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

The Prince Hotel Karuizawa West • OCTOBER 26-28, 2012

AGENDA *as of October 18, 2012*

F R I D A Y, OCTOBER 26

6:00-6:40 p.m. **C O C K T A I L R E C E P T I O N** *Chikuma*

6:40-6:45 p.m. **G R E E T I N G S** *Chikuma*

- Yasushi Akashi, Chairman, International House of Japan
- Hal Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law

6:50-7:45 p.m. **K E Y N O T E A D D R E S S E S** *Chikuma*

- Takehiko Nakao, Vice Minister of Finance for International Affairs, Ministry of Finance

Introduced by: Akira Ariyoshi, Professor, Hitotsubashi University

7:45-9:15 p.m. **D I N N E R** *Chikuma*

9:15-11:00 p.m. **A F T E R - D I N N E R C O C K T A I L S** *Lounge Marron*

S A T U R D A Y, OCTOBER 27

7:00-8:00 a.m. **B R E A K F A S T B U F F E T** *Chikuma*

Panelists, Reporters, and Facilitators please sit at reserved tables

8:05-8:25 a.m. **W E L C O M E & O P E N I N G R E M A R K S** *Chikuma*

8:25-8:45 a.m. **P A N E L S E S S I O N** *Chikuma*

Topic 1: Key Challenges for Post-Crisis Adjustment of the Financial System Including Banking, Insurance, and Securities Firms

- Charles Lake, Chairman, Aflac Japan
- Akihiko Kagawa, Managing Director Chief Risk Officer & Chief Compliance Officer, Mitsubishi UFJ Financial Group

8:50-10:15 a.m. **S M A L L G R O U P S E S S I O N S**

Group	Room	Facilitators	Reporter
1	Asama B	Satoru Murase, Atsushi Fukui	Andy Conrad
2	Asama C	Larry Bates, Yasuhiro Harada	Dino Kos
3	Asama D	Thierry Porte, Akinari Horii	Bill Grimes
4	Asama E	Brian Kelly, Hiroyuki Kamano	Chris Wells
5	Ayame (in Nirenoki Hall)	Allan Smith, Hideaki Fukazawa	Royanne Doi
6	Tsutsuji (in Nirenoki Hall)	Masaaki Kanno, Takashi Oyama	Henny Sender
7	Yamaboshi (in Nirenoki Hall)	Chris LaFleur, Yo Takeuchi	Akihiro Wani

10:15-10:25 a.m. **REFRESHMENT BREAK**

10:25-10:45 a.m. **PANEL SESSION** *Chikuma*

Topic 2: Restoration of Fiscal Sustainability

- Chikahisa Sumi, Deputy Vice Minister for International Affairs, Ministry of Finance
- Gene Park, Assistant Professor of Political Science, Loyola Marymount University

10:50-12:15 p.m. **SMALL GROUP SESSIONS**

Group	Room	Facilitators	Reporter
1	Asama B	Catherine Simmons, Akira Ariyoshi	Andy Conrad
2	Asama C	David Asher, Ryusaburo Harasawa	Dino Kos
3	Asama D	Cliff Shaw, Kozo Koide	Bill Grimes
4	Asama E	Yuji Kage, Yoshio Okubo	Chris Wells
5	Ayame (in Nirenoki Hall)	Bill Jarvis, Ken Takayama	Royanne Doi
6	Tsutsuji (in Nirenoki Hall)	Jeff Bohn, Tomoyoshi Uranishi	Henny Sender
7	Yamaboshi (in Nirenoki Hall)	Doug Hymas, Naoyuki Yoshino	Akihiro Wani

12:20-1:30 p.m. **LUNCHEON KEYNOTE ADDRESS** *Chikuma*

- Jeff Hayman, Chief Executive Officer, Global Consumer Insurance, Chartis

1:30-3:00 p.m. **PANEL SESSION – PLENARY DISCUSSION ONLY** *Asama*

Topic 3: Impact of the Euro-Crisis on International Finance

- Chair: Akinari Horii, Special Advisor, The Canon Institute for Global Studies
- Hans-Helmut Kotz**,** Economist, The Center for European Studies, Harvard University
- Hal Scott**,** Nomura Professor and Director, Program on International Financial Systems, Harvard Law
- Nathan Sheets**,** Global Head of International Economics, Citi

3:00-6:00 p.m. **FREE TIME**

*Optional tour of Onioshidashi Volcanic Park and Shiraito Waterfall. Meet in lobby at 3:15pm. We will return to the hotel at 5:45pm.

3:00-6:00 p.m. **REPORTERS MEETING** *Shakunage*

6:00-6:45 p.m. **COCKTAIL RECEPTION** *Chikuma*

6:45-7:35 p.m. **KEYNOTE ADDRESS** *Chikuma*

- Yasuhiro Sato, Chief Executive Officer, Mizuho Financial Group, Japan

Introduced by: Hiroshi Watanabe, President and Chief Executive Officer, JBIC

7:35-9:15 p.m. **DINNER** *Chikuma*

9:15-11:00 p.m. **AFTER-DINNER COCKTAILS** *Lounge Marron*

S U N D A Y, OCTOBER 28

7:00-8:00 a.m. **B R E A K F A S T B U F F E T** *Chikuma*

Chairs and Reporters please sit at reserved tables

8:15-9:15 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Asama*

Topic 1: Key Challenges for Post-Crisis Adjustment of the Financial System Including Banking, Insurance, and Securities Firms

- Shigesuke Kashiwagi, Senior Managing Director, Government Affairs and Risk Advisory Group, Nomura Holdings
- Allan O'Bryant, Executive Vice President and Head of International Markets and Operations, RGA Reinsurance Company

9:20-10:20 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Asama*

Topic 2: Restoration of Fiscal Sustainability

- Stefan Gavell, Executive Vice President and Head of Regulatory, Industry, and Government Affairs, State Street
- Hiroshi Watanabe, President and Chief Executive Officer, JBIC

10:20-10:30 a.m. **R E F R E S H M E N T B R E A K**

10:30-11:30 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** *Asama*

Topic 3: Impact of the Euro-Crisis on International Finance

- Jay Sapsford, Managing Director and Chief Administrative Officer, Morgan Stanley MUFG
- Takatoshi Ito, Professor, University of Tokyo

11:30-12:45 p.m. **C L O S I N G L U N C H** *Chikuma*

SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR JAPAN AND THE UNITED STATES
KARUIZAWA, JAPAN • OCTOBER 26-28, 2012

BRIEFING POINTS

TOPIC I: KEY CHALLENGES FOR POST-CRISIS ADJUSTMENT OF THE FINANCIAL SYSTEM INCLUDING BANKING, INSURANCE AND SECURITIES FIRMS

- Post-crisis changes to the financial system in the U.S. and Japan
    - The impact of Dodd-Frank on banking, insurance and securities firms in the U.S. and Japan
    - The Volcker rule and Vickers ring fencing: challenges to the investment banking model
- How should the finance industry adapt to a post-crisis world, with a tougher and more complex regulatory environment?
- The implementation of the Basel III framework in U.S. and Japan
- Harmony in international regulation of OTC derivatives markets, and the challenge of extraterritoriality
- Regulation of Money Market Mutual Funds and the repo market in the U.S.
- Opportunities for Japanese financial institutions in the U.S. markets
- State of financial reform in Japan; what more needs to be done?
- The health of the U.S. and Japanese financial systems, and tensions between deleveraging and recovery in the U.S. and Japanese economies
- Challenges for Asia in the efficient utilization of excess savings
- Development of capital and fixed income markets in Asia and Japan
- The implications of domestic politics and ideology on international finance issues posed by increasingly integrated global markets
- Demographic challenges in the U.S. and Japan, and the role of insurance companies in fostering long-term capital markets
- What is the role of financial engineering and innovation in the post-crisis international financial sector?

TOPIC II: RESTORATION OF FISCAL SUSTAINABILITY

- Policy responses to the high debt levels in the U.S. and Japan
- Fiscal sustainability in the U.S. and Japan: reducing the fiscal deficit without hampering economic growth
- The “self-sustaining stimulus” argument: effectiveness of the quantitative easing policies pursued by the U.S. Federal Reserve and the Bank of Japan in terms of fiscal sustainability
    - Inflationary implications and risks of U.S. and Japanese macro-economic policy
    - Long-term effects on fiscal discipline
- The strength of the yen: challenges for Japanese industry and how to mitigate them
- The end of the “lost-decade”? The role of the private sector in re-vitalizing the Japanese and U.S. economies
- Japanese fiscal reform: doubling the Japanese consumption tax and its impact on fiscal sustainability and the Japanese economy
- Trade liberalization and participation in the Trans-Pacific Partnership
- Energy security and sustainability in the U.S. and Japan

TOPIC III: IMPACT OF THE EURO-CRISIS ON INTERNATIONAL FINANCE

- How are current events in the Euro area affecting the international financial markets?
- What are the likely developments in the Euro and how can market participants in the U.S. and Japan prepare for them?
- The effect of uncertainty over the future of the euro-zone on global cross-border capital flows and international financial activity
- Exposure of U.S. and Japanese institutions to the euro-crisis, and the repercussions of financial contagion in the Euro-zone
- How can U.S. and Japanese policy-makers protect their economies from systemic risks posed by uncertainty about the future of the Euro-zone?
- Evaluation of the ECB's Outright Monetary Transactions (OMT) policy - its effectiveness and limits
- Alternative and additional policy solutions to the Euro-crisis: e.g. cross-guaranteed Eurobonds, withdrawals from the Euro
- The future of the Euro-area: banking union or withdrawal
- The necessity of an international approach to the Euro-crisis: a new Bretton-Woods
- Should there be currency reform in the Euro-region as part of an international revision of existing exchange-rate arrangements?
- The role that the International Monetary Fund should play in the resolution of the Euro-crisis

2012 Symposium on Building the Financial System of the Twenty- First Century: An Agenda for Japan and the United States

The fifteenth Japan-U.S. Symposium was held in Karuizawa, Japan, from October 26-28, 2012. Sessions discussed key challenges for post-crisis adjustment of the financial system, including banking, insurance, and securities firms; restoration of fiscal sustainability in Japan and the U.S.; and impact of the euro crisis on international finance. Participants expressed concern about challenges to economic growth including the eurozone crisis and political gridlock in Japan and the U.S., as well as the potential effects of new regulation on financial institutions and intermediation. They also continued to grapple with questions of how to regulate complex financial systems and how to balance short-term fiscal support for weak economies with long-term fiscal consolidation.

Session 1: Key Challenges for Post-Crisis Adjustment of the Financial System, Including Banking Insurance, and Securities Firms

Session 1 addressed challenges facing financial systems, with a particular focus on the implementation of new regulations in the post-crisis period. Participants discussed the causes and consequences of regulatory complexity, as well as issues relating to international standards, extraterritorial impacts of regulations in the U.S. and elsewhere, and the capabilities of supervisors.

Complexity

A major theme of discussions was how regulation could or should respond to the reality of financial system complexity. Participants noted that regulators had responded to increased complexity of the financial system with ever more complex regulations, but many were skeptical that this was the best approach. They worried that complex regulation would create significant costs of compliance and enforcement, while multiplying opportunities for unintended consequences in the form of regulatory arbitrage, loss of liquidity in some markets, disappearance of hedging instruments, and negative impacts on provision of credit in the real economy.

Participants discussed several alternative regulatory approaches for dealing with complexity. A few argued that the only way to deal with it would be by seeking to reduce complexity in the financial system itself through re-segmenting financial institutions and products (e.g., through reviving Glass-Steagall), or reducing cross-border supervision problems by allowing host countries to require multinational financial institutions to establish subsidiaries instead of branches. A more commonly advocated approach was principles-based regulation. Advocates of principles-based regulation argued that attempts to match financial system complexity with ever more complex regulation that sought to explicitly take into account all possible contingencies would be doomed to failure, as regulations would not keep up with new developments in markets. They noted that this approach could allow adherence to the letter of regulations while violating the objectives of promoting financial stability. Another criticism of complex, rules-based regulation was that financial actors would be likely to push up against the very edges of rules as they were written. In addition to the principles-based approach, some participants suggested that "rulemaking by enforcement" (which several identified as an important element of Japanese financial supervision) would be an appropriate means of dealing with that problem. In other words, supervisors would create a flexible system of precedents on the basis of which financial actors would make decisions—by not drawing clear lines, there would be less incentive to push the limits.

There was also considerable discussion of the causes of regulatory complexity. A number of participants focused on issues related to regulatory structure. They argued that the regulatory failures that had contributed to the financial crisis had made regulators and supervisors increasingly risk averse. The political process of lawmaking in democratic

systems was seen by many as accentuating those tendencies toward risk aversion, as politicians sought to avoid blame for failures. In addition, many participants pointed to silo mindsets and turf wars among regulators as significantly complicating regulation and supervision. While this problem was seen as particularly acute in the U.S., due to the country's extreme regulatory fragmentation, participants saw it as occurring in Japan and in the international standard-setting bodies as well.

Other participants emphasized different factors. Several spoke of cultural differences across countries, noting particularly a U.S. tendency toward extensive legalism and rules-based regulation. Others emphasized the particular complications raised by cross-border issues, which they saw as magnifying the complexity of the regulator environment for internationally-active financial institutions. Finally, a number of participants suggested that in fact one of the major factors in regulatory complexity was that major financial institutions actually preferred it, partly as an obstacle to regulatory discretion and partly because complex regulation was seen as offering the opportunity for loopholes that could be exploited by the most sophisticated banks and financial institutions.

Regardless of their analyses of the causes of regulatory complexity, or their preferences for different approaches, however, there was a widely-shared concern among participants over the likely effects on cost of capital and availability of risk capital. Many predicted that the various new requirements regarding capital, collateral, liquidity, and clearing would have a series of undesirable effects. One concern was cost. Participants noted that costs of compliance had increased significantly and that they were likely to be passed on to clients, thereby raising the cost of capital. If the costs were not to be passed on, an alternative concern was raised that low margins would lead financial institutions to take on more risky activities in order to improve profitability. A second concern was the loss of liquidity in key markets, including those associated with hedging (particularly due to the Volcker Rule) as well as wholesale market segments such as securitization and commercial paper. Finally, as a consequence of all of these factors, many participants worried that risk capital would dry up as banks and other financial institutions became more conservative in response to the changed regulations and incentives. Indeed, a number of participants argued that this was already occurring, and that the lack of risk capital would continue to choke the slow recovery of post-crisis economies.

International Standards

There was considerable discussion of international standards in Session 1. Participants recognized several benefits to having greater uniformity of regulation. They agreed that international standards could significantly reduce internationally-active financial institutions' costs of compliance with regulations across different jurisdictions, particularly in the aftermath of the global financial crisis when many countries were calling into question the principle of home-country regulation. International standards should also prevent the problem of contradictory rules, which could make it legally or practically impossible to do business in different jurisdictions. A third benefit that participants noted was that more uniform standards would discourage regulatory arbitrage by financial institutions, which could increase the riskiness and of their business and contribute to future crises. Other participants argued that it could address the potential problems of unfair advantages for financial institutions based in countries with lower

regulatory or prudential standards, or of a race to the bottom among countries seeking to expand their financial sectors.

At the same time, many participants also expressed concerns about possible negative effects and unintended consequences. International standards were seen by some participants as being more resistant to change than national rulemaking. They were concerned that an excessive focus on international regulatory standardization or harmonization would make it more difficult for regulators and supervisors to respond to changing market conditions, thus increasing the likelihood of excessive risk and crises.

This contributed to the concern expressed by many participants that international standardization would lead to negative effects on intermediation. One worry was that global overregulation would increase financial institutions' costs or restrict their functions, which would reduce lending and provision of risk capital. Another was that burdensome regulations in banking and insurance would encourage financial intermediation to move from those sectors into the less-regulated shadow banking system. Some participants argued that the squeeze on intermediation had already begun. In addition to the impact on provision of risk capital, they expressed concern that state-owned financial institutions would increasingly be forced or incentivized to step into the breach to provide funds for investment. Since state-owned financial institutions would not be subject to the same international standards, these participants worried that an expansion of their role would weaken market mechanisms, increase the likelihood of misallocated lending, and compound the competitive problems of private-sector financial institutions.

Participants also expressed concern that international standards of regulation and supervision may not be equally appropriate for all markets or all financial institutions. Several participants worried about the possibility that a banking regulatory model was being extended inappropriately to insurance and other sectors, which faced significantly different risks in terms of capitalization, leverage, and liquidity. Others noted that international standards that were designed primarily to address the issues raised internationally-active financial institutions and systemically-important financial institutions (SIFIs) would inevitably be imposed on purely domestic financial institutions when they became codified into domestic laws or supervisory practices. They felt that the key supervisory challenges of traditional local banks, for example, looked quite different from those of multinational financial conglomerates and that the regulatory burden created by Basel and other standards was therefore misplaced. A number of participants made similar case about different countries' needs as well. They argued that international standards were by and large being driven by the needs and experiences of developed economies rather than those of developing economies. They asked whether emerging market economies would really benefit from creating elaborate supervisory mechanisms designed for complex financial institutions.

Accountability

A second major theme in discussions of post-crisis challenges to the financial system focused on a different aspect of regulation: accountability. In a sense, the risk aversion and legalistic bias of regulators and policymakers in the post-crisis era could seen as a function of accountability, as they sought to show their responsiveness to electorates who

felt that financial regulation had failed them. However, a number of participants focused instead on a failure of accountability.

Concerns about accountability were particularly pointed in discussions of international standards. Several participants pointed to what they saw as a lack of democratic accountability in international standard-setting, which they felt was often monopolized by unelected bureaucrats operating in a non-transparent fashion. Others worried less about democratic accountability. They pointed out that most of the officials making the rules were civil servants who had been delegated that responsibility by democratic governments, and that implementation at the domestic level would remain subject to domestic laws and procedures.

Some participants noted significant differences in the enforceability and binding nature of different international standards, ranging from models and principles of best practices (the OECD model) to peer pressure (the IMF's FSAP model) to soft law based on national enforcement (FSB model) to treaty-like rules (WTO model). They expressed the view that the more enforceable and binding a set of international standards was, the more important would be accountability to citizens and industry participants. Among the examples given were the standards under consideration at the International Association of Insurance Supervisors (IAIS). Like the Basel standards, IAIS standards were seen as being highly binding on national authorities, but these participants were unhappy that the standard-setting process did not include a formal voice for major insurance companies.

Several participants raised the question of how international standard-setting could be made more democratic or accountable. One possibility that was raised was improving channels for industry input by inviting comment or participation by financial institutions or industry groups that would be directly affected by rule-making. Advocates stressed that this would ensure that regulation would take into effect the expertise of practitioners and the costs to financial institutions. However, others expressed concern that greater participation by industry groups might actually decrease the representativeness or democratic accountability of international standard-setting, as it would likely privilege large multinational financial institutions at the expense of smaller players and consumers.

Extraterritoriality and Ring-Fencing

While there was considerable discussion of international standards, participants also worried about the opposite problems of extraterritoriality and ring-fencing as national responses to the global financial crisis.

The U.S. was seen as the worst offender with regard to extraterritoriality. Participants pointed to aspects of the Volcker Rule, CFTC regulations requiring nearly any financial institution involved in derivatives transactions with a U.S. counterparty to be regulated as a U.S. swap dealer, and the Foreign Account Tax Compliance Act (FATCA). Japanese financial institutions were particularly unhappy about the extraterritorial aspects of the Volcker Rule and derivatives rules. All of these rules could force foreign financial institutions to submit to U.S. regulation and supervision across their organization and functions, even if their financial activity in the U.S. was limited. Participants noted that this not only imposed significant costs of compliance on foreign financial institutions but also could place them in jeopardy of violating their home-

country regulations (such as China's confidentiality rules). Some participants spoke of instances in which foreign financial institutions had decided simply to stop doing business with U.S. financial institutions or even U.S. citizens due to the burdensome nature of these rules. There was a widespread feeling among participants that U.S. extraterritoriality would reduce the attractiveness of U.S. financial markets to foreigners while also restricting the ability of U.S. financial institutions to do business abroad.

In addition to the problems that participants saw with U.S. extraterritoriality *per se*, a number of participants argued that it was encouraging extraterritorial regulation elsewhere. A common concern was the extratraterritoriality of EU policies (e.g., concerning derivatives trading and clearing), but participants also cited other examples. These included UK anti-bribery rules and Japan's Anti-Social Forces (ASF) rules, which, like FATCA, were designed to prevent corruption, money laundering, and tax evasion. Some participants also noted that the Japanese FSA had established a principle that in its inspections of financial institutions, it could demand records on overseas affiliates without restrictions.

While extraterritoriality received the bulk of the attention of participants in this discussion, a number of participants also raised concerns about ring-fencing and subsidiarization, which they saw as an alternative strategy for protecting domestic taxpayers, depositors, policyholder, counterparties, and investors from the failure of a foreign financial institution. Although the major jurisdiction that appeared to be moving toward a ring-fencing model in banking was the UK rather than Japan or the U.S., these participants worried that the example might spread more widely, with particularly negative effects on multinational financial conglomerates. Some participants also expressed concerns about what they saw as the rise of subsidiarization as a principle for regulation of insurance companies.

Supervisory Systems

A final issue that participants discussed in Session 1 was whether supervisory authorities were actually up to the challenge of implementing new regulations and standards that had been created in response to the global financial crisis. The discussion looked at three dimensions of the issue: structure of financial supervision, capabilities of supervisors and regulators, and individual and organizational incentives.

A major concern, as in previous Symposiums, was the structure of financial supervision. Participants were particularly critical of the U.S. supervisory structure, which they saw as excessively fragmented. While they noted that fragmentation was most extreme in the state-by-state basis of insurance regulation, they agreed that sectoral and functional segmentation of supervision was pervasive in the U.S. Although they recognized that there had been some efforts to improve coordination and improve overlap (including the Financial Stability Oversight Council and the Federal Insurance Office), many participants remained dissatisfied with the overlaps and turf battles that characterized the U.S. regulatory and supervisory structure.

In contrast, participants generally approved of the more unified Japanese system. They noted that most financial supervision had been centralized in a single organization, the Financial Services Agency. Although other organizations also had roles in financial

supervision—most notably the Bank of Japan, but also the National Tax Agency and the Fair Trade Commission—participants were positive about the level of internal and external coordination of Japanese regulators and supervisors.

Participants also discussed to a more limited extent the potential for colleges of regulators to solve the problem of coordination both within and across national borders. With regard to cross-border coordination, they agreed that some sort of institutionalized mechanisms would be necessary to enable ongoing monitoring and prudential supervision as well as to ensure rapid and effective responses in the event of a crisis. That said, there was some skepticism about whether international colleges of regulators could work as designed. Noting that financial institution failures could impose significant costs on taxpayers, some participants predicted that nationalist responses such as ring-fencing would occur regardless of established principles. Participants also discussed the principle of colleges of regulators as a means of addressing domestic regulatory fragmentation such as that in the U.S. While noting that coordination would likely be made easier because of a governing federal legal system, a number of participants expressed skepticism that such a mechanism would be sufficient to surmount the problems of turf battles and differing organizational cultures. Finally, one participant raised the question of membership of colleges of regulators, noting that U.S. state regulators might lack the knowledge to assemble appropriate international colleges of regulators for multinational financial institutions chartered in their state.

Participants also questioned whether supervisors and regulators were up to the challenge of overseeing highly complex financial institutions and systems. One question was whether there were enough supervisors. Participants noted that the caseloads of inspectors varied enormously by agency, but that in many cases (particularly in more lightly-regulated sectors such as hedge funds) it was not feasible to keep close tabs on financial institutions under their jurisdiction.

They also expressed serious concern about the capabilities of individuals to understand complex financial institutions and to implement new laws and supervisory standards. Some felt that the training of individuals in supervisory agencies was insufficient and that they did not have the resources to provide more extensive training in quantitative analysis.

There were also serious questions raised about incentives. Some participants argued that many of the best people working in supervisory bodies (particularly in the U.S.) were just accumulating knowledge in order to better prepare themselves to make much more money in the private sector. At the organizational level, participants worried about the incentives for turf battles between agencies or divisions (again, particularly in the U.S.), which they saw as hurting effectiveness of regulation and raising the regulatory burden on financial institutions.

While many participants were critical of the capabilities of supervisors in the U.S., Japan, and elsewhere, others asked whether anyone or any organization could possibly manage the complexity of contemporary financial systems. They noted that both markets and the leadership of major banks and financial institutions had failed to see the extent or the types of risk that had led to the global financial crisis.

Session 2: Restoration of Fiscal Sustainability

Session 2 addressed the issue of fiscal sustainability in Japan and the U.S. Participants expressed serious concerns about the stock of debt and continuing deficits in each country, although few expected a funding crisis in the near term. A major concern was the relationship between deficits and economic growth—deficit-cutting would be very painful and politically difficulty if not accompanied by growth, but many participants argued that demand in both countries needed to be weaned from a dependency on fiscal support.

Are Debts Sustainable?

A key question underlying much of the discussion was whether government debt in each country was sustainable. Participants noted that, while the two situations shared a number of important characteristics, many of the particulars differed in important ways.

Japan's Debt Challenge

Considerable attention was paid to Japan's fiscal challenge. Participants expressed particular concern about the enormity of the country's debt. Although they agreed that Japan's gross debt totals were misleading as a guide to sustainability, they noted that Japan's net debt numbers were still comparable to the most highly indebted European government, including Italy and Greece. Several pointed out that it was beyond the magnitude at which many governments had experienced funding crises. Moreover, the rapid expansion of debt would continue as long as the Japanese government continued to rely on deficit financing for current needs—as several participants noted, around half of all government spending was being funded through borrowing, which they saw as unsustainable. In general, participants agreed that Japan's fiscal sustainability really was in question, and that policymakers needed to act quickly to assure markets that they had the situation under control.

Specific attributes of the Japanese economy were seen to exacerbate the problem. The most important of these was the aging of society and the shrinking of the Japanese work force. Aging contributed directly to government spending in the form of national pensions and healthcare. At the same time, the growing number of retirees was having a negative impact on tax revenues. The shrinking labor force (with expectations of further declines due to ongoing low birth rates) worsened the fiscal picture and raised concerns about how much tax authorities could continue to rely on personal income taxes as the labor force declined as a share of the total population. Participants also pointed out that absolute declines in the labor force were tied to weak long-term growth prospects (estimated variously in the 0.5-1.5% range), further complicating the prospects for increasing revenue.

Deflation was seen as compounding Japan's fiscal challenge. Although nominal incomes were declining, income tax brackets were not being adjusted downward, resulting in reverse bracket creep and declining income tax revenues. Many participants also saw deflation as a reflection of weak overall demand, which under normal

circumstances would call for continued fiscal stimulus to maintain growth. On the bright side, a number of participants pointed out that the low interest rates associated with deflation kept debt service costs quite low relative the magnitude of the debt, and thus more manageable. A key question that arose from this observation was whether Japanese debt would remain sustainable if/when interest rates rose.

Participants also pointed to two aspects of the Japanese fiscal situation that they saw as providing some grounds for optimism. The first was the fact that Japanese government debt was overwhelmingly held in yen by Japanese households, financial institutions, firms, and public entities. This reflected the large net savings of the Japanese economy. A number of participants pointed out that many other countries that had experienced debt crises were dependent on external borrowing, unlike Japan. As one put it, "Japan doesn't have a debt problem, the Japanese government does." While participants took some comfort from the self-financing of government debt, they also offered cautions. One was that Japan's current account surplus was declining and would likely shift to deficit at some point in the medium-term. There was some debate over whether that would trigger a crisis, including large-scale capital outflows and interest rate hikes. Most foresaw a more gradual shift, to which the Japanese government would be able to respond incrementally rather than via a major austerity program. Several participants cautioned, moreover, that the argument that Japanese ownership of debt contributed to Japan's sustainability depended on assumptions about the strength of Japanese investors' home bias. While Japanese investors had historically held a particularly strong home bias, they questioned whether it was wise to bet on that preference continuing.

Participants also took comfort from the fact that Japan was not heavily taxed on a comparative basis—indeed, among the most developed economies, only the U.S. tax burden was lower as a share of GDP. Thus, they argued that taxes could be raised significantly without choking off incentives for economic growth and wealth creation.

U.S. Fiscal Challenge

Participants also expressed serious concerns about the sustainability of U.S. fiscal debt, although most were more sanguine about the U.S. situation than about Japan's. This was due both to the smaller debt-GDP ratio relative to that of Japan and what most participants saw as better growth prospects for the U.S.

The basic debt challenges for the U.S. were seen as similar to Japan's. Aging society (albeit not nearly as rapid as Japan's) would mean a growth in entitlements, as health care costs continued to outstrip inflation and nominal GDP growth. Meanwhile, U.S. citizens continued to show a deep resentment of taxes or reduced social security and health benefits as a remedy to the fiscal situation.

A complicating factor was that, unlike Japan, the U.S. was not a net saver and thus depended on external borrowing. Unlike the Japanese government, which relied on the home bias of domestic investors, the U.S. government had to rely on the self-interest of foreign investors. Some participants expressed concern that foreign creditors could at some point lose confidence in the ability of the U.S. to pay back debt without large-scale depreciation of the dollar. If that were to happen, capital flight could ensue, leading to

higher interest rates and possibly a run on government debt. Most participants did not see this as a near-term likelihood, partly because of the status of the U.S. dollar as the world's key currency. But they cautioned that if deficits and debt continued to grow, that status could be challenged at some point.

Three aspects of the U.S. economic situation provided participants with cause for optimism about the situation. First, they noted that the U.S. population and labor force continued to grow, due to large net immigration and one of the highest birth rates among the advanced economies. Thus, they saw U.S. growth prospects as being higher than Japan's, raising the possibility of growing the way out of debt. Second, a number of participants argued that the U.S. economy was also more conducive to innovation than Japan, which could further increase the potential growth rate.

The third cause for optimism, as in the case of Japan, was that on a comparative basis, U.S. taxes were quite low. Some noted that the U.S. tax burden was in addition lower than at any point in decades. Thus, most participants felt that the economy clearly had the capacity to absorb higher taxes, although many expressed skepticism about the political potential of doing so.

Achieving Fiscal Consolidation

A major issue with regard to the path to fiscal consolidation was how to reconcile the need for long-term deficit and debt reduction with the reality of domestic economies that remained weak after the financial crisis. A number of participants expressed deep concern about the possibility that moving too quickly toward fiscal consolidation would cause deep economic damage while still not helping much to lower debt, because recession or low growth would lower government revenues and necessitate new government spending. Several pointed to the examples of Japan in 1997, the UK since 2010, and Greece and Spain in the current crisis as cautionary tales for attacking fiscal problems in the midst of economic weakness. Thus, they argued that both Japan and the U.S. should focus their fiscal consolidation efforts on medium- to long-term consolidation, while accepting high deficits as necessary for the time being.

Other participants challenged the wisdom of holding off on fiscal consolidation, particularly for Japan. They cited three main concerns. First, they feared that Japan faced a greater likelihood of crisis than was generally accepted, and thus argued that deficits must be addressed immediately. They stated that Japan had been sacrificing long-term responsibility for short-term stimulus so long that the long-term might be around the corner. Second, they noted that nearly two decades of fiscal support for the economy had not helped to spur autonomous growth, even as it had piled enormous debt on the government. While they acknowledged that there would be significant pain involved in moving toward consolidation in the midst of economic, they saw the alternative as worse. Third, several participants argued on principle that current spending should not be funded by debt on a continuing basis, as it meant that future generations would be subsidizing current profligacy. Indeed, one participant described fiscal policy in both Japan and the U.S. as a form of "fiscal child abuse."

Participants agreed that meaningful fiscal consolidation would require action on both tax and expenditures, particularly for Japan, whose challenge was seen as

considerably larger than that of the U.S. Much of the discussion over specific policy measures focused on the Japanese consumption tax. While the Japanese government had made a rise in the consumption tax a centerpiece of its deficit reduction plans, a number of participants were critical of this approach. They argued that it would have the effect of depressing consumption at a time when the private sector was already displaying excess savings behavior. Thus, it would reduce domestic demand more than other alternatives. Moreover, it would exacerbate Japan's already-growing problem of inequality, as it would tend to tax poorer families more than wealthier families. Thus, they stated a preference for other tax policies, such as reforming land taxes and estate taxes or improving tax collection by implementing a system of taxpayer ID numbers.

Other participants disagreed strongly. They argued that none of the taxes discussed by opponents came close to the magnitude needed to close Japan's yawning fiscal gap. They also contested the idea that the consumption tax was in some way unfair. They noted that it was broad-based, thus ensuring that retired people (an ever-increasing and generally affluent segment of the population) would have to pay for current spending instead of adding more and more burden to working people. They also argued that, because the consumption tax is easy to administer, it would address other fairness issues, such as tax evasion by many self-employed people. Finally, they argued that, rather than trying to address inequality by not increasing the tax on consumption, it would be better to deal with it directly through the progressivity of the income tax system or through transfer payments.

With regard to spending, participants observed that in both the U.S. and Japan, a great deal of political discourse had been devoted to the idea of cutting discretionary spending. However, there was widespread agreement that cutting discretionary spending alone could not come even close to address the problem sufficiently. Rather, participants agreed that spending cuts would need to focus on the major drivers of rising government expenditures: pensions and health care. Again, the necessary adjustments were seen as being considerably larger in Japan than in the U.S., due to the more rapid aging of Japanese society, but the basic issues were seen as similar. In both countries, participants agreed that there needed to be ways of holding back the growth in entitlement spending through a combination of benefit cuts, premium increases, and restrictions on eligibility (e.g., increasing the retirement age for pensions). Several participants also pointed out that a significant problem for the Japanese pension system was the non-payment of contributions by young people who doubted that they would get full benefits from the system. Some participants felt that creating realistic plans for shoring up national pension systems would reduce that problem by improving the incentives for young people to contribute. A final point made by a number of participants was that Japan was in great need of a unified taxpayer ID number system in order to better track income and tax payments and to reduce what they saw as a pervasive problem of tax evasion.

A final component of macroeconomic policymaking that participants saw as relevant to Japan's fiscal situation was monetary policy. As noted, participants saw deflation as making fiscal consolidation more difficult, due to downward pressures on tax revenues. Moreover, many participants felt that more expansionary monetary policy could also help to support the economy as fiscal support was gradually withdrawn. Thus, they felt that the Bank of Japan should act more vigorously in promoting quantitative

easing. Not all participants agreed, however. Several expressed skepticism about the benefits of long-term easy money, arguing that it did not promote sustainable growth as there were few incentives for firms to deleverage or to pursue the highest-return activities. Some also worried that the extremely low interest rate environment reduced pressure on the Japanese government to reduce debt, possibly leading to such a build-up that a crisis would be more likely to ensue.

The question was also raised of whether there were useful lessons from Japan for the U.S. Some participants spoke approvingly of the courage of the Noda administration in calling for a consumption tax hike and comprehensive solution to the financing of pensions and medical insurance even in the midst of economic hardship. Others cautioned that the Japanese fiscal contraction of 1997 offered important object lessons in the dangers of removing fiscal stimulus, which they saw as analogous to the U.S. "fiscal cliff." At least one participant argued that much of Japan's debt was a result of stimulus measures enacted in the 1990s to address economic weakness; he felt that the U.S. was being wise in trying to retreat from large-scale stimulus.

Politics of Fiscal Consolidation

While there were some disagreements among participants about how best to pursue fiscal consolidation in Japan and the U.S., there was a clear consensus that there were significant political obstacles to effective consolidation in both countries. Participants noted a grave mistrust of government among American and Japanese voters that made them suspicious of any efforts to increase revenue. The "Tea Party" phenomenon in the U.S. received considerable attention, but some participants cited survey data showing Japanese voters as being even more mistrustful of government than U.S. voters.

Another common political obstacle to the kind of comprehensive reform of social security that all participants agreed was necessary was intergenerational conflict. A number of participants identified generational voting behavior as an important element in perpetuating a system that appeared to advantage older people over younger ones. They noted that in both the U.S. and Japan, older citizens voted in significantly greater numbers than younger ones. In Japan, some argued that this phenomenon was accentuated by the fact that rural voting districts, which had much higher percentages of senior citizens than urban areas, were overrepresented in the Diet. As for the U.S., a number of participants commented on the American Association of Retired People (AARP) as a powerful lobbying group in legislation related to social security and Medicare.

For many participants, an additional challenge for fiscal sustainability was how to lock in long-term fiscal consolidation while providing fiscal support for the economy over the next couple of years. Several argued that there would always be short-term excuses for postponing fiscal consolidation and were thus suspicious of bargains that shifted major savings into the future. Others pointed out that locking in consolidation could lead to contractionary policies at a time when the economy was in a weak condition, as occurred in Japan in 1997. However, most agreed that under current circumstances it would be most appropriate to focus on longer-term fiscal consolidation by making social security and health insurance sustainable on their own terms.

Looking at political gridlock in the U.S. and Japan, including divided government in both countries, many participants were pessimistic about the prospects of either political system delivering and following through on commitments to fiscal consolidation. Others, however, saw more potential. A number of participants, for example, were cheered by Japan's fiscal deal over consumption taxes and the Noda administration's initiative to come up with a comprehensive social security deal. Others were skeptical, arguing that the consumption tax hike would not be sufficient to eliminate the primary deficit as quickly as claimed and that the prospects for a serious social security deal were limited. For the U.S., some participants felt that the looming prospect of the fiscal cliff might provide the impetus needed to force cooperation between Republicans and Democrats.

Growth Prospects

While much of the discussion of fiscal sustainability focused on measures related to revenues and spending, participants also discussed the potential of Japan and the U.S. to grow their ways out of their fiscal situations. Few participants thought that growth without fiscal reform would be sufficient, but they agreed that promoting growth would be an essential part of making the adjustment economically and politically sustainable.

Most of the discussion in this regard focused on Japan, where aggregate growth had been weak for two decades. (In general, participants saw U.S. growth prospects as more favorable than those of Japan, based on better demographics and a system that continued to be supportive of innovation.) The issue of a declining labor force was again a major topic of discussion, as many projections for slow growth were based on that assumption. This problem was highlighted by participants who pointed out that Japan's per capita real economic growth had actually been healthier than most developed economies over the last decade. From this perspective, the key component to developing a growth strategy was expanding the labor force. Ideas included better utilization of women by reducing barriers and enabling them to balance work and family life by expanding maternity leave, introducing more flexible hours, etc. Many participants also called for drawing on Japan's large pool of healthy senior citizens, many of whom they saw as capable of staying in the work force. Some participants advocated greater immigration as a means of expanding the labor force, although they were met by some skepticism about the social impact and political feasibility of doing so at a large scale. Finally, there was some discussion of policies to make childbearing more attractive, although such efforts would not begin to affect the labor force for twenty years of more (and despite some skepticism about the plan's feasibility).

Another approach to promoting growth in Japan was through monetary policy. A number of participants expressed the opinion that the BOJ could do a great deal more to ease credit and to create inflationary expectations in order to encourage consumers to spend more. One technique in particular that was suggested was massive unsterilized foreign exchange market intervention, whether on the BOJ's own books or in a coordinated action with the Ministry of Finance. Advocates argued that this would be both an effective means of monetary easing and a boon to Japanese exporters and import-competing firms. This idea has been raised in many past Symposia.

In addition, a number of participants suggested structural reform as a means of improving Japan's long-term growth rate. They argued that protectionism and

overregulation were choking off innovation and the growth of small and medium-sized enterprises. Therefore, they called for an aggressive strategy of deregulation and liberalization. Some participants advocated signing onto the Trans-Pacific Partnership (TPP) as a means of forcing such liberalization. Others pointed to specific regulatory reforms that they felt could have a large impact, such as eliminating tax, zoning, and land-use rules that supported Japan's many inefficient agricultural practices.

There was considerable discussion of what should be Japan's industries of the future, where innovation and business opportunities could create rapid growth in productivity and employment. Among the most commonly cited sectors were green technology, health care, and agriculture.

Still, a major question for many participants was what role the government should take in promoting them. Some seemed to suggest selective promotion through industrial policy. Others were skeptical of the ability of government to effectively promote growth. They felt that it would be better for government to step out of the way once suitable rules and infrastructure were in place. A different concern over the role of government in the economy was seen in comments that political uncertainty, built up over years of chaotic governance and prime ministerial musical chairs, was a major hindrance to investment and growth.

Japanese Banks and Government Debt

In discussing fiscal sustainability, a point that emerged many times in discussions was the large role of Japanese banks in absorbing Japanese government debt. Participants noted that government borrowing depended on the willingness of banks to keep purchasing JGBs regardless of low returns and rising risks (as seen, for example, in CDS prices).

Beyond the issue of fiscal sustainability, participants raised significant concerns over the economic effects of Japanese banks' mounting holdings of government debt. One of these was the massive interest rate risk that many participants saw banks taking on, as such a large part of their assets were in the form of government debt—if (or when) interest rates were to go up, these participants feared that the value of JGB holdings would drop sufficiently to put banks' health or even solvency in jeopardy. Other participants were less worried about this risk, noting that most major Japanese banks had significantly reduced the duration of their JGB holdings in recent years and arguing that other assets remained at least as risky.

A different concern was that, by choosing to amass huge amounts of government debt, banks were withholding credit from the private sector. Such a crowding out of risk capital, they worried, was contributing to economic stagnation. Others disagreed with claims about crowding out, arguing that there was limited demand for credit, reflecting the weakness of the Japanese economy.

A question in this discussion was why Japanese banks held so much government debt, given the low returns and the losses in principal that would occur if/when interest rates were to rise. While some pointed to the lack of better alternatives among private sector borrowers, many saw government policy as central to banks' decision making. They argued that accounting rules encouraged holding JGBs, which were classified as

riskless in calculating capital-asset ratios. Some also suggested that banks and other financial institutions may be receiving subtle encouragement by regulators and supervisors to continue building up their holdings of government debt.

The "why" question was an important one in thinking about the last element of the fiscal sustainability question: who would buy JGBs going forward? Many participants appeared to expect Japanese banks to continue accumulating government debt, but others felt that the existing justifications would soon no longer be sufficient to continue doing so. If Japanese banks were to slow their accumulation of Japanese government debt, participants were hard put to come up with plausible alternative purchasers. A number of participants mentioned foreign central banks as likely buyers, although probably not in sufficient amounts to substitute for Japanese banks. At least one participant stated that he had stopped recommending purchase of JGBs to his clients. If that were to become a more widespread decision, then Japan's fiscal sustainability crisis could come sooner that anyone had imagined.

Session 3: Impact of Euro Crisis on International Finance

Session 3 considered the eurozone crisis and its impacts on international finance. Much of the discussion focused on the causes of the eurozone crisis and how the eurozone countries should deal with both the current issues and the longer-term structural problems that had led to the crisis. They also addressed more briefly the impacts internationally, including sovereign debt markets, exchange rates, recessionary impacts, and likely effects on international standards.

Origins of the Eurozone Crisis

Participants agreed that the core of the eurozone crisis could be found in the formation of monetary union itself. They observed that the eurozone had never been an optimum currency area, but that political leaders had committed themselves on the basis of beliefs about convergence and in an effort to promote greater political and economic solidarity. Further, there was a substantial problem in having a monetary union without a fiscal union. The basic problem had been exacerbated by the later entrance of economies such as Greece that were even further removed from convergence with German productivity and fiscal conditions than the original Southern members.

As a result of the shift to a single currency, lower-productivity economies with perennial deficits found wages converging toward those of higher-productivity economies, but without commensurate growth in productivity to justify them. Meanwhile, the higher-productivity countries ended up with current account surpluses while the lower-productivity economies racked up deficits. These were easily funded in euros, as the disappearance of currency risk encouraged provision of funds to governments and financial institutions in Southern Europe that contributed to government deficits and asset bubbles that eventually culminated in the eurozone crisis.

Some of the defects of the system had been known in advance, including the potential problem of internal imbalances. However, the means by which the eurozone countries tried to prevent fiscal deficits within eurozone countries—the Stability and Growth Pact—proved to be unenforceable. And, as some critics had predicted before the establishment of the EMU, the lack of a mechanism for transfer payments between economies made adjustment extremely painful and politically charged.

Other policy issues were seen as being in play as well. These included the decision to accept all eurozone sovereign debt as risk-free for regulatory purposes, which reduced market discipline and may have contributed to the ability of Greece to borrow at a rate of only 30 basis points above Germany as the global financial crisis began to unfold. A number of participants saw a moral hazard issue as well—although the ECB charter appeared to state that there would be no bail-outs by the central bank or other member countries, market participants never really believed it, and acted accordingly. Also, the principle of national-level banking oversight and resolution was seen as giving false assurance to Northern European supervisors that their financial institutions could be effectively insulated from problems elsewhere in the eurozone.

Finally, many participants pointed to inappropriate responses to the Greek crisis as exacerbating the situation by encouraging contagion and increasing the ultimate costs of resolution. In particular, they argued that the insistence of the German government that the problem was solely of Greek sovereign debt and that therefore the burden of adjustment must fall on Greece had created unsustainable requirements for austerity. Fears of contagion had meant that this decision essentially forced austerity on other Southern European countries as well, leading to enormous economic pain (e.g., 50% youth unemployment in Spain). Many participants felt that it would have been cheaper for Germany to provide more transfers and reduce Greek debt immediately than to suffer the effects of the crisis indefinitely. They also argued that Germany and France should have defined the problem as a domestic banking issue as well as a sovereign debt issue; had they done so, they might have focused on bank recapitalization domestically rather than punishing Greek profligacy, with better results for their own economies as well as Greece.

Resolving the Crisis

Several suggestions were made for how the eurozone should address the crisis and put into place mechanisms for preventing, or at least better managing, future crises. In general, participants were skeptical about the utility of the Pact for the Euro, which they saw as having the same problems of enforcement as the original Growth and Stability Pact. They also felt that the revised pact would do little to address the problems of differential productivity and cross-border imbalances within the eurozone.

Participants discussed both short- to medium-term and longer-term issues related to crisis resolution. In the short-term, there was a general appreciation for the assertive actions of the ECB in providing liquidity to distressed governments and banks, despite the clear mandate that it was not supposed to act as a lender of last resort. Many participants also argued that there would need to be greater fiscal generosity on the part of Northern countries in order to prevent extreme austerity from having crushing economic, political, and social effects in countries like Greece and Spain. This could be done through the European Stability Mechanism, eurozone-wide bank resolution funds, and/or the issuance of eurozone bonds.

Perhaps most importantly, participants agreed that there would be a need for real exchange rate depreciation for the Southern economies. They argued that there was no way that these economies could pay back their external obligations and move back into balance without a significant reduction in their relative wages and cost structures. For some, this called for depreciation of the euro, as they believed that the effects of deflation would be too painful. However, many participants argued that depreciation would be inappropriate as long as the zone as a whole retained a rough current account balance. They argued that real appreciation for Germany and Nordic countries would be equally important. Rather than depreciation of the euro as whole, which would transfer the burden of adjustment to the rest of the world, they argued that those economies should accept higher inflation as part of the package.

The main approaches that participants discussed regarding long-term structural changes could be divided into two categories: greater federalism and mechanisms for temporary or permanent exit from the euro. The federalist solutions included expanded

powers for the ECB, eurozone-wide banking resolution, and the establishment of a permanent system of eurozone bonds that would ensure access to necessary funding by eurozone member governments. At the same time, there was considerable concern that these measures would lead to moral hazard, while also being politically unacceptable in Germany, Finland, and other surplus countries. Overall, many felt that this was a cost that the eurozone countries would have to bear, as it would be less costly and disruptive than alternatives. However, they also discussed means by which the moral hazard problem could be minimized. For example, with regard to eurozone bonds, there was support for the idea that there should be GDP-based limits to issuance, after which each country would need to issue its own bonds, which would presumably command a much higher risk premium in markets.

The other major approach was to create mechanisms for temporary withdrawal from the euro. While most advocates acknowledged that these could not be established in the midst of the crisis for fear of creating runs on the sovereign and corporate debt of the Southern members, they argued that an orderly process needed to be in place in the event of a recurrence of crisis. Among the steps that they saw as necessary were procedures for the reintroduction of a national currency, a clear legal basis for redenomination of externally-held debt into that currency, a legal basis for temporary capital controls to prevent capital flight, and procedures for reentering the euro (if deemed appropriate) after a period of time in the ERM. Not all participants were supportive of the idea, however, arguing that if the eurozone were demonstrated to be divisible, it would damage the political achievements of the EU and create new incentives for capital flight in the event of problems in a given member country.

Effects on Japan and the U.S.

Turning to effects on Japan and the U.S., participants focused on three issues: perception of the importance of fiscal debt, transmission of recessionary effects, the possibility of euro depreciation, and potential changes in international standards.

Several participants noted that the Greek crisis had re-sensitized politicians and markets to the dangers of excessive sovereign debt. The eurozone sovereign debt problems had informed political debates in both Japan and the U.S. that had shifted increasingly to concern with fiscal consolidation. Some participants felt that investors as well had become more wary of government debt, further raising the stakes for the fiscal consolidation efforts of Japan and the U.S.

Another major problem was the potential impact on global demand. Participants noted that demand was weakening in many economies, including the emerging market economies of China, India, and Brazil, which had been bright spots in the global economy since the onset of the crisis in 2008. Continued or exacerbated weakness in the world's largest single market could spell serious trouble for Japan and the U.S., particularly as they were about to embark on fiscal consolidation programs.

Euro depreciation was a concern for a number of participants as well, particularly in thinking about the Japanese economy. While there was some debate about how overvalued the yen was on a real effective basis, there was a clear sense among many

participants that the strong yen was choking off opportunities for recovery. Depreciation of the euro would only exacerbate that problem.

Finally, participants discussed the potential impact on international standards, particularly those governing the accounting for value of sovereign debt. There was a clear consensus among participants that it had been inappropriate to allow eurozone banks to account for Greek debt as risk-free. They felt that this had encouraged excessive debt issuance by the Greek government, inadequate risk pricing, and excessive holdings by German, French, and other eurozone banks. Some participants argued that it was only logical that sovereign debt should be evaluated on the same basis as other debt. Others cautioned that there could be profound and far-reaching implications if the concept of "risk-free asset" were to be discarded, as much financial theory was based on it.

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