Can Japan’s Ailing Banking System Be Cured?

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Japan’s non-performing loan problem is not going away. Despite efforts to clean up the mess, the Japanese government estimates that banks are still mired in ¥43 trillion in problem loans, and private analysts say the actual figure may be much higher. While Prime Minister Koizumi has said he will stick to his plan to promote the disposal of banks’ bad debt over the next three years, he faces stiff resistance to restructuring from factions within his own party. With Japan’s economy still seriously hobbled, many worry that the cure could be worse than the disease, with bank restructuring sparking more corporate bankruptcies and higher unemployment. On the other side of the coin, major questions remain over how to restore corporate Japan back to health.

Still, analysts see some signs of positive change in Japan’s banking system. They point to tougher regulatory oversight by the FSA, the recent spate of bank acquisitions by American funds like Ripplewood and WL Ross, and consolidation within the industry. But while these may be steps in the right direction, analysts say much more will have to be done to address the problem of non-performing loans if Japan is to avert a full-blown banking crisis.

Can Japan’s ailing banks be cured? How will loan workouts and corporate restructuring proceed? This half-day conference tried to answer those questions by bringing senior Japanese and American politicians, policymakers, bank executives and analysts together to discuss the prospects for reform within Japan’s banking system and the continuing efforts to tackle the bad loan problem amid worsening economic conditions at home and abroad.

The conference was organized by Japan Society, New York and the Center on Japanese Economy and Business of Columbia Business School.
Can Japan’s Ailing Banking System be cured? To speak about it is obviously a daunting task not just for me but also for any policymakers in Japan. Japan’s economy appears to have entered a short cyclical recovery driven by progress in inventory adjustment worldwide. Surprisingly enough, optimism about the Japanese economy is growing again within the government after equity prices rebounded from the February low. Japan’s economy has experienced three short-term recessions during the past decade. A financial crisis repeatedly emerged during each recession period. Each recession was followed by a short and weak recovery mainly supported by inventory build up in the manufacturing sector. Overall, Japanese GDP has declined throughout the decade. Seventy-five percent of GDP consists of the known manufacturing sector in which huge non-performing loans concentrate. The fading sense of emergency on the part of the government indicates that a serious deficiency lies in the national government system.

A caveat must be placed against the optimism which is the exact same phrase I used in my speech in Washington, D.C., in 1999 when the Japanese economy was about to enter a cyclical recovery for the second time. Now I have the same diagnosis and the same prescription.

“The fading sense of emergency on the part of the government indicates that a serious deficiency lies in the national government system.”

I have to warn again by quoting a Japanese old saying; Hotoke-no-kao-mo-sando-made (Buddha condones no more than three times). Maladies of the banking systems are quite apparent. We should always start with the recognition of the grave magnitude of non-performing assets.

One year ago Prime Minister Koizumi announced that his administration would concentrate on the disposal of non-performing assets. However, the reality was to set slightly more than ¥12.2 trillion in bad loans off the balance sheets of the banks within the next two to three years. The Financial Services Agency (FSA) disclosed the
outcome of the special inspection of major banks on April 12th. This inspection covered 149 large, heavily indebted companies, the result of which reported also as only as little as ¥3 to 4 trillion to the narrowly defined disposition target of bad loans. I hope this initial inspection will be the first step in disposing non-performing loans accumulated on the balance sheets of the banks.

We must bear in mind that more than ¥80 trillion of so-called “category two loans” or substandard loans on a self-assessment basis, which is the equivalent of 16 percent of GDP, remain concentrated on real estate, general construction, retail, wholesale and non-bank sectors.

First, judging from special inspection results by the FSA, I suspect the Koizumi administration has decided to postpone the resolution. According to the FSA, no major banks are under-capitalized. As a superficial matter of BIS standards, capital might be sufficient. But in reality in the major banks, tier one core capital is ¥18 trillion, but there are two tricky items which are included in the tier one; that is ¥6 trillion of deferred tax assets that present allowances for the future income tax deduction, and ¥5 trillion of public funds that is not common stock and is expected to be repaid in the future. In sum, the hardcore capital is only one-third of the stated ¥18 trillion. Today, both banking experts and the Japanese people consider additional capital injection to the major banks to be necessary sometimes. Under the circumstances, we always have to be mindful of possible contingencies in the financial system.

Second, the weak earning power of Japanese banks undercuts the positive effect of a resolution. Japanese banks’ return on equity is below 15 percent, which is substantially low compared with U.S. banks, which generally keep over 25 percent. Three factors can be pointed out: low interest rate spreads, low service fee earnings, and high credit cost. There have been structural and historical grounds that Japanese banks’ lending practices have traditionally been based upon collateral evaluation. They have established no effective risk-based pricing model derived from cash flow evaluation.

Third, corporate governance systems should also be addressed. As a result of major bank mergers, over 15 major banks have now been consolidated into four big groups. I think the recent Mizuho problem, where ATMs and fund transfer computer systems clogged because of insufficient system integration testing in the process of mergers raised all types of corporate governance questions since the trouble apparently could have been avoided if the new management had had the merger preparation process in order. Also, it is reported that although in the early stages computer system experts had warned that trouble might occur, top management ignored the warnings in order to keep the merger schedule unchanged. We have to rebuild the corporate governance system that can take back resilience of Japanese firms.

Fourth is cross-shareholding. Along with life insurance companies, Japanese banks are one of the largest investors in the stock market. The banks hold over ¥40 trillion worth of equities on the balance sheets for the purpose of maintaining long-term relationships with their borrowers. In reality, they prove to be unprofitable assets. Thus, banks are expected to sell equities outright over ¥4 trillion within two years. At this juncture, banks’ shareholding purchase corporations, the government sponsored equity purchasing entity was established early this year in order to prevent a massive wave of selling from putting further downward pressure on the stock market. In my opinion, it is ridiculous. The simple share price-supporting device addresses none of the fundamental problems associated with the cross shareholding and double gearing between banks and life insurance companies. I think enhancing corporate governance and improving transparency through full disclosure with a reliable accounting system is the only way to solve the structural problem.

What must we do to get out of the current crisis situation? Conventional wisdom. It is apparent that it is just through the disposal of bad loans and putting the real assets—for example, real estate or

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viable divisions of failed corporations—back to work in the real economy is an inefficient way. How do we do it? I think the answer is quite simple. First, establish stringent rules for evaluating bank assets and provision sufficiently and recognize losses. Second, remove bad loans from balance sheets and, if necessary, nationalize banks or inject public funds. Third, revitalize asset markets by way of tax and legal system improvements.

These measures are adopted in the U.S., Sweden and more recently in Korea. In Korea, 7 percent of GDP has already been spent to clean up banks’ balance sheets. Aggressive asset disposal was quite effective in de-leveraging the corporate sector in Korea. With respect to bank restructuring, the Korean government took aggressive actions such as capital reduction, drastic business remodeling, management from outside the banks and compulsory mergers. We already know what we must do.

At this juncture, the weak capital market function must be addressed. It is apparent that when a banking system does not function well, capital markets should play the role of financial intermediary. Japan’s capital market, however, has failed to attract both foreign and domestic investors. Out of ¥1,420 trillion worth of household financial assets, only 7 percent is in equity markets, and only 2 percent in mutual funds, while 54 percent is in bank deposits and postal savings. Let me make four points regarding this.

First, investors do not trust Japan’s accounting system. This must be improved, such as the quick introduction of an accounting rule for impairment of fixed assets. Second, the creation of a strong and independent SEC is necessary to ensure fair trading. Third, an independence of mutual fund industry from apparent broker dealers must be protected for the purpose of enhancing transparency and restoring trust of investors. Fourth, capital gain taxes should be effectively reduced to zero as long as the Japanese economy lacks the risk capital in macro terms. I believe that as long as Japanese banks have limited capacity to manage assets well, we have to improve capital market.

In conclusion, there are three possible scenarios for the course of reform in the financial system. First is a compulsory and aggressive resolution like in Korea; second is to continue to conceal the current crisis situation; and third is a pre-emptive, sporadic nationalization, like in Sweden’s case. Many people may think that my remarks are pessimistic about the future reform of the Japanese banking system. In the short term I must admit that, but in the longer run that is not correct. I am optimistic about the long term because the problem we are facing was originally caused by the speculative bubble burst. From the speculative bubble in Holland in the 17th century and the South Sea Bubble in England in the 18th century, various forms of economic bubbles have occurred. However, history tells us that no nation has disappeared or declined simply due to the bubble burst.

However, behind the prolonged crises lies our governance problem not only in the business sector but also in the political sector. As massive political scandal has broken out in the Diet in these times, Prime Minister Koizumi and his administration seem to be losing political determination to proceed with the resolution. In this sense, Japan’s situation is such that everything is politics. As I mentioned, every market participant acknowledges that banks’ core capital is fragile, which means if accounting changes, capital shortage must be recognized and the crisis can suddenly emerge—meaning any political switch can be a possibility for drastic changes in the course of reform policy.

The problem we are facing is not the inability to envision solutions, but the inability to put them into practice. As a politician I believe what is most needed now is the political will to restore the functions of financial markets for the sake of national interests, as well as for the benefit of the international economy.
Q: If the problems have been identified and the solutions are out there, what are the political forces that are against reform and why?

SHIOZAKI: The reason why the bad loan resolution has not been accomplished yet is that heavily in-debt companies, major banks, and the FSA are all in the same boat. They're playing the politics and avoiding whatever disadvantage might occur.

Q: Do you foresee any changes in the nation’s policy leadership in the financial services area? And do you think there will be any new major bank reorganizations or consolidations, mergers in the near future?

SHIOZAKI: Koizumi is now thinking of reshuffling the cabinet and that might change things a little bit. But it’s all up to the prime minister how far he would go in that resolution. And the second answer is yes, probably there are going to be some waves of consolidation in the financial industries. But that might happen when a crisis comes and otherwise not much would happen, as I see it.

Q: Do you think the Japanese public is ready to take the hard medicine that needs to be done to solve the banking crisis?

SHIOZAKI: I think they were last year and I think still it is never too late, and Koizumi can persuade them of that.

Q: I sense some resentment in Japan about recent government bond rating downgrades by Moody’s and S&P, and I wonder if you feel that those downgrades are fair and whether or not there could be resentment in the general public that the outside world or certain Western institutions are treating Japan unfairly?

SHIOZAKI: I wouldn’t say it’s fair or not because it is a practice of the private sector. What we should get from that as a message is that we fail to convince our controllability and manageability on the economic policy front.

Q: Do you think Japan still needs postal saving as a financial institution? Because it’s huge and everyone thinks it’s deterring healthy competition around Japanese financial industries.

SHIOZAKI: Well, since I’m not in my election district, I would say yes. It’s unhealthy to have ¥370 trillion worth of public money through postal savings and postal insurance, which is over one-third or one-quarter of total household financial assets.
Cleaning Up Japan’s Non-Performing Loans: A View from the Private Sector

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The exhibits before you reflect a number of items, namely ¥35 trillion of non-performing loans as of September 2001 (see Figure 1), and for fiscal year 1992 through 2001, cumulative loan losses of ¥74 trillion (Figure 2) and cumulative government assistance of ¥23 trillion (Figure 3). You heard from a prior speaker that there were $200 billion spent by the U.S. on its situation. Japan has already spent more than that, but it is obviously a much smaller economy. That helps you get a feel for the idea that these problems are much larger in scale relative to Japan than they were to here. In the last four years institutions with ¥33 trillion of deposits have failed, and in the 12 months ending in February of 2002, ¥28 trillion migrated from time deposits to demand deposits because people were afraid that with the lowering of the deposit insurance ceiling to ¥10 million on time deposits that they would have credit problems.
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NPLs outstanding in Japanese banks


Figure 1

Cumulative bank loan losses recognized

Source: Financial Services Agency; loss on disposal of bad loans includes net transfers to allowance for loan losses, direct write-offs and other bad loans dispositions. Figures include all banks except for 1992–1994, which are only composed by data from city banks, long term credit banks and trust banks.

Figure 2
There are 20 major hypotheses about Japan’s banking crisis that have been suggested by various observers. The official position is that the government asserts that the problems are largely identified and under control. The remaining 19 opinions are more negative. First, banks in the economy are so intertwined that neither can be fixed until both are fixed. Second, bank problems are so large that there must be wholesale nationalization, international takeovers or both. Third, the yen may have to drop to 150 to the dollar to stop internal asset deflation and to stimulate exports. Fourth, Japanese banks should improve their BIS ratios and returns on assets by securitizing loans. Fifth, the banks have such severe IT hardware and software problems that it will take years and billions of dollars to solve them. Sixth, banking problems can be solved only by radically changing management practices, not just infusing capital. Seventh, the banks have virtually all of their equity capital invested in cross holdings of equity and therefore are fundamentally unsound. Eighth, banks need higher interest rates so that they can earn their way out of the NPLs but the borrowers cannot afford to pay more.

Ninth, until Japan’s public debt markets develop, demands on the banks will continue to exceed their capacity. Tenth, many feel that banking consolidation simply creates institutions that are too big to fail, and therefore, guarantee eventual de facto nationalization. Eleventh, dropping government insurance on all deposits over ¥10 million next April 1st, some people fear, may create a new banking crisis. Twelfth, it is essential to privatize and break up the postal savings

“Banking problems can be solved only by radically changing management practices, not just infusing capital.”
system so that it does not compete so effectively for deposits. Thirteenth, even the recent special FSA investigations may not have forced the banks to acknowledge all of their problem loans. Fourteenth, even the expanded mandate of RCC has not created enough buying and selling of non-performing loans. Fifteenth, there also may be a new crisis in 2002–03 as very large amounts of banks’ subordinated debt mature and need to be refinanced to preserve capital ratios. Sixteenth, real pessimists articulate that new loans are going bad as rapidly as the banks write off the old ones, so they make no net progress. Seventeenth, bank capital is weaker than it appears because as you heard earlier, 31 percent of it is deferred tax assets, at best a highly contingent item. Eighteenth, corporations have such high leverage and such low returns on assets that huge NPL levels are inevitable and permanent. The last and most pessimistic is the observation of some that government may just be paying lip service to reform.

My own conclusions are first to reject the last opinion. The Koizumi administration is making an earnest effort to deal with the problems of the banks. In my view there is validity to the other 18 concerns, and because there are so many complex issues and because the banking crisis is so many times larger relative to Japan than ours was relative to the U.S., it will take more time to resolve. But if three factors occur over the present fiscal year, I believe that real progress will be evident. First and most important, the yen must drop significantly relative to the dollar. A $0.20 decline in the exchange ratio would add about 1 percentage point to the Japanese GDP. The foreign exchange change would also arrest the internal deflation of asset values. Whenever a currency is seriously overvalued, internal deflation inevitably follows.

Second, the FSA must really pressure the banks to divest of NPLs. The only real way to resolve the adequacy of reserve issues is to have the loans sold. Then there will be no debate. If they are sold to investors who make them into equity and help the borrowers restructure both their balance sheets and their businesses, the commercial sector of Japan will be rationalized and improved.

Third, government must stick to its announced schedule of dropping the insurance limit on all deposits to ¥10 million as of April 1, 2003. Market versus long term will be stricter regulators than any government, but this would be the first time that depositors will really have to make credit decisions about banks and, therefore, government must take measures to prevent the wholesale flight of municipal and provincial government deposits, otherwise there could be runs on the smaller institutions.

If these three factors occur, I believe that a year from now Japan Society will be able to host a follow-up conference with justifiably a more confident tone than is possible today.
banks are concerned—are safe and sound and solid. I have to admit that we have to go muddling through but the steady approach is the only way to go. So, there are no dramatized approaches that are clear. We have to go forward step by step and the FSA and the Ministry of Finance is determined to do so.

First, I would like to touch upon the results of the special inspections that Mr. Shiozaki mentioned. The Financial Services Agency (FSA) has published the results of the special inspections last month. The special inspections focused on the loan classification of large borrowers whose stock prices, external ratings and other indicators had been undergoing significant changes. The inspections gathered broad attention in Japan because some people insisted that some banks, depending on the results of the inspection, might need a public fund injection. Out of 149 targeted borrowers, 71 were downgraded, including 34 re-classified as “in danger of bankruptcy” or below. The capital adequacy ratio, however, ranged between slightly above 10 percent and around 11.5 percent for internationally operating banks, and between slightly above 8 percent and around 10.5 percent for domestically operating banks, even after strict special inspections. As far as the major banks are concerned, they have a sufficient amount of their own capital and do not need public fund injections.

Non-performing loans are a heavy burden on the banking system and are partially responsible for the sluggish economy in Japan. New non-performing loans, however, have emerged mainly because of deflation. Even if banks take drastic measures to dispose their non-performing loans, new non-performing loans appear continuously under deflationary conditions. I think the most fundamental problem is deflation of assets such as land and equity after the bubble bursts, which caused a demand shortage, and therefore, deflation of commodity prices.

Under deflation, the virtual burdens of existing debts increase substantially and real term interest rates become high. So, under deflation, it is very natural for enterprises, particularly those that already own heavy debts and real estate, to fall into difficulties in repaying their debts as scheduled even if they have profitable projects. Therefore, measures to dispose non-performing loans should tackle at the same time both microeconomic tasks, namely banking and enterprise sector reform, and also macroeconomic tasks—namely, anti-deflation measures.

Basically, the non-performing loans’ disposal is a matter of the private sector, but in the case that non-performing loans amount to such a level that it affects the macroeconomy, the government should intervene in the disposal. There are several ways for the government to take measures: first, setting a time frame for final disposal; second, provisioning and providing frameworks for facilitated disposal of non-performing loans and for corporate restructuring; third, strengthening bank supervision and disclosure of banks’ financial status; fourth, promoting consolidation of financial institutions. The government has called for the major banks to remove outstanding and non-performing loans classified as “in danger of bankruptcy” off banks’ balance sheets, and those classified as “in bankruptcy” to be removed over a two-year-period. New non-performing loans have to be eliminated within three years from the date they are classified as a non-performing loan.

The FSA has been strictly monitoring the progress being made in the disposal of non-performing loans. The FSA set up more concrete goals, as Mr. Ross mentioned just now. Last month, in order to accelerate the removal of the non-performing loans from banks’ balance sheets under the time frame I mentioned a moment ago, banks are now requested to tackle specific measures to dispose, in principle, half of such loans within a year and a major part of such loans—I mean around 80 percent within two years.

Removal of non-performing loans from banks’ balance sheets may be carried out in three ways. The first way is through the sale of these loans. The second way is through the legal procedures based upon the Bankruptcy Law or the Civil Rehabilita-
tion Law, similar to U.S. Chapter 11 proceedings. The third is through out-of-court corporate work-out with such financial measures as securitization and debt-equity swap arrangements. All major banks have been urged to accelerate the disposal of non-performing loans by such measures, as a sale to buyers including the Reconstruction and Collection Corporation (RCC). The RCC is also expected to aggressively purchase non-performing loans. The RCC was established as a 100 percent subsidiary of the Deposit Insurance Corporation to facilitate banks’ resolution of non-performing loans problems. The RCC has now expanded its functions in securitization of non-performing loans and real estate’s collateral utilizing recent relicensed trust banking. The RCC has already put such securitization in practice. Furthermore, the RCC has been granted flexibility in deciding prices at fair value to facilitate the purchase of non-performing loans based on the recently revised Financial Reconstruction Law.

The RCC is to make efforts to resolve such purchased non-performing loans within three years. The RCC is also to actively deal with corporate restructuring. It has already given results for more than 40 cases of corporate restructuring. In addition, the RCC is to participate in the “Corporate Restructuring Funds, what we call “deleveraging funds,” to be established by the governmental financial institutions such as the Development Bank of Japan (DBJ) and private investors.

I heard some funds have been established. The DBJ is ready to invest up to a total of ¥100 billion in these funds. The funds purchase stocks that banks and the RCC have acquired through debt-equity swaps. These funds are expected to be powerful vehicles for corporate restructuring.

In order to strengthen the bank supervision the FSA decided to establish a de facto resident inspector system. Inspection units are to be reorganized corresponding to each major banking group so that each unit can continue, throughout a year, to inspect the banking group under its responsibility. In addition, the FSA is going to conduct inspections focused on specific functions such as internal audit systems and the risk management systems across the banking group by special teams, including amply experienced experts recruited from the private sector. The FSA will explore measures to promote consolidation of financial institutions with particularly regional institutions in mind to strengthen their profitability and to ensure smooth financing of small and medium-sized enterprises.

I am not going to say much about microeconomic policy today, but all of you here understand its importance. Without getting out of deflation, we will not be able to get completely out of the non-performing loans problems. There’s no “good deflation” in the real world. Deflation is punishing borrowing corporations and entrepreneurs, which are the engines for economic development. Deflation is an agonizing problem which impacts society. Since deflation is a monetary phenomenon, the major player here is, needless to say, monetary policy. We continue to need expansionary monetary policy.

As for budgetary spending, there is little room for quantitative increase. However we can make budgetary spending more effective by giving priority to spending that will induce more private investments such as urban revitalization, science and technology and elder care. The structural reform such as deregulation will not only elevate potential economic growth on the supply side, but will also stimulate economy on the demand side.

Now, we are seeing some signs of a bottoming out of the economy in Japan, as Mr. Shiozaki mentioned. It is high time for us to intensify our efforts to realize sustainable economic growth. The FSA and the MOF, under the Koizumi administration, is determined to steadily move forward. Today we have a lot of investors and experts here. Your investments and advice are always welcome to Japan.

Can Japan’s Ailing Bank System Be Cured?
I WANT TO START WITH three general statements. First, today I believe we are talking about the world’s most significant international economic problem. It always surprises me how little attention it gets. Second, this problem is getting worse, not better. To date, the Japanese government’s policies have attempted to contain rather than solve the asset quality problem. I believe that containment is not a sustainable strategy as we move toward the end of this decade. Third, during this containment the interplay of declining asset values, demography, the rating agencies, and government fiscal and monetary handcuffs are all acting to reduce the available policy options that the Japanese officials will have when they finally confront the need for a solution.

It goes without saying that it is impossible to project a healthy economy in Japan over the near or medium terms unless the country enjoys a healthy banking system. In turn, and connected to that, it is impossible to project sustained growth throughout most of Asia without a healthy Japan. I think one of the many under-analyzed phenomena in the last 10 years was the role of the Japanese banks in the so-called Asia Crisis in 1997–98. Most of the bank capital that left Southeast Asia before and during the crisis was in fact Japanese, and it was reacting to the need to bring capital home to shore up weakened balance sheets and equity accounts for regulatory reasons.

That syndrome or behavior pattern is really paramount when you look at the Japanese situation itself. First, we are dealing with extraordinarily tough, hard asset deflation. It is difficult to come up with parallels to that hard asset deflation, which is all around collateral. Some of the parallels are deflationary periods in more or less agricultural societies, and those had a duration much longer than the kinds of business cycles one gets in a more manufacturing-based society. At the moment, the essence of this problem, as it affects the Japanese banking system, is deflation in real estate values affecting collateral accounts. As asset values decline, bad loans multiply.

Connected to that is capital adequacy. I think the whole BIS standard issue with respect to Japan is an interesting one. When history is written in the next century, I think the treatment of the cross-holding stocks in Japanese banks at the original BIS capital allocation process by the world’s regulators will be seen as a mistake. Absent that, please remember that BIS capital standards, whether it is Basle I or Basle II, have the functionally equivalent effect on a financial institution that the gold standard had on countries in the 1920s and ’30s. If you write off a loan and do not have new equity to replace that asset within your capital account, you are forced to shed good assets to keep yourself in regulatory compliance. This is the self-fulfilling prophecy going on in Japan, and it is one of the reasons why it is so difficult to solve the problem.

A third factor, profitability, I think—and I take Wilbur’s point about how the size of this problem dwarfs the size of the U.S. in the early 1990s. Nevertheless, one of the ways the U.S. banks did get better, especially the commercial banks as opposed to the S&Ls, was that they were given a sweetheart interest rate climate where they could put very simple interest margin profits into their capital account and try to solve that gold standard problem with the BIS capital ratios. I think that is a policy prescription which I will get to, but there is not much of an interest margin right now in Japan at these nominal interest rate levels.

Market perceptions are another factor that everyone has to keep in mind. I had a friend that works at Citigroup who once described the rating agencies as the people who go out on the battlefield and shoot the wounded. That was in the midst of a happy negotiation with the Korean government. But when you consider that, and consider how
much a part Japan is of the international economy, the way the rating agencies are going at the moment vis-à-vis Japan, this crisis elicits so many declarative statements that people never think through. One of the most common is that Japan is still a net lender to the world. It is absolutely true. Japan has hundreds of billions of dollars in net foreign assets. But in fact, the foreign assets and foreign liabilities are not matched. The Japanese institutions with the net foreign assets are not the Japanese institutions with the net liabilities. As a result, the banking system as a day-to-day participant in the international markets is vulnerable to many things. In an era where there is a declining yen, most Japanese banks access the international market system to do something in dollars, euros and yen. As the yen deteriorates, other participants’ (American, European, etc.) exposure to the Japanese banks grows as a result of that devaluation. They are obviously prone to the same rating agency scrutiny as Japan is. Again, it is a self-fulfilling prophecy. Many people call that “wrong way exposure” or “correlated exposure.” I am saying that notwithstanding the fact that most arrangements of big international banks with Japanese banks in this day and age are collateralized, exposure to Japan will be an increasingly “hot topic.”

Finally, I think there are several policy prescriptions. First, there must be a shift away from containment to solution. Second, there must be greater transparency, disclosure and regulation. Third, there must be confidence among Japan’s international partners. Where is the bottom? No one knows right now. The core of the Japanese problem is real estate. There could be government programs that take over bank-owned real estate in some form or another, and separate that out from the corporations that cannot pay their bills. That is a typology that might be politically easier for the Japanese authorities to confront. Fourth, if we are going to devalue the yen (and again I agree with Wilbur), every effort must be made not to do it in a dramatic or quick fashion. This underscores my point: the longer this goes on, the more dramatic the solution will have to be. What the world does not need is a big foreign exchange move at the same time as some sort of capital controls are put in Japan. The effect of that on Southeast Asia, Korea and especially China is not something any of us want to think about.

JAMES McGINNIS, Senior Analyst, Mizuho Securities Japan

GIVEN THEIR PRESENT CAPITAL ADEQUACY ratios, the Japanese banks have basically done all they can do. Japanese banks will solve this problem within the time period that they are able to acquire the earnings. They are going to write off bad debts at the same pace that they earn money. No amount of government regulation is going to change their minds. From the Bank of Japan’s standpoint, Governor Hayami has already engaged the enemy. It comes down to whether or not Mr. Shiozaki, the Ministry of Finance, is prepared to play ball because ultimately it matters if this will end on peaceful terms or in full-scale war?
I think that the Resolution Credit Corporation (RCC) is the primary solution to this. You have to use the RCC to buy the bad debts from the banks at a level that will not bankrupt them. You cannot apply a static solution and inject money into the Japanese banks because you do not know what the size of the problem is. The argument about market value is ridiculous because there is no secondary market to price the loans. The only transfer price can be the original loan volume minus the reserve amount, and you have to decide on what the reserve amount is. If you decide the reserve amount is 20 percent, they are gone. If you decide the reserve amount is going to be something less, then they are not gone. You must decide that number, and then take those loans off the balance sheets of the banks.

How do you fund the problem? You can fund the problem by having the Japanese banks lend the Japanese government the money to buy the loans off the balance sheets. The Japanese government issues a guarantee. It becomes sovereign risk. They are not counted as risk assets. Take those companies into the RCC. If you want to restructure the companies do so with government money. I am not an expert on the auto industry but, in fact, the reconstruction of Nissan is not because Carlos Ghosn is a genius, but because the Japanese Development Bank put ¥500 billion into that company. There is no way that IBJ and Fuji, which comprises the present Mizuho Group along with Dai-Ichi Kangyo Bank, could have handled that problem. If you want to reconstruct the companies, take them into the RCC, use the Japan Development Bank, and lend the money to them. If they go bankrupt or you decide to put them into receivership, then you have two options: the government can pay for all those losses, or you can allow the banks to amortize them over a period of time just as you are allowing the under-funded pension liabilities in corporate Japan to be amortized over a 15-year period. This is pretty much the only way it is going to work.

As for double treatment of large borrowers and small borrowers, the bad debt problem in Japan has now reached the cyclical side. In the West, you rarely see the cyclical side because the economy cleans itself on an ongoing basis. In the final analysis, if the bad debt problem is not addressed, it will not be the major banks that go bankrupt. It will be the Japanese regional banks. The regional banks, regardless of their position or country, always protect the big borrowers. They always build firewalls around them.

"If the bad debt problem is not addressed, it will not be the major banks that go bankrupt. It will be the Japanese regional banks."

My experience of nine years in the banking industry on the credit side, before I became an equity analyst, was waking up every morning to the news that some dress shop, coffee shop or dry cleaner went bust. Are these small companies going bankrupt every day? Yes. They comprise 70 to 80 percent of the loans of a regional bank. They do not comprise 70 to 80 percent of the loans of a major bank. That is where the ultimate problem is going to crop up if you allow the cyclical side to continue. I think it is a rather simple problem. It is a matter of the Japanese government engaging it. You cannot give a blood transfusion to somebody and say we are going to give him a pint of blood because you do not know if he is going to bleed two pints or three. You must get something in there that deals with this in a flexible manner.
Q: If one advocates a depreciation of the yen to 150 or whatever number in that range, how does one avoid this becoming a very rapid adjustment with all kinds of problems once it becomes a policy objective?

ROSS: Nobody is saying the yen should go from 128 to 150 in 24 hours, nor is anyone suggesting that it should be a formally articulated policy of the government. I think international politics would not permit that. I do think what is essential and probably the way to get there would be at a creeping pace. As some of you may be aware, the yen had been a lot closer to 100 two and a half years ago than to the 130 odd level that it got to. And I just think that the way of the world should be that the yen gradually morphs its way down to something like 150.

Q: Mr. Honda said there is no good deflation. Maybe asset deflation could be handled differently by just letting things rip fairly early after a bubble, and for the market to clear and get it behind you?

HONDA: Yes, there is good deflation theoretically, but I said there is no good deflation in the real world. If the deflation that is happening really in Japan is a good deflation, the GDP should be increased because the good deflation might be caused by the production, productivity increase or cut cost of the distribution system. In that case, the GDP also should be increased at the same time. But what’s really happening in Japan is GDP is not increasing upward. So, the deflation is just because of the demand shortage in Japan.
Corporate Restructuring & Workouts of Japan’s Bad Loans: How to Proceed?

Presider:
HUGH PATRICK, Director, Center on Japanese Economy and Business, Columbia University Business School

Presenters:
KEN SUKE HOTTA, Chairman, Morgan Stanley, Japan Limited
RICHARD A. GITLIN, Partner, Financial Restructuring Group, Bingham Dana Murase
TIMOTHY COLLINS, Chief Executive Officer, Ripplewood Holdings, LLC

KEN SUKE HOTTA, Chairman, Morgan Stanley, Japan Limited

The future of Japan’s economic rules depends largely on its banking system where banks can make a profit. There is some good news to witness reforms going on in such areas as the accounting standards, the bankruptcy laws, etc., but not enough. The first and utmost concern is whether initiatives to eliminate non-performing loans will bear fruit. As it started last month, the termination of the full guarantee on the banks’ time deposit will force competitions in the banking industry, correcting “over-banking” through industry consolidation. Something we have seen more of in recent years. In brief, the Japanese economy could start to grow by weeding out “zombie” banks and the companies. But, unfortunately, the Japanese government and the banks seem to be stuck again.

A useful way to think of Japan’s economic situation is to look at the model our economist Robert Feldman uses: the “CRIC” cycle. This cycle shows that poor policy responses to crises will prevent substantial...
improvements, leading to complacency. Naturally, the complacency generates another crisis. Japan has gone through three of these cycles over the last ten years. By the fourth crisis, at the beginning of 2001, we had all hoped that this time, with Prime Minister Koizumi’s new initiative, Japan would finally be able to make strong and immediate reforms to break out of this cycle and realize a fresh, new era of economic health and growth. During the past year, Koizumi’s reform agenda suggested a need for several surgeries. But what is happening is various anesthetics are being used and no serious surgeries are being performed. Accordingly, the ultimate and effective responses have not come on the scene yet.

One of the frustrating things in the financial sector is that Japanese banks, a central factor for Japan to break out of this CRIC cycle, have not been able to produce a viable new revenue model, leaving the conventional “jack of all trades.”

I believe we need to take more drastic steps to reconstruct a healthy banking system and thus rehabilitate the Japanese economy more quickly. There are different alternatives with varying degrees of speed of action and government intervention. Figure 4 presents four possible scenarios in terms of the methodology. The vertical axis shows the degree of speed and the horizontal axis shows government intervention.

Quadrant two is the “hard-landing” approach, meaning the government forces the bad bank to exit. In quadrant one and quadrant three, these scenarios take a “soft-landing” approach, meaning that you wait for better visibility by circling over the airport and eventually run out of fuel and crash. Quadrant four represents no action, or “the rising tide will cover all” approach.

I believe the top right quadrant, nationalization with RCC’s active involvement, is an option Japan needs to push banks and corporate restructurings forward. This approach requires that first, banks assess their loan portfolio very stringently and swiftly and set aside sufficient reserves; second, banks with a
capital shortage should be divided into “good banks” without NPLs and “bad banks” with NPLs; and third, “good banks” and NPLs should be sold separately via a market mechanism. In this option, taxpayer support is indispensable. Therefore, “transparency” and “justice” through the market mechanism are a must to this healthy process.

“For bank management, the time is now to stop waiting and wishing for God to save the economy.”

Much needs to be done, but we have a chance to do things right. Everyone benefits from a reformed, strong and open Japanese economy and financial sector. These changes involve many players from different backgrounds, each with a positive role to play. For bank management, the time is now to stop waiting and wishing for God to save the economy. Rather, to reinforce restructuring efforts more aggressively and create a strong earning model, set an imperative management goal such as the ROE, or the numerical target of the shareholder value. If it is not achieved within a reasonable time frame, say a year or two, the management should exit. If it is achieved, they should be properly rewarded.

For the corporate world, it is time to focus anew on the core businesses to regain profitability and productivity. For the regulator, focus on overseeing the banks’ management goals and results. Stop discretionary guidance. Rather, encourage bank management in order to produce a more profitable business model. For the nation’s leader, push forward with an agenda of reforms without getting side tracked by vested interests in the limited sectors of the economy. He must not hesitate to use taxpayers’ money for resolving this banking problem. For the investors, Japanese or non Japanese, consider the potential opportunities from Japan’s restructuring, and the very attractive returns on investing risk capital and management skill in Japanese assets. If we can all push forward, challenge becomes opportunity for everyone.

**RICHARD A. GITLIN, Partner, Financial Restructuring Group, Bingham Dana Murase**

Japan has accomplished a great deal over the last two years in putting into place techniques that allow for corporate restructuring. They have adopted the INSOL principles, which are guidelines for out-of-court restructuring. They adopted the Civil Rehabilitation Proceeding, which is similar to Chapter 11, and they have actually done some DIP loans through the Development Bank of Japan.

We know these can all be improved, and in fact they all are being focused upon in Japan. However, it is not the lack of technique that is inhibiting restructuring in Japan. Japan is not restructuring its companies in an effective way to reallocate capital, notwithstanding all these accomplishments.

Why is restructuring so important and what can we do to stimulate restructuring? Figure 5 compares how different countries address problems when they occur in their economic cycle. The left-hand corner of the figure illustrates when the company first gets in trouble. The right-hand corner represents liquidation of the company. The U.S. has developed techniques over the years to fix companies early. The UK’s law is not as effective as the U.S. in doing that, but they still have managed to create informal systems in the UK to fix
companies early. Fixing companies early enough creates jobs because you are reallocating the capital in time. Unfortunately, Japan fixes companies down in the lower part of the quadrant. Every time you wait to fix a company, regardless of where you go in the world, you shift from a foundation of growth to losses. You shift from the potential of job creation to job loss. Had companies like Mycal been addressed two or three years earlier, the pain would have been far less for Japan.

What do we do when we restructure? What is it all about? Why do we emphasize restructuring? Those of us who restructure simply reallocate capital. You try and get capital from a nonproductive use to a more productive use. Figure 6 illustrates approaches one may use restructuring three different companies; a good company, which needs fixing; a bad company, which really has no future but it has some very good businesses within it; and a bad company that has no good businesses with some capital that is tied up and not being used productively. What do we do? In the good company we often do debt for equity conversions. We sell their non-core assets, invest the money in the core and fix the balance sheet. In the bad company with some good businesses we take the good businesses and put it in the hands of someone who can invest money in the businesses. When we liquidate a company at the end of the day, we free up capital and assets, and they are used more productively someplace else in society’s economy.

“Fixing companies early enough creates jobs because you are reallocating the capital in time.”

Frankly, all of them reallocate capital. The more efficiently you approach restructuring when you have a problem, the quicker you will rehabilitate your company. I think one of the reasons the U.S. bounces back so fast from downward economic cycles is because we actually do that very well.
What will stimulate this in Japan? Until the banks in Japan move from a reserve strategy to a value strategy, it is not going to happen. They have to think about how to maximize the value of the problem loan. The only one that is going to get them to move in that direction is the government, and the government is going to require sticks and carrots to do it. Whatever philosophy is developed, if you encourage the banks to tackle a good company and make it better, that will be good for the economy. But the banks have to take a capital hit. Japan should reward banks with capital if they take the right actions, and toughen attitudes toward them if they do not. The two must be intricately tied together.

We need a coordinated policy to get this done in Japan, because when you look at the pieces that have to fall in place for restructuring everybody has a small role to play. It really does not fall well on any one institution in Japan.

Japan should be thinking about what industries to stimulate, how to do it, and how to integrate policy. There are not enough people within the labor group in Japan who know how to go into companies and turn them around. It is not a subject that has been focused upon. We did not have those in the U.S. in any meaningful way until the RTC. Now we have a huge industry. There is a role to be played to stimulate industrial growth in Japan.

I have recommended that there be a limited-term minister appointed for the purpose of coordinating policy for restructuring companies and banks in Japan. This certainly could be part of the Office of the Prime Minister.

In effect, when we put together the Deleveraging Fund in Japan, it was a mini version of this. It was building levels of cooperation between the FSA, METI, the Ministry of Finance and Development of Japan. The fund emerged only when consensus among the agencies was achieved.

The more we can get good examples of Japanese talent and Japanese money participating in this process, the more accelerated the process of restructuring will be in Japan.
IN 1974 AND 1975 I was a member of the United Auto Workers grinding crank shafts. I remember walking out of the plant for the last day, being laid off, being 18 years old and not particularly worried about my future. I was off to college. I also remember spending a year of my life with other members of the United Auto Workers who were not so sanguine about how they were going to pay their mortgages and car payments, or feed their children. They were looking out on a very grim reality in corporate America. We should always remember when we are critical of Japan or impatient about the rate of change that we have forgotten many of our own trials and tribulations. Remember that Chrysler almost went bankrupt, that IBM almost disappeared and that General Electric was not always heralded as the industrial success that it has been.

I have two general observations to make. First, while there are many unique problems in Japan and many unique elements of the business culture, there are also many elements that parallel the U.S. experience over the last 25 years. I would be remiss if I did not mention that a large part of our tentative success in Japan has been because we recognized very early on the uniqueness of the needs and of the culture in Japan, and we are sensitive to that. But there are many parallels in terms of where corporate governance was in the U.S. 25 years ago and in terms of the impediments we faced 25 years ago. These parallels are valuable and instructive as long as they are enrobed in the reality that Japan is importantly unique.

The second observation from my anecdotal experience is that while there are many problems, concerns and issues about the Japanese economy, the glass is also half full given the extraordinary strength of the underlying Japanese industrial fabric. In the last month or two I read a McKinsey study about the sources of productivity growth in the U.S. over the last seven or eight years. The counter and intuitive observation was made that a great deal of the productivity came in sectors that were not correlated with massive investments in Internet technology or information systems—that it was really the fundamental restructuring of many basic industries including retail, wholesale, construction and building products. Japan is a tremendous tinderbox waiting for a spark that will unleash decades of productivity growth.

To reinforce that, we have the example of the recent U.S. economic experience. We seem to be overcoming a really short-lived recession and facing a dramatic rebound after what I thought at the time was a death knell to the economy created by the Internet and telecom bubble. We have recovered, which says to me that we are getting better and better at the process of reallocating capital in the U.S. My experience in the U.S. is very supportive of that.

We have invested in the restaurant equipment industry, which went from an industry that was highly fragmented, large and unfocused to one that, over the last decade, became much more focused with a handful of competitors having broad capabilities and product lines, and the ability to serve their
customers in truly extraordinary ways. The industry has the ability to amortize engineering and product development. We invested in the building products arena where we saw one great company leverage its relationships in the distribution channel here in the U.S. to once again broaden its product line, dramatically reduce its cost of distribution and serve its customers better. I think that is a good parallel with a number of industries in Japan.

We have now invested in six businesses in Japan. Shinsei, obviously the most visible, but also a large resort in southern Japan, Miyazaki Sea Gaia. Sea Gaia was a resort that had an amazing amount of investment and an equally amazing amount of debt. It did not have enough money to do marketing or really respond to the changing needs of its customers, and it became very moribund. We have re-launched the brand and brought over a world-class hotelier. He told me yesterday that occupancy is up 22 percent year over year. The customer experience is remarkably different.

Likewise we bought Denon about nine months ago. Denon is an audio and home theater supplier. It is just about to merge with Marantz, which will give it a broad product line, and even more powerful global distribution. We have invested in Alpha Purchase, which was a start-up to go direct from the manufacturer to the customer and skip three levels of distribution in maintenance repair and operating items. The savings the customers of Alpha Purchase experience are really remarkable just by moving from the three-step distribution channel to direct ship from manufacturer to customer.

We also invested in Nippon Columbia, which is the oldest music company in Japan as a stored collection of Japanese traditional music. We brought in a vibrant group, separated Denon, and focused its resources on its core competence. I have received the sales reports and they are actually creating hits, which is what they were really all about in their golden era.

My experience is very simple. It is sort of Occam’s Razor of the investing world. There are many parallels between the U.S. and Japan with respect to the process of refocusing, reallocating assets and what went on in the U.S. over the last 25 years. There are many things we can learn, and we have learned and applied much to our experience in Japan. So far we have had very gratifying results. Whether it is at Shinsei or Sea Gaia or Denon Marantz, Alpha Purchase, or Nippon Columbia, we have really seen a remarkably quick response to a little bit of leadership and a lot of debt reduction. I have enormous hope that once Japan gets the ball rolling down that hill that it will pick up speed and create decades of productivity growth and GDP growth.
**Intra-Panel Discussion**

**PATRICK:** How do you get rid of the bad debt? Who takes the hit? How is it distributed among the banks, the equity owners and the government? What are the policy implications?

**COLLINS:** In our case there is no simple answer to that. In some cases we are taking the hit, we are putting new money in to reduce the debt. In others, they have gone through debt equity conversions with existing lenders and shareholders. The fundamentals are that the debt is an impediment to doing the right thing from a business point of view. It does not really matter to me as an investor and a controlling shareholder in these businesses who takes the hit or how it is taken. The impediment I think historically in many cases is that the companies are so grossly over-leveraged they can’t get after the fundamentals of the business and they become sort of zombies, as somebody described it, sitting there marking time and letting these great assets rust in the road. So, the most important thing for us is what can we do to serve the customer better and be better than the competition and make sure that the balance sheet doesn’t get in the way of our ability to mobilize those resources. But in parallel, it doesn’t work unless you’re creating a different structure in the industry. It’s really all about how you get at the fundamentals of making the business better competitively and in its ability to serve the customer.

**GITLIN:** Restructuring in Japan is often associated with reduction of debt, especially in the big companies. Mr. Collin’s articulation is very accurate because it is not the reduction of debt, it is what you are investing in and whether you have become a better strategic player after restructuring. The concept used primarily more in Japan than anywhere else is the concept of sponsor. In Japan, when the company is in trouble you look for a sponsor to come in. If the sponsor comes in properly with new money and new talent, it can be very productive for Japan. What probably needs to be developed more in Japan in order to take advantage of the talent of Tim and others, and many others, is more debt for equity swaps, more vehicles under which we can shift the capital from a non-productive use to a productive use. We’re starting to see a little bit of that but are not really finishing with a Tim-type solution, where at the end of the day you have a much stronger business plan and business solution.

**HOTTA:** Well, my observation is that the bank management has been slow in terms of recognizing the seriousness of the non-performing loan. As everybody here has witnessed the so-called “golden recession,” that was the huge amount of individual household assets and companies and the country’s huge credit against the foreign countries and so forth. So the bank management has been keeping the same attitudes. But the economy gets more and more depressed and the people have begun to wake up. For example, if you, as a frog, put yourself in cold water, you can very pleasantly swim in the cold water. But perhaps the water is being heated gradually and over time, you are just about to die. Then you realize—oh, this is really hot water! So, this is the kind of a situation that we are now getting into.

**PATRICK:** Ken, why are Japanese willing to stay in much hotter water than elsewhere? Why does this persist so long and only when you’re very close to bankruptcy does restructuring occur?

**HOTTA:** Well, there have to be incentives for every player including the regulators, policy makers, corporate bulls and of course, the bank management, to get this done quickly. If you were rewarded to do so, I think the people will rush to move on. That’s my observation.
U.S. Perspectives on Japan’s Banking System

The Honorable Paul H. O’Neill
Secretary of the Treasury
United States Department of the Treasury

I AM A JAPAN FAN. In my private sector experience, I developed the highest respect for Japanese industry’s ability to rise to the challenge of world competition, and to challenge the rest of us to do the same. Japanese companies like Sony and Toyota, among others, defined the notion of world-class manufacturing, offering the world’s consumers value-priced, better products year after year, and daring companies around the world to do the same.

In many ways, it was Japan’s challenge that forced the U.S. economy to shake off its malaise of the late 1970s and early ’80s, and become what it is today. The fact that American companies rose to that challenge, and greatly improved their own productivity and quality is in no small way due to the competition that they faced from their Japanese counterparts.

Japanese workers, too, are among the most diligent and productive in the world, and they rightly feel great pride for their country’s economic accomplishments in the past half-century.
But the past decade has been difficult for all of us who believe in the potential of the Japanese economy. After decades of world-leading growth, Japan’s GDP grew by an average of just one percent annually over the past 10 years. Unemployment has been rising, deflation has cast a long shadow on consumption and investment, and banks and corporations are heaped with bad and doubtful debt.

With such potential, and historic accomplishment, why has Japan performed so poorly over the past decade? More importantly, how can Japan return to growth? The costs of underperformance are high, both for Japan and for the rest of the world. Japan’s citizens miss out on higher living standards and Japanese young people are frozen out of the job market. The rest of the world lacks a dynamic Japanese market for its goods and services.

In fact, if Japan’s economy had grown over the past 10 years at its full potential of, say, 3 percent annually, real GDP would have been more than 20 percent larger in 2001—that’s a difference of nearly $900 billion alone. And over the past decade, growing below potential has cost Japan a total of nearly $5 trillion in lost income or almost $40,000 in foregone income per person. That lost income translates not just into lower living standards, but also into $760 billion less investment to support future growth.

There are three areas for action in Japan that would restore growth: first is ending deflation; the second is overcoming financial sector problems; and the third is deregulating and opening the economy to competition. I believe the last one is the most important, but I’ll address them in the order I’ve listed them.

For the last seven years, Japan has been mired in deflation, as the broadest measure of prices, the GDP deflator, has fallen by nearly 1 percent annually. The phenomenon of deflation is corroding Japan’s economy, multiplying the burdens faced by debtors, while discouraging investment and consumption. Japan has to end expectations of persistent deflation for the economy to recover and grow.

Last March, the Bank of Japan committed to expand the money supply until inflation was at least zero. Since then, the BOJ has sharply expanded the growth rate of base money. But the growth rate of broader money supply has not changed much, and deflation remains entrenched. While sustained monetary expansion is an important step for addressing Japan’s economic woes, the expansion of base money has not produced an expansion in bank lending.

Why are banks not lending? It is not because of a lack of liquidity. Rather, anemic lending reflects deep weakness in the balance sheets of the Japanese banks and the corporate sector.

An important role of financial institutions is allocate capital between savers and investors by pricing credit fairly and accurately. A healthy financial sector supplies funds to companies that can put the money to the best use for their level of risk. That has not been happening in Japan. There is plenty of capital there, but too much of it continues to prop up old investments gone bad, instead of going after better opportunities and fueling growth. Some banks are stuck in so many old, bad loans, they are afraid to take any new risks, even in promising areas, further stunting the economy.

By some estimates, as much as a quarter of all bank loans in Japan are in or near bankruptcy. Many of these loans are described as “non-performing.” Non-performing means “non-productive.” Loans that are not performing are not producing for the Japanese economy, or at least, they are not producing enough to justify their existence.

Bank lending is supposed to be an instrument for growth, not a life support machine. If Japan’s financial markets were functioning properly, companies
that cannot pay their debts would restructure, or if necessary, liquidate, so that their capital assets could go toward more productive opportunities.

Financial institutions have to make tough choices on their non-performing loans, and start making new loans, priced appropriately for the level of risk. For example, banks should offer the cheapest credit to the world-beating export companies, which also get financing from the international markets. They should offer higher priced credit for entrepreneurs and well-founded start-ups, which are riskier than some established firms, but offer promise for future growth and new industries. And they should impose the highest rates on credit to unproductive and highly-indebted firms that have no real plans for restructuring.

Because too much investment is going to low-return uses, investment productivity has foundered. Japan's business capital stock increased more rapidly than any other major industrial country over the past 10 years, but it did not produce much growth.

Look at this another way: GDP in Japan is less than half GDP in the U.S., but business capital stock in Japan is roughly equal to that in the U.S. Therefore, U.S. fixed investment is on average twice as productive as Japan's.

Investment resources in Japan aren't going where they can be most productive. In too many cases good money is going after bad.

The new generation of bank managers and corporate leaders should put the failing companies out of their misery, and not waste the hard-earned savings of Japanese workers. It is better to do it now, when there is still some value to salvage, than to wait until the desperate, bitter, bankrupt end.

There is plenty of advice out there on how to resolve the bad loans and clean up the bank balance sheets. Everything that can be said, has been said.

The Japanese government has the right idea creating the Financial Services Agency and strengthening the Resolution and Collection Corporation. I am convinced that Prime Minister Koizumi's agenda is the right path. Now they have to make it happen. Just as the U.S. and other countries in the past 20 years have had to deal with painful banking crises, and came out the better for it, Japan has to deal with its own. I am confident it will. The time for half-measures and postponement has passed. It has to be done, and the quicker, the better.

The finance problems in Japan are a reflection of problems in the real economy. Non-performing loans are symptomatic of bad investment choices. So even as Japan starts freeing its capital from the prison of bad loans, the private sector has to start identifying and moving capital into the real opportunities, those where investment will enhance productivity and produce a superior return. Moving capital and other assets out of low-return, low-productivity industries into activities that generate higher returns is the key to raising economic performance.

Making sure that high-growth opportunities exist, and that firms exploit them to the fullest, is necessary for any economy to achieve its full potential, and is of special importance to Japan.

There is no question that Japanese firms respond when the right conditions exist. Japan's export-oriented companies—Toyota, Canon, and many others—are among the most competitive in the world. They are constantly innovating and adjusting to the competitive landscape in other countries, and consumers, employees and shareholders worldwide are better for it.
Industries in which Japan’s most successful firms operate share two characteristics. First, they cannot be controlled by domestic regulation—there is no way to limit entry, set prices or enforce restrictive standards—because they are worldwide markets. Second, there is no way to shield firms from competition in these industries. Faced with competition, these firms rise to their best.

Unfortunately, too much of Japanese domestic industry is cocooned in a web of regulations and trade barriers. Eliminating regulatory barriers and introducing competition throughout the Japanese economy entails thousands of smaller, highly important decisions in trade, regulatory and fiscal policies. It is not my place or the place of the U.S. government to lecture the Japanese government on how to proceed—these are decisions for the Japanese people.

The process is not painless. Increased price competition through deregulation and structural reform requires adjustments and some dislocation. But it also creates opportunities, encouraging new entry by both domestic and foreign firms, increasing employment and renewing economic growth.

Prime Minister Koizumi has acknowledged that structural reform “with no sacred cows” is necessary for economic recovery and strong, sustained growth. He deserves our support. Another revolution that Prime Minister Koizumi can take much credit for is emphasizing the role of private activity in producing growth, and de-emphasizing public expenditure as life support for the economy.

The prime minister has already outlined steps to cut back inefficient public works expenditures and to abolish or privatize Japan’s public corporations. He has also made it clear that Japan will need to reduce its budget deficit substantially in order to stabilize Japan’s spiraling public debt. The Council on Economic and Fiscal Policy has begun this process, and I hope that budget planning and implementation will carry it through.

The adjustments required by cutting deficits can also be eased by assuring that fiscal choices provide the maximum benefits to private activity. Cutting taxes, particularly those that discourage private activity and investment, coupled with reducing expenditures, can generate higher growth and fiscal balance.

I have referred a number of times to the importance of international competition. International trade provides an environment where firms can compete with the best and rise to their best. But trade among nations also flourishes because we have agreed on governing rules for actions and responses. An agreed-upon dispute settlement system is critical to maintaining a trade-friendly environment. Unilateral trade actions outside the WTO dispute settlement procedures set a bad precedent for the world trading system.

The U.S. spent nine months conducting and reviewing a safeguard investigation on steel, in accord with international trade rules. Any nation that has a complaint with this action should use the agreed WTO dispute resolution process to seek redress.

Earlier, I described the vast difference between Japan’s economic potential, and the recent course it has taken. In 1991, Japan’s economy was nearly nine times the size of China’s, and three-fifths the size of the U.S. But if the trends of the past decade continue for Japan and the U.S., and if China grows at the 7 percent annual rate most analysts project, in 25 years the Japanese economy will be less than one-fourth the size of the U.S., and only four-fifths the size of China.

If that day comes, our successors won’t even debate these topics. Japan will no longer be an engine for the world economy, it will be a boxcar. That scenario should not happen. Japan has to rejoin us, at full speed, as a leader in the global economy. If Japan grows by 3 percent annually over the next 25 years, in 2027 Japan’s economy will be about 40 percent of the size of the U.S., and 33 percent larger than China’s. This should be the target. The leading economies in the world need to grow at their full potential, for the benefit of their own people and, more broadly, for the benefit of people everywhere.

The people of Japan have the capacity to make their own future and return to growth. Not by fleeing from the competitive world economy, but by embracing it and showing their true potential, as they have before. I believe they will, not only because I am an optimist about Japan, but because the stakes are too great to fail.
Q: Give us your thoughts on both Japan and the U.S. in terms of improving corporate governance and in terms of improving accounting systems.

O’NEILL: I believe, as the president has said, that we should hold CEOs to the highest possible standard. My street talk way of saying this is people who get the big bucks should get the big responsibility with it. Now, let me divide what I mean by responsibility. I believe it’s a responsibility of CEOs to know everything that’s material about the place that they’re responsible for and to share everything that they know in an understandable way with the people that they’re responsible to, and I would say that his shareholders for sure, debt holders, suppliers, customers and very importantly, employees. All of those bodies should have everything that the CEO knows and the CEO should be responsible for knowing everything that’s important.

Now, CEOs should not be responsible for being right all the time because that’s not possible. So, it’s okay to go ahead and make dumb business decisions and the system will deal with you for that, but it’s not okay to not know. To not know that your enterprise has a $1 billion off-balance sheet transaction and to back those transactions with stock at a pegged price which may never occur, and for you not to know that it is a failure of commission not to know. And it’s a tremendous failure of omission to know and not share it. Those who would be guilty of either one of those things by me are not worthy of being CEOs. We’ve got to be a lot sharper and clearer about what we mean by accountability and responsibility for people who are supposed to be leaders and those who abuse our trust, if they do it in a criminal way, they ought to go to jail, period.

Now, to the question of do we apparently need to tighten up the standards some? Let me say rules instead of standards. Apparently it isn’t obvious to every CEO that off-balance sheet transactions of any magnitude need to be shared, so we need to tell them all I guess. I can’t imagine people who have good will and intent don’t know that already, but apparently we’ve got to write it down for them. So, we ought to do that. But I also think every quarter the CEO should certify, “this is everything you need to know, here it is, you can understand it.” Then we ought to raise a new standard for audit firms. The president has also said this. We should say to the audit firms you’ve got to attest that the CEO told you everything and you asked for everything, you were denied nothing, and on the basis of that profound knowledge what he or she said is true. Not that they did it according to some cookbook called a generally accepted accounting principle, but you’re attesting to the veracity and the integrity of the CEO that he knows what he’s doing, he told you all about it. Then we have to do one other thing. We ought to say to the accounting firms every quarter you’ve got to give a grade to the firms that you’re auditing one by one that tells that firm how their practices compare to the benchmark of the best that you do business with on a scale of A to F. First of all, you would find there are not many A’s. There would be lots of C’s and that would be an inducement to work toward being an A for the companies. There would be some F’s and that would be an inducement for the accounting firms to resign the accounts. Think to yourself: when was the last time you can remember that an accounting firm, an auditing firm resigned an account because they couldn’t go along with what the management wanted? I don’t know of any. That’s instructive.

Q: Before there is a significant crisis, how much time do you think Japan has left to act?

O’NEILL: Well, one of my great fears is that the answer to your question is a long time. I really have a passion about the potential in Japan and the highest regard for the people that I know in Japan, and it’s a fate that I think we should urge not happen because it’s so important for Japan and for the rest of the world that this kind of lingering sickness not go on. If you look at the physical activity in Tokyo and you see the bustle and hustle and the rest that’s a familiar physical appearance of Japan, and people are obviously not in the streets banging their cookware about how things have gone to hell—in some senses what’s happening in Japan is like the fable about if you have boiling water and you throw a frog into it, it will jump out immediately, but if you put it in cold water and turn the gas on underneath, the frog gets boiled because it gets used to the temperature so gradually it doesn’t realize it’s dying. I think that’s what’s greatly to be resisted in the case of Japan because it could go on. But again, I must say to you, I have a lot of respect for the traditions of Japan and for the consensus building decision-making process.