

November 27, 2008

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:

- Japan had three false starts on financial sector reform, but eventually succeeded in 2002-04.
- 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.
- Japan's biggest mistake was early emphasis on blanket fiscal stimulus. Traditional macro policies could not address structural problems.
- Japan's biggest success was building regulatory infrastructure for strict asset assessment.
- Other countries have much to learn from Japan's eventual success, despite differences of national institutions and global conditions.
- 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 | | | | |
| Sufficient 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 Murayama² 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.

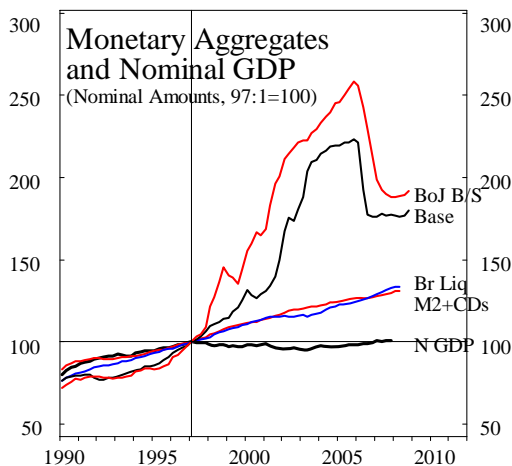
² Murayama was a Socialist, but the fiscal package was designed largely by the LDP, which had formed a coalition of convenience with the Socialists in order to return to power after the loss to PM Hosokawa's Japan New Party in the 1993 general election.

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

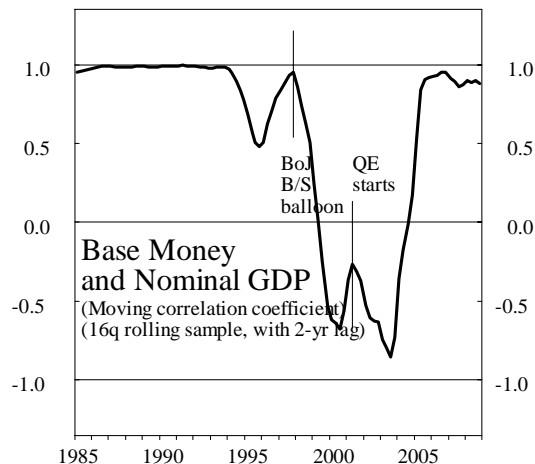
Monetary Policy, Money Growth, and Nominal GDP



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

| | GDP growth | Contributions | | | Non-capex |
|-------------|------------|---------------|-----------------|-----------------|-----------|
| | | Net exports | Domestic demand | of which: 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:

- 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.
- 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.
- 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.
- 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.
- 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 1992-94 | Phase II 1995-96 | Phase III 1997-99 | Phase IV 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.

November 27, 2008

Japan Economics

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 Shiryō, zaisei to Kinyū no Arikata ni Kan Suru Kyōgikai | 16-Jan-98 | Morgan Stanley | Regulatory policy | Handout for Japan 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 |
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| Dawn! | 1-Oct-02 | Morgan Stanley | Regulatory policy | Koizumi gets serious about solving the financial problem |
| A Hint from Nietzsche | 15-Dec-06 | Morgan Stanley | Regulatory policy | Presentation material for Japan FSA conference |
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| How Much Restructuring Is Still Needed? By Whom? | 31-Aug-00 | Morgan Stanley | Corporate reform | Balance sheet approach to restructuring |
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| 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 Shiryō." Any of the papers may be requested from the author.

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The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

20 Bank Street, Canary Wharf
London E14 4AD

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

Three Exchange Square
Central

Hong Kong

Tel: +852 2848 5200