Making Japan a Global Leader in Finance

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Japan has resolved its lost decade challenges and is embarking on a path of positive growth, rising employment, stabilized prices, and improved bank condition.

But will it become a *global leader in financial affairs*, as it must become in order to maintain productivity growth and to establish its rightful position in world affairs?

What does it mean to be a global leader in financial affairs? Three things:

1. A leader in global financial policy making, particularly for global policies toward emerging markets countries, particularly in designing effective assistance and reforms in the wake of crises. Influence can be exerted either through the IMF or other, ad hoc channels.
2. A leading financial services nation, as Prime Minister Koizumi has envisioned. That is, a country that is able to provide the full range of modern financial services efficiently to consumers and firms.
3. A promoter of corporate managerial efficiency through effective financial market policies that encourage good corporate governance and that, most importantly, create a *contestable market for corporate control* (mergers, takeovers).

Japan has made progress in all three areas. But future prospects are more promising in some areas than in others. Japan has played an important leadership role in the new Asian regional initiative for pooling liquidity across countries, which importantly creates a counterbalancing force to the IMF. This not only will help Asia, especially given the likelihood that emerging market crises will recur, but it may more generally help to reform the IMF from outside, forcing it to make liquidity protection rules more explicit and less political, and limiting the extent to which the IMF sometimes serves improper purposes. This is an important contribution.

But in the other two areas I am less optimistic. I recognize that progress to date has been great in those areas (including the unwinding of cross shareholdings, the creation of more rational bank lending policies, and improved public attitudes toward foreign ownership). But I believe that the potential for progress is much greater, and I am fearful of impediments to progress. The impediments that remain include:

1. Problems in the structure and rules of the financial system.
2. Risks of a wrong turn in corporate governance/takeover laws under consideration.

The common problem is a remaining absence of market discipline, which economic research shows is the *only* reliable force for ensuring stable, lasting growth in both the financial sector and the broader economy (which depends on the financial sector as the gatekeeper that ensures efficient allocation of resources).

I would emphasize that the rules and regulations in the United States do *not* provide a model to be imitated in the area of market discipline. Indeed, one of the risks for Japan is imitating American or European rules too closely. American finance is successful *despite* the limitations in its rules and regulations. Japan needs to innovate, not imitate to provide new mechanisms that go beyond the American or European rules and regulations, and Japan currently has a unique opportunity to do so. In particular, the formalistic American approach to corporate governance rules (Sarbanes Oxley), the American emphasis on independent directors as the key to proper corporate governance, and American takeover laws are all inadequate and not worthy of imitation by Japan.

The bold, helpful policies that I have in mind do have advocates within and outside Japan, and I hope that they will succeed. What worries me?

With regard to takeover policy, the Livedoor case has created an unfortunate backlash against hostile takeovers. Part of that backlash reflects the Japanese view that hostile takeovers in the US have promoted short-termism and destruction of long-term corporate value. It is important to recognize that this is *not* the view one finds in the empirical work done by professors. The academic community of finance professors is strongly supportive of hostile takeovers as a crucial ingredient of discipline, and regards poison pills in the US as inimical to desirable competition for corporate control.

The current proposed METI guidelines seek to find a balance between excessive limitations and no limitations on hostile takeovers, and in doing so propose to allow poison pills. I see that as a mistake and a missed opportunity. Japan should not permit poison pills. There are far better ways of finding the appropriate balance that METI seeks, and the commercial code tradition in Japan is especially potentially helpful for codifying a commitment to the contestability of the market for corporate control, and it would be better to pass a law (rather than mere guidelines) that clearly establish encouraging rules for takeovers. What would a desirable law look like?

1. No poison pills.
2. Triangular stock mergers (stock for stock across countries) would be allowed.
3. Focus would be placed on empowering institutional investors (pensions and mutuals) by clearly delineating rules for takeover offers and stockholder proxy fights to ensure that informed investors have the information they need and the choices they deserve.
4. Focus would be placed on slowing the process down (e.g., for a few months) to ensure that all bidders have a chance to participate, but not stopping it, or slowing it for too long.

With respect to banking reform, there is significant unfinished business for reestablishing a healthy banking sector founded on the central principle of market discipline. It is worth noting that without market discipline, banks do not perform well (either in stability or growth), and this is a widely confirmed empirical finding for many, many countries.

Unfortunately, the market and the banks have learned from the Japanese crisis that the government is unwilling to allow depositor losses in large banks. Indeed, the removal of blanket deposit insurance has been more formal than real because of the continuing unlimited protection provided to demandable deposit accounts. The Basel II system offers no promise of restoring market discipline either, since it is based on supervisory interventions and book equity requirements, which experience and research show are useless in promoting market discipline. What can be done? Professor Mitsuhiro Fukao of Keio University has proposed a solution involving a new requirement that banks issue credibly uninsured debt in the market as part of their capital requirement. I do not have the time to explain this proposal here, but I strongly endorse it as a means of providing transparency and discipline in the banking sector in a way that other rules and regulations do not.

Other unfinished business in the banking sector includes:

1. Reforming accounting standards to limit the use of tax loss carryforwards as a capital account item
2. Encouraging banks to take advantage of the current low-interest rate environment to reduce their high exposure to interest rate risk by swapping out their risks related to long-term JGB holdings
3. Privatizing the postal savings system

The last of these is important, both for its economic effects and its crucial symbolic effects, which would have immediate positive economic consequences. Prime Minister Koizumi is right to emphasize this point. What would postal savings privatization accomplish?

1. Enhanced competition in retail banking, which is essential to realizing the financial services nation vision of the government.
2. Reduced diversion of funds toward the support of unnecessary and inefficient directed credit programs, which are no longer needed in Japan.
3. Perhaps even more importantly, privatization would be a crucial signal of Japan's political commitment to modernization and reform that the market would react to immediately in the form of increased foreign direct investment in Japan and increased stock prices.

In closing, I want to take this opportunity to thank my hosts at the Keizai Koho Center, and all the Japanese leaders that generously agreed to spend time with us teaching us about their impressive accomplishments and their visions for the future of Japan. It is an exciting time for your country, and I am grateful that you invited me to learn about it.