years ago, Nikko AM has been offering a full lineup of investment trusts to retail investors and high value-added advisory services to institutional investors.

Its investment trusts are distributed through a network of around 200 distributor institutions including banks, securities companies, and Japan Post Bank. The firm offers investors access to both Nikko AM funds that invest mainly in Japanese equities, fixed income, and REITs and, through its independently developed third-party sub-advisory platform, opportunities to strategically utilize a global range of top-performing, independent asset managers over a diverse range of asset classes.

The Nikko AM Group[1] has assets totaling 9.6 trillion yen under management at the end of June, 2009[2], and has overseas offices in New York, London, and Singapore.

[1] "Nikko AM Group" stands for Nikko Asset Management Co., Ltd. and its group companies.

[2] Consolidated assets (including advised assets) of Nikko Asset Management Co., Ltd. and its overseas subsidiaries.



Nomura Holdings, Inc. is a leading global financial services organization. Through its subsidiaries and affiliates, Nomura provides financial services for individual, corporate and government clients. Founded in 1925, by Tokushichi Nomura, the Nomura Group presently employs more than 26,000 people worldwide.

Nomura offers financial and advisory solutions through its global headquarters in Tokyo, more than 150 branch offices in Japan, and an international network, doing business in more than 30 countries with regional headquarters in New York, London and Hong Kong. In the U.S., Nomura offers equity, fixed income, investment banking, research and asset management services.

The Group's business activities include investment consultation and brokerage services for retail investors in Japan and, on a global basis, brokerage, trading, underwriting, investment banking, merchant banking and asset management services.

For additional information concerning Nomura, please visit our website at www.nomura.com.

The Norinchukin Bank

The Norinchukin Bank (the “Bank”) was established in 1923 as a quasi-governmental financial institution and became a private bank in 1959. The Bank is one of Japan’s largest and most distinguished banks.

The Bank is the central bank for Japan’s 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.



Pacific Alliance Group, the Asian alternative asset investment manager, was founded in 2002. Pacific Alliance Group and its affiliates manage assets in excess of US$4 billion across three strategies covering Private Equity; Absolute Return and Distressed; and Real Estate. Pacific Alliance's investors include leading institutions, as well as high net worth investors from Europe, US and Asia. The Group has over 120 staff across offices including Hong Kong, Beijing, Shanghai and Tokyo.

www.pacific-alliance.com



Prudential Financial, Inc. companies include The Prudential Insurance Company of America, one of the largest life insurance companies in the U.S.

Leveraging our heritage of life insurance and asset management expertise, Prudential is focused on helping approximately 50 million individual and institutional customers grow and protect their wealth. Prudential's businesses offer a variety of products and services, including life insurance, annuities, retirement-related services, mutual funds, investment management and real estate services. Coupled with its head office 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 20 years of consecutive growth in policies in force. Gibraltar Life serves the broad middle-income market through Life Plan Advisors. Gibraltar Life's strength is in its close long time relationships with associations such as Kyoko (Teachers' Association) and Shoko (Small Business Owner's Association).



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 services 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. (Sumitomo Trust) is a trust bank established in 1925. We currently have approximately 5,800 employees working in 62 domestic branches and 8 overseas offices. Sumitomo Trust's management model is an indispensable financial institution providing real estate related services, asset management and custody services based on commercial banking. This model guides the operations of Sumitomo Trust's five business groups and divisions, and enables the company to actively carry out our unique strategies.

We will keep our focus firmly on our characteristics as a trustee ("Trustee-ness") and the specific merits of Sumitomo Trust ("STB-ness"). We aim to become an "essential partner" with our customers and society, as an independent and unique "asset management-oriented financial intermediary services group.



Tokyo Stock Exchange Group, Inc. is the holding company of Tokyo Stock Exchange, Inc. (TSE), one of the leading global exchanges and the largest securities market in the Asia-Pacific region. The TSE is best known for its equities market, valued at US$3.5 trillion and the number of listed companies exceeds 2,300 as of the end of September 2009.

In addition to its core Japanese equities market, the TSE provides markets for derivatives products such as Japanese government bond futures, TOPIX futures, ETFs, and REITs. Not only market operation, the TSE group also offers clearing and settlement, market information distribution and other related services.

The TSE group makes every effort to maintain abundant liquidity and a high level of integrity as well as provide market participants from Japan and overseas with attractive investment opportunities.

For further information about Tokyo Stock Exchange Group, Inc., please visit our website at www.tse.or.jp/english.



Unio Holdings is a New York City based owner-oriented investment and operating company. It believes in the principle that companies will be more effective when they combine the know-how and execution of the businessperson with the perspective and long-term vision of the business-minded investor. Unio's principal business is acquiring operating companies that must be closely connected to their customers and compatible with Unio's credo and culture. Based on the same investment approach it uses for acquiring operating companies, Unio's second, complementary business is investing in publicly traded securities as a minority shareholder. Unio's organizational purpose is to build an "enterprise of autonomous enterprises" whose productive power is enhanced by their exposure to Unio's credo, culture & investment and management practices. Its financial purpose is to produce for Unio's shareholder-owners enduring cash flows, an acceptable return on capital, and rising enterprise value.



Unison Capital is a pioneer of private equity investment in Japan, operated by a handful of seasoned Japanese professionals with no ties to large corporate groups. We help portfolio companies devise strategies to enhance their value from a long-term perspective without any conflicts of interest.

Unison Capital has invested more than ¥700 billion in corporate value, accumulating in-depth experience and expertise in business management. This strength is reinforced by a global network of financial institutions, non-financial firms, corporate managers and a variety of professional service firms. We invest only in promising companies—those operated by enthusiastic managers and employees with potential to keep increasing corporate value. By working in unison with management teams and employees, we help companies realize new levels of growth.



Operating 35 offices in 23 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 available 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 over 20 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. Robert Grondine and Chris Wells have been leading figures in the international legal and business community in Japan through their leadership in the American Chamber of Commerce in Japan, Bob as President and Chairman and Chris Wells as Co-Chairman of the Financial Services Committee, which has brought major positive changes to the Japanese financial system for the benefit of all players in the past decade. Following the end of his term as General Counsel to the Asian Development Bank in September 2007, Arthur Mitchell has brought his well known breadth of experience in Japan and Asia to the White & Case team.