

**“Lessons from Japan for a Troubled World: Finance, Economics, and Politics”**  
**Robert Feldman & Thierry Porte.**  
**April 14, 2009**  
**Program on U.S.-Japan Relations, Harvard University.**

**Robert Feldman:** Thank you, everyone, for coming today— I’m delighted at the turnout, and I look forward to a very lively discussion. Thierry and I thought that we would organize this in a point-counterpoint fashion: that is, I will discuss the framework first of how we look at the Japanese process of financial reform over the decade and a half that it took, identify a few key stages or components of that reform, and then at each stage, I will hand things over to Thierry, to give a “practitioner’s perspective” as opposed to my “academic-type perspective.”

I should also note that Thierry hired me into Morgan Stanley, in 1998, for which I’m very, very grateful. The job description was, “Your job is to save the Japanese economy. Without an economy we don’t have a business.” (laughter). We’re still working on that. (more laughter).

**Thierry Porté:** Yes, and there’s still a business.

**Feldman:** And there is still a business, yes. If I may, let me ask you to turn to page two of the handout (see attached file). It’s a paper I did a couple months ago on very much the issue for today. If one talks to investors around the world, or policymakers, or looks at the Congressional testimony of Secretary Geithner, they view Japan’s financial reforms of the 1990s and the early part of this decade as a failure. Mostly they’re talking about the long time it took to get things done. But I don’t really regard Japan’s financial reform episode as a failure. I regard it as a success that took a long time.

And so the question in my mind is, “What did Japan have to do to get it right?” In this little paper on page two, I present a chronological history in the first little box, and then I identify the success factors that were necessary to bring Japan out of the problem. These factors are the core of the discussion today.

But I want to go one step further—and this is also quite important—which is to create a model out of these success factors. The model is about how the factors interact with each other. The simplest distinction is between additive versus multiplicative interaction. If relationship is additive, you can do a lot of one, and if you’re not doing another one, it doesn’t really matter. But if the interaction is multiplicative, you’ve got to do all of them, or the overall result is zero; call it a multi-factor Cobb Douglas production function in a very simplified form.

I think that the relationship among the factors is multiplicative. You’ve got to have all of the pieces in place in order to get a successful reform. If one factor is absent, *the reform program does not work*. So that’s the structure of the argument.

## **The Five Factors**

What are the five factors that have to be there before everything is in place? The factors are presented in my exhibit one: The five factors came together—finally, finally—in 2002-4 and brought recovery.

First factor: an economic growth strategy. One of the issues during a big financial panic is the collapse of GDP growth. We have seen that in the U.S., in Europe, in Japan. How do you re-allocate resources to revive growth? That's the fundamental question.

Second factor: safety net. When a financial panic hits, people get very scared, and they start allocating their assets in a very, very conservative way. People start putting cash in mattresses, and trust no one to pay later. So, what kind of safety net needs to be created or expanded in order to get people to calm down?

Third: unfortunately, it's necessary in many cases to have capital injections into large systemically important institutions. That requires conditionality. What conditions are necessary to improve the governance of those institutions, and to convince the population that those injections are being done on a fair basis? This was a big issue for Japan, and obviously is a big issue for the United States.

Fourth: Public support—you cannot get the money available to support the system unless there's public support for the initiative. What needs to be done? What are the conditions under which that support comes forth? What carrots and what sticks?

Finally, in my approach—Thierry has an extra factor to add at the end—comes strict asset assessment. You must tell the truth about what assets are worth. And if you're not telling the truth about what the assets are worth, nobody will have confidence in the institutions. So how do you go about having a believable strict asset assessment, and what are the preconditions for doing something like the stress test that the U.S. Treasury is working on right now?

So those are my five factors; Thierry has added another one here, which you might be able to interpret as one of my five, but let's call it a separate factor, microeconomic reform. These panics are partly a macroeconomic issue—you can deal with them in part by supportive monetary and fiscal policy. However, there is a larger (in my opinion) microeconomic issue. And so you have to go in and work on a company by company basis with the borrowers, on an institution by institution basis with the lenders, and with the regulators, to reorganize the way you do regulation to make all the micro parts work together in a coherent macroeconomic whole. So I'll call that the microeconomic reform aspect of the agenda.

So that's the general structure that we're working with. Once again, all five, or six, factors have to be there before it works. And once they start working together, then recovery is relatively quick.

Let's talk a little bit about growth strategy. Japan's growth strategy did not start with PM Koizumi. On the contrary, if one goes back to the Mayekawa Report of the 1980s, you could see the germination of Japan's growth strategy in the 1990s. To me, one of the key events was in April/May of 1995. The yen hit Y80/US\$; the economy was going into a tailspin. And at that point, even Prime Minister Murayama, a Socialist prime minister, in a coalition government, decided that he would accelerate a five-year deregulation program to three years. And he went back to the bureaucrats and said, "Do this."

An example of how growth strategy affects growth came in the decision to deregulate the ownership of cell phones; until that point, NTT owned the cell phones and you rented one from them. However, once this deregulation was decided, in 1995, there was a boom in investment in that sector. Even more important, the new infrastructure released a tremendous amount of creativity among the Japanese people in how to use these new gadgets. And that was a key element in getting growth going again.

**Porté:** Let's look at a practical example. Under the economic growth strategy, you cannot pursue a strategy without having the tools. And as Dr. Feldman has mentioned here, the work-out process is one aspect that is needed to be able to propel things forward. What is important to recognize about this period from 1992 to 2004 is that at the outset, the tools did not exist. Japan's bankruptcy laws were antiquated, the court system was not organized for dealing with these complicated issues, you did not have asset management companies that could work out bad assets. This is a process that we are becoming familiar with here in the United States, by which the Federal Deposit Insurance Corporation, which in effect seizes banks, and yes, for those of you who have been wondering, nationalizes banks. We have been nationalizing about two banks every week for the last six months in America. It is done through the FDIC: they seize a bank, they reorganize it, in effect they nationalize it, and they put it back into the public.

None of these things existed in Japan when the banking crisis started in 1992. In sum, we did not have the tools. I will now spend a moment to go through a number of things that were done in Japan to address this.

The first rationalization of merger procedures under the Commercial Code took place only in 1997. Resolution schemes for banks were only finally created in 1998 under the Early Strengthening Law. The ability to create holding companies, which is important when reorganizing businesses, took place in 1997, when the Anti-Monopoly Law was reformed. Share-swaps for mergers, as well as procedures for creating a parent and a subsidiary took place in the Commercial Code reform of 1999. An entity called the Resolution and Collection Company, which was an asset management company, established for the express purpose of buying bad assets, was created in April 1999. This was really the first of its kind.

A number of things happened to reform the bankruptcy laws: the Civil Rehabilitation Law (*Minji Saiseihō*) was reformed in April 2000. Voluntary procedures

for corporate debt restructuring and debt forgiveness took place in September 2001. Finally, the Corporate Restructuring Law, which provides flexibility in terms of bankruptcy procedure and reorganizing a company in restructuring, was enacted in April 2003.

Over this period of the decade, ending in 2003, we had all the tools that would be necessary to conduct the work-out process necessary to help an economy in trouble to be transformed into an economy that can have future growth.

**Feldman:** Thanks. This did not happen in a single stroke. It took place in packets through the period. And this brings up something that actually was invented as a result, of an internal Morgan Stanley meeting that Thierry organized in 1997. I came to the firm just after that, and absorbed the result. A few months later, as I was walking past the Imperial Palace between client meetings, it struck me that the result of internal meeting was what I call the “C.R.I.C.” cycle, which stands for Crisis, Response, Improvement, and Complacency. It is a cycle because you just go in these circles, again and again and again. There’s actually a solid mathematical structure for it; this cycle works like a hog cycle in agricultural economics. I’ll spare you the details, but through the 90s, in these various phases of the reform process, we had the crisis, response, improvement, and then, people got *lazy* again and went into complacency – the result of which was another crisis (See attached paper)

For example, Thierry mention the RCC, but there was actually a predecessor. It was called the CCPC (Cooperative Credit Purchase Corporation). That became a warehouse, but it didn’t really work. And so, the economy went south again, and the authorities. had to try something else. There is a constant dialogue between the markets and the policy makers about what needs to be done next.

So that explains why we had so many stages in getting all the things that Thierry mentioned actually done. Let’s move on to safety net.

Same story there: a lot of CRIC cycles in the safety net area too. But there are very different forms of safety net. The obvious one is what happens with deposit insurance. Japan did have a deposit insurance corporation, starting in the early 1970s, but the coverage wasn’t so particularly broad. In 1996, they decided to spread that out.

There were many other parts of the safety net. One was the very aggressive increases in base money after 1997. If you look at a chart of base money, all of a sudden from ’97 it just starts going through the roof. In the 10-15 years before 1997, base money as a share of GDP averaged about 8% in Japan, but by the peak, in 2004-5 or so, it was up at about 23%. This is a *very* large amount of money printing.

In addition, the part that the LDP in Japan enjoyed the most was the fiscal spending. The equity market fell from 39,000 at the end of 1989, to 14,309 in August 1992, and Prime Minister Miyazawa announced a very large fiscal package. So whenever, disaster strikes, the LDP comes up with *that* part of the safety net. This was not really

meant to improve the productivity of the economy. It was constructed for political reasons, and justified with a very simple Keynesian approach: if you just spend money, then the economy will recover.

I had banker after banker after banker come to me and say “If we would just grow then we wouldn’t have to worry about these bad loans anymore.” How fast would the economy have to grow? How much extra GDP would you need before you can increase your capital enough to really cover the bad loans? And the answer turned out to be something like 200%.

But basically, these fiscal policies were a safety net to keep things from completely collapsing. In that sense, they were successful, in the sense that Japan did not have a lot of negative growth, even during the 1990s. So, you do have to give Japan *some* credit on the safety net agenda.

**Porté:** I would focus on deposit insurance. Actually, the Deposit Insurance Corporation (DIC) was started in 1971, and for 20 years there were no losses. But then, starting very slowly in 1991-92 you started to have institutions that ran into trouble; by 1994-95 we had the famous Tokyo Kyowa and Anzen credit cooperatives, which were found to have more than 80% of their loans non-performing, a big proportion of which were actually being lent to the gentleman, Mr. Takahashi, who controlled those two banks. (Feldman: “Anzen, by the way, means ‘safe.’”) “Safe,” yes, the “Safe Bank.” It is rather ironic (laughter). At this point, the DIC began worrying about its future.

In 1971, the insurance on deposits was one million yen. It was only increased to 10 million yen in 1986, and it remained at 10 million yen. You have to realize that in 1995, with these failures, people on the streets were trying to get their money out of the banks; this had been something that had not been seen in many decades. A growing problem became evident in the form of people taking their money out of banks and putting it under the mattress, of home safes becoming a hot consumer product, and of Japan Post receiving increasing sums of money due to its status as a government institution deemed to be totally safe.

As we look back now—I wonder if you would agree, Robert—there was a fairly bold response, which was to put a blanket guarantee on all deposits. We moved from 10 million yen to a total guarantee of deposits. This garnered quite a bit of criticism with regard to moral hazard, but was absolutely essential in terms of providing a safety net and some base level of confidence. Initially, it still did not stop deposits from leaking out of the banking system, but it certainly did stem the tide. By 1998 when the bankruptcies of Long Term Credit Bank and Nippon Credit Bank occurred, all those deposits were safe; no depositors lost money.

It is also important to look at the treatment of senior debt. This is becoming a topic of discussion here in America. The decision made in Japan was that not only deposits should be completely protected, but also all senior debt. In the case of Long Term Credit Bank and Nippon Credit Bank, they were very big issuers of what were

called debentures—one-year, three-year, five-year bearer notes. These were attractive investments for individuals as well as financial institutions.

Policy makers believed that if debentures and senior bonds, and indeed subordinated bonds, were swept up in a bankruptcy, the impact on the system, because the holders were both individuals as well as other financial institutions, largely insurance companies, other banks and non-banks, would have been quite catastrophic. As a result, they created that safety net, to ensure that banking system would not face an ultimate crisis of confidence.

It is worth noting that it is possible to unwind these things. In April 2002, the FSA reintroduced limited insurance on deposits, although it did maintain the full guarantee on demand deposits for an additional period. Ultimately, the blanket guarantee was lifted in April 2005, except for what are called “zero-interest” or “settlement” accounts, which are basically accounts of everyday business among financial institutions, and between financial institutions and corporations. Ultimately, the safety net was relaxed and put into what could be considered to be a more normal place. I would argue that this was something that was handled in a very effective and necessary manner.

**Feldman:** If I may add one comment, Thierry’s observations bring up a theoretical point about the difference between risk and uncertainty. In one of the Japanese newspapers the other day, a Japanese economist that pointed out this distinction, first made by Frank Knight in the 1920. Essentially, “risk” is when you know the probabilities of different outcomes, and make a decision about which risk you want to take on the basis of some kind of knowledge of the probabilities. With “uncertainty” you don’t even know the probabilities. And so you’re naturally going to pull back. If you’re a money market guy, wondering about whether the counter-party is actually going to be there the next day, you’ve got an uncertainty problem. And that’s why the Bank of Japan had to come in, after the Sanyo and Yamaichi bankruptcies, and essentially guarantee all the money market transactions, just the way the Fed did in similar circumstances a couple months ago. So the safety net really is an issue that addresses the distinction between risk and uncertainty.

Let me move to capital injections. Japan started out its capital injection adventure in the early 1990s, with the so-called Housing Loan Corporations, and this was a disaster. The reason it was a disaster is, first of all, the initial resolution proposals had no conception of responsibility, on the issue of who made the bad loans, who was responsible for cleaning them up, etc. In the popular mind, the banks were held responsible for introducing the agricultural institutions into making loans on various large projects. And when a project went belly-up, due to factors that the bank may or may not have known about, the co-lender was exposed to loss.

The co-lender didn’t think they were responsible because somebody else told them to do it. The bank view was, “Wait a minute—you had a piece of this loan too, so you should also take some of the hit.” The agricultural institutions didn’t see it that way;

they wanted to be made whole. The politicians got involved, and the general public got involved as well, and it became an extremely contentious political issue.

The basic idea here is, “Where’s the accountability for the allocation of capital in a project that has failed?” So that was the first failure in the capital injection agenda. In this case, the nation muddled their way through it. It was very clear that some new procedures were necessary to figure out how to do capital injections in a way that guaranteed that the public interest would be protected, but also that would keep the system working.

I would say that the set of laws, one of which Thierry just mentioned, that they developed in ’97-98-99, was actually a very, very good set of laws. And it was the result, I think, of political competition. By that time, the Democratic Party of Japan had been formed, and the plan that was put out by the Democratic Party at that time, the so-called “Phoenix Plan,” was quite good, including prompt corrective action, and much of what we now consider standard procedure.

Thus, there was political competition aimed at the public over how to do these capital injections. The phrase “strict asset assessment” actually was part of this debate. I always associate that phrase with PM Koizumi, because when Minister Takenaka came into office as the financial affairs minister, PM Koizumi said “We need strict asset management.” That phrase was actually first used by Yukio Hatoyama of the *Democratic Party* in 1999.

So the capital injection agenda includes conditionality, but also included things like prompt corrective action, getting the financial oversight authorities to act quickly, improving inspection and supervision expertise, expanding the number who were available to inspect the banks. Japan started the 1990s with only about 300 bank inspectors, total. This is not even close to enough! In short, the entire capital injection infrastructure had to be created.

The issue of compensation was a *big* issue in Japan as well. The bankers association for years had simply refused to provide any data on how much people in banks got paid for different jobs. Everybody else in the Nikkeiren (a major business organization) submitted such data, but the banks never did.

That was not regarded as fair play. The solution in Japan was that if an institution accepted public money, which most large ones did, it had to take a cut on the total compensation bill. In reality these cuts were about 20-30% off the peak. They stayed as far away as possible from mandating pay for individuals or positions.

Now there are differences between the Japanese situation then and the U.S. situation now, particularly in the dispersion of compensation inside the institutions. The top guys in Japan were not paid anything like what the top guys in the US get paid. Even

regular traders in Japan were on much lower compensation than in the US. So there are obviously aspects that need to be adapted. But Japan did have that very same issue.

**Porté:** I will expand further on this conditionality aspect and describe what was required when public money was put into a bank. This is the concept of the bank revitalization plan. As a condition of receiving government funds, banks were required to prepare this plan. It is important to underscore that it is the bank's plan: the bank management must present to the Financial Services Agency and the Deposit Insurance Corporation a four-year plan for the bank. That four-year plan must present business strategy. Management must present the strategy for rationalization of operations, which is to say, how to improve earnings and to control expenses. Expense control is a very important issue, and both personnel expenses, as well as non-personnel expenses, are scrutinized.

Management is required to provide a fairly detailed set of financial targets over four years. If a bank has public money, management presents a four-year plan revised every two years, recognizing that things can change. Targets must be provided for net revenues, expenses, operating business profit, exceptional gains and losses, net income, the "overhead ratio," which is the ratio of expenses to revenues, and finally, the growth of retained earnings. The fundamental objective is the repayment of public funds and so the plan must describe how management will achieve it. This is a function of how much you can grow your retained earnings grow.

Management also present its management systems, governance, dividend policy, and a plan for remuneration. A couple more details beyond what Robert mentioned is in order. First: directors, members of the main board, are not permitted to receive any bonus. Zero—that is the rule. There is a ceiling for the total compensation of directors and executive officers. There is a total ceiling and it is up to the management and board to determine how to divide the total compensation pool. There is then a total ceiling for compensation for all employees of the bank and there is a ceiling for the *average* compensation for the bank. The bank must operate within each of these limits.

This is a very clever approach, in my view. The plan is highly negotiated with the government, of course; but at the end of the day, it is the management's plan. That implies two things: when it comes to compensation, and deciding who gets paid what, that is the *management's* problem. It is not the government saying, "This person gets paid this much; this other person gets paid so much." There was a recognition that there had to be a certain degree of conditionality, but that there should be a limit to the government's decision-making role. There should be self-responsibility on the part of the managers to get the job done based upon this agreed plan.

There is one final aspect which is worth noting: there is a rule, included in the guidance of the financial restructuring law, that describes how these revitalization plans must be evaluated. This is called "the 30% rule." If the bank misses the targets on any of the measures, the financial measures described above, by 30% or more in one year, then the bank is subject to what is called a "business improvement order." Management must go back over the plan, and report back to the FSA and the DIC, how the bank will

improve performance. If the bank fails for a second year, then the senior management must resign. This is a rule specified in the governance of banks with public funds. There is no emotion about this. This is what a bank management must sign up for when you obtaining taxpayer money.

Having myself worked under a revitalization plan, I won't say that it's fun, but at least it's clear. Moreover, it is fair and proper, when one considers that you have received the taxpayer money and must be responsible for repayment.

**Feldman:** So the key thing is that there is not only conditionality but there is also accountability including firing people who don't perform. Not something that's very commonly associated with Japanese corporate governance, but there it was.

Of the key thing about Japan: Once the rules are set, and made clear, Japanese are very good about following the rules exactly. Take tax day. If your taxes aren't paid on March 15, you pay the fine. No excuses, no reasons, no justifications; you pay on time — that's it. So when there are clear rules, there's discipline. Thierry has just shown us is how that culture worked with the conditionality agenda.

Let me move on to public support. Absolutely essential part of any financial reform plan, because without public confidence in the financial system, you don't have a financial system. So what were some of the key things in getting public support?

First, the taxpayer must be paid fairly for the capital they are contribute. That's why they took the preferred structure for the capital injections, and so at least the FSA or the politicians could go back to the public and say, "Yes we injected your capital, but, by the way, we've got conditionality, and you're going to get paid a good dividend." You convince the taxpayers to support this kind of initiative by paying them a return on their capital. And so that was done in a reasonable way.

Prosecution of criminals is also very important in this sort of agenda. In Japan's case, unfortunately, there was a lot of organized crime involved in the bad loans. And one of the things that the RCC, which Thierry mentioned earlier, did, was take a very hard line on ejecting organized criminals who squatted in distressed properties, and expected to get paid off by the building owners or banks so that the property could be liquidated. Things could get very nasty. In 1994, the Nagoya branch manager of a major bank was murdered. The crime was never solved, and questions about the quality of police work were raised. This not only scares people, but reduces confidence in the rule of law. So until the criminal activity is dealt with clearly, you're not going to get public support.

The final thing is top management. When there is clearly a failed institution, you have to get rid of the top management in order to get the public to back the revival policy. I think the perfect example of this, where it worked very well, was the Resona Bank case. Many mistakes had been made, and much responsibility was spread across regulators, the borrowers, and banks, but basically when Resona failed in May of 2003, Minister

Takenaka, then the Minister of State for Financial Services, fired 140 people at the top of the bank.

A very talented new management team was recruited, and this team changed a lot of the procedures in the bank, the so-called “old boy network” procedures. For example, Resona introduced a policy that the bank simply would not own stock in their portfolio, unlike other Japanese banks. And one of the results has been that Resona—not owning any stock—has outperformed the other banks recently, which still own a lot of equities.

The point here is that public support is garnered by clear demonstrations that there is accountability for performance.

**Porté:** Another aspect of need for public support is dealing with public anger. That certainly is something we have experienced here of late in the United States. It is important to understand in studying the history of the banking crisis in Japan that this issue was present from the very beginning. In 1992, it was first revealed that there were serious problems with the housing loan companies [*jūsen*]. The ruling Liberal Democratic Party realized that they had to do something. In August of 1992, the LDP held their annual summer seminar in Karuizawa, and leaked out the notion that some public support would be needed.

Prime Minister Miyazawa, at that time, was in favor of that. He certainly had the right idea. But the public response to it was violently opposed. An extreme amount of anger was exhibited at all levels, from the man on the street all the way to the *Nikkei*, which stated “If we’re going to do this, then we have to stop paying dividends, cut the salaries, and fire the management of banks.”

That was 1992. What was the result of that outburst of anger? Unfortunately, it was delay. The *jūsen* problem was not resolved until 1996. The first capital injection into banks did not take place until 1998. A second round of injections then followed in 1999, and the bank capital issue was not ultimately resolved until 2002-2003.

How did Koizumi and Takenaka overcome this anger? I would argue it comes down to a few essential things. First, they came into office with a mandate for reform. Koizumi had enormous popularity. Second, they made it very clear: “This is a crisis. There is no alternative to action.” They based their policy on the notion that there would be no economic recovery possible without resolving the bad loan problem. “Fix the banks, and we can fix the rest of the economy. If we don’t fix the banks, we cannot fix the rest of the economy.” They made this crystal clear, and they staked their policy positions on this, in a very clear and easy to understand way, to the public.

The third aspect is they made very clear—this was the job of Minister Takenaka—that if additional capital would be needed, there would be strict conditions, including removal of bank management. And as Robert has described, in the case of Resona, this is indeed what happened. The Resona resolution went through without a

great deal of argument. It was made very clear to the public and it was made very clear to the bank management.

Finally, Minister Takenaka made clear what the ultimate objective was and what the consequences of not meeting the objective was. Takenaka told the bank management: “You must reduce your non-performing loan ratios by half—in two years. If you do not, you will be fired.” Within 18 months, they were down by half.

**Feldman:** It’s very interesting, also, that the Takenaka Plan that Thierry just described was actually only introduced in October of 2002. The first year of Koizumi was not a particular success in dealing with the bad loan problems, because, prior to Takenaka’s appointment as Minister of State of Financial Services on Sept 30, 2002, they had not been able to demonstrate concretely that they were really, really serious. Even after Takenaka came in, the markets *still* didn’t believe them, until Resona came along and the government proved that it was not just talking about firing managements They actually *did it*.

One other thing that I think was very interesting in that plan, was that Takenaka asked “kitchen cabinet” people to come up with a plan, as an alternative to the Financial Services Agency developing a new plan. With Takenaka’s backing, the private sector contributed the ideas. With the imprimatur of the minister on it, the FSA implemented the new plan, including a provision in that plan that specified jail for auditors who signed false books.

This latter provision was a great item of debate in the interaction among the auditors in Resona bank—which of course was the result of a merger. Some of the auditors wanted to value some of the deferred tax assets with a liberal interpretation, and others did not. So there was a fight among the auditors, but that fight would not even have occurred had Takenaka not laid down the law about sending people to jail for signing false books.

So, once Takenaka re-wrote the rules, he had to prove that he really would implement them. So announcing is good, but you’ve got to implement. That’s the public support component. And once Takenaka implemented his new policies clearly and forcefully, bank stocks took off, and public support also improved. So that’s the public support part.

The final component is strict asset assessment: I mentioned that just before. One of the things that’s necessary for strict asset assessment is highly trained personnel. In the early 1990s, Japan’s bank inspection function had only about 300 people: obviously insufficient. And so over time that was realized and they decided to increase that; now the FSA has about 1,300 or so staff.

I would like to stress clear rules for inspections, and strict asset valuation. When I say “clear rules for inspections” what I mean is valuation of assets along a set of rules that is understandable, and that both sides agree is correct. In the 1990s, each bank had its

own definitions of what would constitute a bad loan; three months overdue, six months overdue were common ideas, but what was truly bad was pretty much left up to the banks to decide. And I remember one conversation I had with an FSA official, just after a large retailer had gone bankrupt. I said to him, “How could you possibly let the banks classify that company as merely a class 2 (that is, slightly gray) institution? Their debt was trading in the market at 50 cents on the dollar; they had a seven to one debt-equity ratio; how could you possibly let the banks classify this as an asset requiring only two or three percent reserving?” And my friend said to me, “But look—we’re just inspectors. We can’t tell the banks how to classify the assets. We don’t know anything about the retailing industry; that’s their job!”

As a taxpayer, I was disappointed (laughter). This issue was resolved by the Bank of Japan. In September of 2002, the Bank of Japan published a paper about discount cash-flow evaluation of companies. This paper was a guided missile aimed at the FSA, saying “Look—you’ve got these big, troubled companies; the way you value the assets of a big, troubled company is to look at their revenue stream, do a discounted cash flow calculation on that revenue stream, then you know what the assets are worth and you can look at that valuation relative to the liabilities that they owe. Then you know whether they have any capital left. So, please use this method when you evaluate, or when you classify companies as class one, two, three, or four.”

The banks and the FSA had published aggregate numbers on what the banks said their non-performing loans were. Takenaka became Financial Affairs Minister a couple weeks after that the BoJ paper was published, and ordered a reevaluation for the 150 largest troubled borrowers, along the lines that the Bank of Japan suggested.

With this new approach, Takenaka published the FSA’s new version of the bad debt levels along with the bank’s own versions. No individual banks, no individual borrowers mentioned, but just the aggregate numbers. Guess what? There were discrepancies. Large discrepancies. Once those standards for how to do the strict asset assessment were implemented, with the minister’s and with the *Prime* Minister’s backing, then, as Thierry just mentioned, things came right pretty quickly. But that was the hardest part: to get people to really admit the truth on their balance sheet.

**Porté:** This illustrates is what we talked about earlier: you must have the tools to be able to do the job of restructuring and reforming the banking system. You also have to have the data. The aspect that I would just emphasize is from the early history of the banking crisis: prior to 1993—in this day and age, what I am about to say may seem extraordinary—Japanese banks did not have to disclose their non-performing loans. There was no disclosure. In 1993, in response to the emerging problems that were being observed, the top 21 banks, which is to say the city, trust and the long-term credit banks, were then required to disclose loans to bankrupt companies and delinquent loans in arrears of six months or more. That is all.

All other banks did not have to do any disclosure. Moreover, there was a fairly lax definition of non-performing loans. When there is no data, analysts will rush in to the

void in order to create data. One of the turning points therefore, in this entire process of asset assessment, occurred when analysts began to publish reports, with their own views of what the non-performing loan levels were. Since they could not get the data, they decided to try to create the data with their own assumptions and assessments. These numbers were vastly higher than those that were being published by the banks. They were certainly higher than what the authorities wished to see out in the public domain. They created an enormous stir with non-Japanese investors who were becoming increasingly important in the Japanese equity market. These developments created a crisis of confidence.

The crisis came to a boil when, in 1995, the Mitsubishi Bank merged with the Bank of Tokyo. Mitsubishi Bank had been reporting its financial statements under US GAAP because it was registered with the United States Securities and Exchange Commission. Under U.S. GAAP, their non-performing loans were 1.8 trillion yen. They presented in that filing under the merger the Japanese GAAP number. Under Japanese GAAP, their non-performing loans were 0.7 trillion yen. “1.8” and “0.7”: you can imagine the furor that this created, and again, foreign firms’ analysts continued to produce negative reports and the market became really quite concerned.

This all finally came to a head on the 25<sup>th</sup> of July, 1995. Foreign banks were told that they must send their banking analysts to the Ministry of Finance for an important meeting. 60 analysts appeared at the Ministry of Finance to be told that they were *all wrong* about the numbers that they were producing with regard to NPLs. And in a famous statement, Sei Nakai, Deputy Director of the Banking Bureau, said in public that the 21 major banks are too big to fail.

What was really going on there with this situation: a recognition that the problem was large, that the authorities had lost control of the process, and that the authorities had to address this issue of the non-performing loans, and particularly the disclosure of the non-performing loans. Thus, the long process began that would bring us to the proper conclusions in 2002-2003. In 1995 the definitions were revised; they were revised again in 1998-2000; they had to be revised further when finally, the Bank of Japan decided to put its own impetus into the process with the introduction of discounted cash flow evaluations of loans. It is an important and interesting tale of the need for proper and strict asset assessment.

**Feldman:** At the risk of seeming cynical, one must also realize that some people (in both public and private sectors) don’t want the truth to be known. A recent cartoon in the *New Yorker* explained a lot. There was a long table, with the rotund boss at one end and a skinny quant with a plastic pocket-protector at the other end. The boss is saying to the quant, “Get me some better numbers, or I’ll get myself a better numbers guy.” The economics jargon for this situation is “incompatible incentives.”

I’m sure the boss in that cartoon was under a lot of pressure to produce good results. The quant was under a lot of pressure to keep his job. To solve such problems of incompatible incentives, you need a system that guarantees integrity, and there are two

parts to such a system. One is open disclosure, where you can check what other people are saying. Open disclosure is an incentive to tell the truth. The other part is for professionals, like the whistle-blowers. They must have enough money in the bank to walk out, if necessary, to protect their professional integrity.

Let's move on to the final point, the micro-reform factor. One important contributor to demand on both Japanese and American financial systems over the last 10 years has been the Harvard-International House annual conference on the future of the financial system. At the conference of, I think, 2001 or 2002, Glen Hubbard, who was then chairman of the Council of Economic Advisors, made a telling observation. He pointed out that Japan was dealing with not so much a bad loan problem as a bad *asset* problem.

Now the distinction is a little bit academic in one sense, because a low productivity factory for a company is backing for the loan on the asset side of the bank's balance sheet. If it's a bad factory, the loan that built it is a bad loan; of course. In fact, Hubbard was making a much deeper point: the non-performing loan problem for the banks was a reflection of the fact that the use of physical capital in Japan was sub-standard. And so if you're really going to clean up a banking system, you have to do it in a way that ensures that capital is used efficiently. That is a micro-economic, non-financial sector issue; it is a real sector issue.

On this agenda, Japan did a brilliant job in forming the IRCJ in 2002-2003. This was the Industrial Revitalization Corporation of Japan, the *sangyō saisei kikō*. What they did there, basically, was to create a *public* private equity firm. So it's a private equity firm run by the public, or at least, funded by the public. But what this did was essentially create a public imprimatur for dealing with large troubled companies, for getting all the lenders to coordinate with each other, with a little bit of government money but also with an implicit whip behind that money. That is, if the lenders to a particularly troubled company did not operate the way that the IRCJ wanted them to, then the regulators would come in and, say, "Reclassify the loan, not as class 2 but as class 4."

So there was at least the threat of "regulatory arm-twisting." But what I thought was so wonderful was the government funding an institution that was staffed *entirely* by private sector people. The head of that institution, now the president of the Tokyo Stock Exchange, Atsushi Saitō, absolutely refused to allow anyone who was still employed by a bank to come and work for him on secondment. The IRCJ staff had to be independent. Moreover, the IRCJ was located outside of Nagatachō (the political district), outside of Kasumigaseki (the bureaucratic district): they located it in Marunouchi (the business district). True, you can walk from Marunouchi to Nagatachō in about 20 minutes, but the difference in attitude is tremendous.

The IRCJ also had a very interesting provision about compliance. The compliance officer for the IRCJ came from the Tokyo Prosecutor's Office. And it was perfectly okay for anybody from the Diet to call up and inquire about a particular deal. However, if they

wanted to call, they had to call the compliance officer first—who came from the Tokyo Prosecutor’s Office. So nobody called. (laughter).

There was a TV camera located above the IRCJ’s copying machines— there really was! So everybody knew who was copying what. The IRCJ was very good about keeping strict confidentiality on everything they did. Ironically, some of the banks did not want the IRCJ to work, because it was going to upset the apple cart. But there was strong public support, and work it did. Unique in the annals of government institutions, not only did it work, but it even shut down *before* the five year mandated life expired. Astonishingly, it even made a small profit for the taxpayers. The long term effect was also important: It educated a small but important generation of private equity people who could go out and ply their trade elsewhere. We need them today, and they’re out doing very good work.

So I would say that Japan had one story of magnificent success—late in the process, of course—but magnificent success in public-private partnership in the corporate micro-economic reform.

**Porté:** I think that this is a good place to conclude our discussion, because this example of the IRCJ brings in all of the elements that we have discussed. You see the elements under the economic growth strategy of a whole work-out procedure. All the things we mentioned earlier needed to be in place to enable this institution to do its work. It effectively provided a financial backstop to these troubled companies. They ended up working through 41 companies: some very large, such as the Daiei, Mitsui Mining, Kanebo; and some quite small, such as the Usui Department Store.

They provided a backstop and then worked them out. They also provided the necessary capital—so capital injections could be part of this process. It clearly had the necessary public support because of the transparency and the stringent rules by which it operated. It started by necessity with a very strict assessment of what the company was worth.

I would conclude by asking “How was this so successful?” There was certainly an enormous amount of skepticism. I think there are three elements, and these are worth remembering. First, there is complete transparency. I mean the process by which it worked was completely specified and left nothing to the imagination, in all of its aspects—extremely important in terms of getting people to participate and also getting people to accept the final outcomes.

Second, and this is getting a little bit into the details: this was really the first time that we saw in Japan a proper, what is termed a “due-diligence process.” Due diligence is when you go into a company and you examine it, top to bottom, to understand all of the details, so that you can then make an evaluation of what you think the entity is worth. Until this time, the notion of due diligence, well established in the United States and in Europe, was not so well established in Japan. There was enormous reluctance on the part of a Japanese company in the case of a merger and acquisition opportunity, to agree to

allow this kind of “proctology exam” to take place, because of concerns of confidentiality and failure, among other things. The IRCJ really enshrined this process in a very professional way and this is now an accepted process in business in Japan.

Third, there is the value of a proper governance process. One of the important things is that the IRCJ people dealt in a straightforward manner with reality, but also recognized the nuances. Some of these big companies employed a large number of people. They recognized that they had to work their way through that. That recognition was based on a long-term perspective, and involved ensuring that whatever the final transaction would be, that there would be a proper return for the risk taken. That did not mean that everybody was able to keep their job, but it also did not mean that everyone would be fired. With the transparency of the process and the rigor that was applied, the IRCJ was indeed an enormous success.

**Feldman:** If I could just add a couple little extra things to that. In the consultations and study groups that were going on as that IRCJ was being formed, I was fortunate enough to participate in one or two of them, and it was a fascinating discussion. At one point, I pointed out that we needed some clear numerical benchmarks for deciding what should and should not be considered for revitalization cases, and I talked about things like the cash flow-liability ratio, or other financial metrics. Then, Toyama-san, the man who eventually ended up as the number two guy at the IRCJ said to me, “Feldman-san, I’m sorry, I just don’t agree with that; that’s not right.”

He went on: “Corporate revitalization is about the future, not about the past; you’ve got to go in, and look at the company, business by business by business, and do a *future* cash flow estimate from each business line, and see how much cost will be associated with achieving that future cash flow. So don’t worry so much about the debt levels right now. See what kind of cash flow is going to come out of this business.” He was totally right. It is about the future.

Years later, Toyama-san said that in working through all of these companies (the IRCJ actually revived about 41), he discovered that the quality of labor at the Japanese companies was excellent. People were focused; they wanted to do their jobs right, and in many cases, it was labor that was laughing at management. In short, management was underperforming, not labor. And this is something very important to remember about Japanese companies, is that there are many, many hard-working, focused workers who are a tremendous national resource. When organized properly, they will do everything necessary to keep the economy afloat and keep living standards rising.

So I think one of the issues that we have in the United States is really “What *is* the quality of American labor?” And is it as focused as—is it as good as—Japanese labor? And that’s going to differ company by company. My guess is that there’s probably more dispersion in the U.S. than there is in Japan. But it’s an issue that we do have to deal with; how strict and how disciplined is our labor force in situations where turnaround is necessary?

**Porté:** I think we have covered the key issues. We would be delighted to take questions.

**Pharr:** Great. Just to start off, our starting point was: financial crisis requires a multiplicative process, as you say. Six things have to be in place. There are two models of how you do it. One is a model that's implicit in what the U.S. is doing, which is really a 100-days model, based on people's reading of what happened in the 1930s, which turns out to be actually inaccurate, but an assumption that ideally, you do all of those things, simultaneously, as quickly as possible. And that is the most desirable.

Then we have the model of what actually happened in Japan, in which the whole process took between eight to twelve years. Although you're saying Japan is a success story, it still took far too long. Do you believe that the real ideal out here is the 100 days model (the faster, the better)? If one steps back and looks at the way Japan went about it over a long-term process, you could argue that there was a certain merit in the approach that they took. For one thing, they had time to bring the public along. It takes a while for the public to absorb how serious the situation is, and therefore, also to figure out credible assurances so that they're willing to commit resources for turning things around.

Japan also avoided the major disruptions of massive layoffs, by retaining the permanent workforce while relying more on part-timers. Thus, Japan kept a certain integrity of its labor force, which could be, from a long term perspective, a desirable thing. In the long run, the pump-priming and stimulus packages might have gotten smarter in the process. In other words, there is a lot of learning time built into doing it over a somewhat longer period of time. Where you really come down on the time frame within which the resolution of the banking problem can take place?

**Porté:** This is an excellent question.

**Feldman:** Maybe I'm just a cynical economist, but I think people learn through the same process of a CRIC cycle. The more time you take on these things, the more complacent people get. So I don't view Japan's process as having been kind of a rational, thought-out process; I view it as a series of crises and missteps, where they learned something at every phase. Did it have to take 12 years? Probably not, but again, as Thierry said to begin with, they didn't have the infrastructure to start out with, so they needed a couple crises to build the infrastructure, and then sort of do it as they go along.

What are the conditions under which persuasion occurs? Sometimes it's appeal to rationality; in other cases, it's sheer terror. The U.S. Congress rejected TARP the first time; the stock market crashed 700-plus points the next day, and then Congress passed the law. This is the "education process" that has to go on in a democracy, where power is distributed. In terms of avoiding massive layoffs, that's probably a good thing; on the other hand, that also leads to complacency, and keeps some vested interests in place. The gap between wage and productivity, I think, was one of the key issues in the slowness of the Japanese economic revival, and we needed some big shocks to the labor market to get people to think hard about what is a correct wage for allocating resources properly and keeping living standards up.

If you pay people a lot more than they're producing, that means somebody else is going to get denied their fair wage. One of the things that I and others—Toyama-san in particular—are beating the table on right now is that the generation gap. People in their late 40s, 50s, 60s, with permanent employment, have been defending their own seniority wages at the expense of younger people, who are probably getting paid less than what they really produce. This is a source of tremendous inequality, but also of unfairness. Not paying a person for what they produce is unfair. And that is, I think, a serious social problem, because it's holding young people back, and it's giving them incentives *not* to acquire the skills they need.

So you can say, yes, social stability's a good thing, but too much social stability today leads to more social instability later on, particularly in the labor market.

**Porté:** I think you've laid out the question very well, Susan, and I would say this: in a phrase, Japan is the slow-motion movie of resolving a banking crisis. The United States right now is the fast-forward film of resolving a banking crisis. But it's not clear to me that either speed is the correct speed. And to put that in context, the question we should ask ourselves right now, if we look at the Japanese history, is "Are we in 1998-1999, or are we in 2002?" The reason that is important is that if we are in 1998-99, which to describe that briefly, is the first capital injection, the second capital injection, the economy is moving down, the crisis is upon us, we realize now we have a systemic crisis and we have to act, but we still don't have all the tools, we don't have a clear plan, and the public isn't with us.

Then, if we're in 1998-99, we have a long way to go. In addition, we have not recognized the truth about all those bad assets. And let me tell you, if you spend any time watching CNBC, and you think that any of these people are telling the truth, you are, you know, kidding yourself (laughter). But if we are in 2002, then that's a different story. We know where we are, we have one version of the truth, we have a pretty good idea that we are dealing with systemic risk. And we have all the tools that we need and we just have to work our way through it. It doesn't get done in 100 days, but it probably gets done in a year to eighteen months. And we'll be fine. I think that that's the key thing. Right now we have some policy makers who seem to just be insistent that we're not Japan in any way, shape or form. And I would say, it's a little bit too early to say that.

**Feldman:** Yes. If I could add one other little thing: the words "fast" and "slow" have to be used relative to the demographics of the country. Because the aging of the population is *so* much faster in Japan than in the United States, the Japanese have less time (and even in the 90s, they had less time) to deal with this. So my sense is that you have to pace your financial and economic reforms relative to the aging of the population.

**Pharr:** Thank you. Andy Gordon.

**Gordon:** This was absolutely fascinating. One thing that you didn't talk about today—that may be simply that your focus was financial reform—during this period of fifteen years that you're talking about, a different sense that the problem was systemic in a much broader way was all over in the public discussion in Japan. There was a sense that Japan has so much inefficiency in the real economy which have to be dealt with and transformed before things can get set right again, whether it's agriculture, services and distribution, etc. To the extent that getting the financial reform right allowed the early 2000s until recently to have a reasonably strong economic performance, would you not agree that the essence of the problem was systemic in that sense?

**Feldman:** I think that we've got two systemic problems; one is the financial systemic problem, and the other is, call it "the systemic problem of resource under-utilization," which I think is not so much an economic system-only problem as the interaction of the political economy with the (call it) "economic economy." There are obviously vested interests that would love to remain in power, even if the economy is weak, vis-à-vis the rest of us, who would like the economy to be better regardless of who is in power. And unfortunately, the way decisions are made, and the way decisions about how decisions are made, are both still controlled by a relatively narrow group of people. And so I think that the systemic problem is not so much one of resource under-utilization, although that is a problem. The problem is: Who decides how things are decided?

**Porté:** Yes, I think the focus of our talk was clearly on the financial issues, but I would agree with Robert, it is really the allocation issue that was at stake here. And progress was made on some fronts, but others were lost in the context of other battles. As Robert has described in his construct of the CRIC cycle, I think that complacency which often follows improvement has a great impact. Whenever we experienced, over the course of the 1990s, *any* improvement, we then immediately fell into a complacency phase.

**Feldman:** People get lazy fast.

**Pharr:** Sorry, I'll take a question here, and with great apologies, we do have to end with this question, so if you could keep it brief.

**Questioner:** This idea of marking assets to market, the fourth area in terms of truth in asset valuation. Is my perception incorrect, that Japan and America are now going in opposite directions? That Japan was called upon to, mark their assets to market, and would have done so, but now, with the recent ruling of the Securities and Exchange Commission that American institutions are no longer necessary to mark it and it can be put on book value? Have we gotten towards truth in asset valuation in any way?

**Porté:** I think that it's a little bit more complex than that, but there's no doubt that the United States has taken a step back from the pure mark to market accounting. The commissioner of the Japan FSA made a statement last week that disagreed with that decision on the part of the accounting authorities here in the U.S. So, yes, we're moving in a somewhat opposite directions. Now, I think there's been a little bit less rigor in some

of the assessment in Japan. But I think that that is right, and I think that brings up another point that I have to say I feel duty-bound to state: over the course of the 1990s, whether as private-sector actors or American government officials, we went to Japan and we said to our Japanese counterparts, “You have to nationalize your banks. You have to use mark to market accounting. My goodness, how can you *imagine* stopping short-selling? Don’t even think about that, and get this market moving!” This is what we did at that time.

We did not recognize that there were so many things that needed to be put in place that were simply not there, and that take time. You can look at the state that we’re in today. I think that we have good reason to be humble in America. I certainly feel that way.

**Feldman:** If I could add just a little thing to that: the history of mark to market accounting is also very interesting. It’s very recent in the United States. An accountant told me about this, and he said “the real reason that mark to market accounting was introduced in the United States is the accountants didn’t want to get sued.” Because they were valuing things at different prices and if somebody came and sued them afterwards, they were subject to legal liability. So they said “Okay, let’s use a market price, because that’s independent,” whether that market price made any sense or not. So the whole mark to market movement wasn’t really based on economic logic; it was based on legal protection for the auditors. And so if that’s the case, then we have to think, once again, about mark to what? Is the market always right? Obviously not. As an economist, it’s painful to say so. But it’s a fact, and a well-established one in the face of much convincing theory and evidence from public goods, information asymmetry, economies of scale, network economics, and recent advances in the psychology of economic behavior. So, we do have to think a little bit more about which assets should be marked to market and which shouldn’t, and how long the adjustment periods should be, etc.

**Pharr:** I am sure there are more questions and comments, but I am afraid that I must bring this session to a close. I would like to thank all of you for coming, and our panelists, for a fantastic session (applause).